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Corporate and Financial Weekly Digest

OCTOBER 9, 2009

SEC/CORPORATE

SEC Publishes Proposed and Final Credit Ratings Reform Rules

The Securities and Exchange Commission published the text of proposed and final rules to enhance disclosures regarding the quality of credit ratings, remove references to credit ratings in certain SEC regulations, rules and forms and broaden liability for "experts" under Section 11 of the Securities Act to include Nationally Recognized Statistical Rating Organizations (NRSROs). The proposed and final rules are aimed at reducing market participants' undue reliance on credit ratings and increasing NRSROs' accountability for their ratings. The SEC's vote on these proposed and final rule changes was previously reported in the September 25 edition of *Corporate and Financial Weekly Digest*.

The SEC's proposal includes adding a new Item 202(g) to Regulation S-K that requires issuers electing to obtain and use a credit rating in connection with a registered offering to disclose in the prospectus, among other items, all material scope limitations of the credit rating, any related published designation (such as non-credit payment risks) assigned by the credit rating agency, the source of payment for such credit rating and whether the credit rating agency provides any other services for the issuer. Registration statements would be required to include a statement that credit ratings are not recommendations to buy, sell or hold securities, that the rating is subject to revision or withdrawal, and that investors should perform their own evaluations of the security. These disclosures would be applicable to private offerings in which the privately offered securities are exchanged shortly thereafter for registered securities, and would likewise apply to issuer's oral and written selling efforts with respect to such securities.

The SEC's release further proposes that if an issuer is required to disclose a credit rating, then the issuer must disclose all preliminary ratings obtained from other credit rating agencies. The purpose of this proposal is to disclose and curb instances of "ratings shopping." Additionally, Form 8-K would be revised to provide that if an issuer has previously disclosed its rating, and the rating changes or is withdrawn, then the issuer must file a current report on Form 8-K disclosing such change or withdrawal.

Click here to view the SEC's release regarding the foregoing proposed rules.

The SEC also published final and proposed rules removing references to credit ratings from certain rules, regulations and forms. Adopted rule changes include removing the distinction between "investment grade" and "non-investment grade" corporate securities for purposes of Rule 3a1-1 under the Exchange Act, Regulation ATS, Form ATS-R and Form PILOT, each of which relates to the regulation of exchanges and alternative trading systems. Click here to view the SEC's release regarding these final rules.

The SEC is seeking additional comments on its proposed deletions of other references to credit ratings, including replacing certain references to "investment grade" securities in Regulation M with references to non-convertible securities issued by "well-known seasoned issuers," as defined in Rule 405 under the Securities Act, as well as other alternatives. Click here to view the SEC's release regarding these proposals.

The SEC is also seeking public comment on a proposed amendment to subject NRSROs to liability under Section 11 of the Securities Act when a rating is used in a registered offering by eliminating the current protection of NRSROs in such situations. Currently, Rule 436(g) under the Securities Act exempts the 10 credit rating agencies presently registered as NRSROs from Section 11 liability, while other credit rating agencies remain subject to Section 11. The SEC proposal would rescind Rule 436(g). Public comments on the proposed rule amendments must be received by the SEC within 60 days after their publication in the Federal Register. Click here to view the SEC's concept release regarding this proposal.

LITIGATION

Fraud on Market Theory Unavailable under Pennsylvania Law

The Third Circuit ruled that the plaintiff could not rely on a fraud on the market theory to recover for alleged common law fraud under Pennsylvania law, and affirmed the District Court's dismissal of the plaintiff's claims that the defendants had fraudulently doctored the results of tests conducted on a commercial medical device.

Defendants were hired as consultants to perform research for Sunrise Technologies International, Inc., a manufacturer of medical equipment. Defendants helped Sunrise develop and obtain government approval for a laser intended to permanently correct farsighted vision. After initially failing to obtain Food and Drug Administration approval, the device was later approved as a temporary means of correcting farsightedness. Plaintiff alleged the defendants misrepresented the results of clinical trials and made other false statements about the laser's effectiveness which artificially inflated the Sunrise stock price. Plaintiff further alleged that when the limitations of the device were revealed the stock price fell.

Plaintiff asserted common law fraud claims against the defendants—but not against Sunrise—under Pennsylvania law, alleging that the defendants' fraudulent activity wrongfully induced him to invest in Sunrise. Although plaintiff could not show that he directly relied upon defendants' alleged misrepresentations, he contended that his reliance on the company's artificially inflated market price satisfied the "reasonable reliance" element of his fraud claim. The Third Circuit disagreed. While noting that some prior decisions indicated that Pennsylvania courts might follow federal securities law and recognize the fraud on the market theory as a basis for establishing the reliance element of common law fraud claims, the court found that no Pennsylvania decision had ever done so. Accordingly, the Third Circuit affirmed the District Court's grant of summary judgment in favor of defendants. (*Aubrey v. Sanders*, 2009 WL 3059055 (3d Cir. Sept. 24, 2009))

BROKER DEALER

SEC Approves Exchange Rules for Uniform Clearly Erroneous Procedures

The Securities and Exchange Commission approved new exchange rules that implement uniform standards for breaking trades that are deemed to be "clearly erroneous." Clearly erroneous execution rules had varied from exchange to exchange and in many cases were based on the subjective judgment of exchange officials. The exchanges, led by NYSE Arca, worked together with SEC staff to develop a set of more objective "model" rules. Such rules were recently adopted, with immediate effectiveness, by BATS Exchange, the Chicago Board Options Exchange, Chicago Stock Exchange, International Securities Exchange, NASDAQ Stock Market, the NASDAQ OMX BX, National Stock Exchange, New York Stock Exchange, NYSE Amex, and NYSE Arca.

Read more.

FINRA Proposes Trace Reporting for Asset-Backed Securities

The Financial Industry Regulatory Authority has filed with the Securities and Exchange Commission a proposed rule change to amend the FINRA Rule 6700 Series (except for Rule 6740) and FINRA Rule 7730 to designate asset-backed securities, mortgage-backed securities and other similar securities (ABS) as Trade Reporting and Compliance Engine (TRACE) Eligible Securities. The proposed rules establish reporting, fee and other requirements relating to such securities. To incorporate ABS in TRACE, FINRA proposes amendments to Rule 6710, Rule 6730, Rule 6750, Rule 6720, Rule 6760 and Rule 7730. FINRA's proposal only contemplates collecting ABS transaction data as an initial matter. After a period of collection and analysis, FINRA would determine whether public dissemination of ABS data would also be appropriate.

Read more.

CFTC

CFTC to Determine Whether 24 ICE OTC Energy Contracts Perform Price Discovery Function

In two releases issued this week, the Commodity Futures Trading Commission has provided notice of its intent to determine whether 24 contracts listed on the IntercontinentalExchange, Inc. (ICE) perform a "significant price discovery function." All of the contracts to be reviewed by the CFTC are over-the-counter energy contracts, including 13 natural gas basis swap contracts and 11 electrical power swap contracts.

As an exempt commercial market (ECM) under CFTC rules, ICE and contracts traded on ICE generally are subject to minimal regulation by the CFTC. However, ECM-listed contracts that the CFTC determines perform a significant price discovery function (significant price discovery contracts, or SPDCs) subject the listing ECM to many of the obligations that apply to designated contract markets, such as large trader reporting, publication of daily trading information, and the establishment of position limits or position accountability levels for SPDCs.

The comment period with respect to the affected electrical power swap contracts closes on October 21; the comment period with respect to the affected natural gas basis swap contracts closes on October 26.

The CFTC press releases regarding these determinations, including full lists of the contracts affected, are available here and here.

Comments Requested on DCM Application of Media Derivatives, Inc.

The Commodity Futures Trading Commission has requested public comment on the application by Media Derivatives, Inc. (MDEX) for designation as a contract market. MDEX plans to offer cash-settled derivatives contracts based on domestic gross box office revenues (over specified periods) for individual motion pictures, which contracts are intended to serve as risk management tools for the motion picture industry. MDEX contracts would be cleared by the Minneapolis Grain Exchange.

The comment period for the MDEX application closes on November 5. Related materials and the CFTC press release regarding the application are available here.

INSURANCE CAPITAL MARKETS

House Bill Would Create Federal Insurance Office

On October 1, Congressman Paul Kanjorski, Chairman of the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, released a discussion draft of legislation titled the Federal Insurance Office Act of 2009. The proposal would create a federal insurance office to coordinate and establish federal policy on international insurance issues and monitor all aspects of the insurance industry including “identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the U.S. financial system.” The authority of the office would extend to all lines of insurance except health, and its director would be appointed by the Secretary of the Treasury. While the main function of the office would be to monitor the industry and gather information, the proposal authorizes the preemption of any state insurance regulations found to violate international insurance agreements. The office would also assist in administering the Terrorism Insurance Program within the Treasury and consult with state regulators regarding insurance issues of national and international importance.

To read a discussion draft of the proposed legislation, click here.

STRUCTURED FINANCE AND SECURITIZATION

Federal Reserve Announces TALF Rating Agency Rule and Begins ABS Risk Assessments

On October 5, the Federal Reserve Board announced two changes to the procedures for evaluating asset-backed securities (ABS) pledged to the Term Asset-Backed Securities Loan Facility (TALF). First, a proposed rule has been published that will set criteria for determining which national credit rating agencies’ ratings may be used in TALF to establish the eligibility of ABS to be pledged as collateral. The proposed rule, which requires a certain minimum level of experience in rating deals of any particular type, will likely result in an expansion of TALF-eligible rating agencies for ABS and is intended to promote competition among rating agencies and protection against credit risk.

Second, starting with the November subscription, the Federal Reserve Bank of New York (FRBNY) will conduct a formal risk assessment (similar to the risk assessment currently required for all commercial mortgage-backed securities) of all ABS as a part of the TALF review process. To facilitate the risk assessment, new rules require each issuer wishing to bring a TALF-eligible ABS transaction to market to provide certain information at least three weeks prior to the subscription date. The Federal Reserve believes that the risk assessment will help ensure that TALF collateral complies with the existing high standards for credit quality, transparency, and simplicity of structure. Instructions, timelines and a statement of principles describing the standards guiding the risk assessment of TALF collateral are available on FRBNY’s website.

FRBNY has also issued a number of updated documents for its TALF program, including a new due diligence document and Appendices 4A, 4B and 6 to the TALF Master Loan and Security Agreement, which are all available on FRBNY's website.

The Federal Reserve press release is available here.

ANTITRUST

EU Moving Toward Private Damages Actions

A draft EU legislative act was revealed last week that would allow victims of antitrust violations to bring private lawsuits in the courts of European nations. It would provide a vehicle for consumers and companies to recover their actual losses and lost profits. The proposal is reported to also include a class action mechanism that would be available to state bodies or government-appointed nonprofits. The European Commission will reportedly consider the proposal in the coming weeks.

Private antitrust suits are common in the United States, and U.S. antitrust law provides for recovery of treble damages by private parties injured by antitrust violations. In addition, class actions are broadly available to victims under U.S. law. In contrast, antitrust enforcement in Europe has been largely the province of government agencies, with only a few countries permitting private actions. However, in the near future that could change. Companies with sales or operations in Europe should be aware that private damages actions (including class actions) for violations of EC competition rules may emerge as a more significant competition law risk in Europe.

EXECUTIVE COMPENSATION AND ERISA

Executive Compensation Remains in Congress's Crosshairs

Last week, executive compensation turned up in an unlikely place—the Senate Finance Committee's health care reform bill. As part of the mark-up process, the committee approved an amendment to its bill that would limit a health insurance provider's compensation deduction. Specifically, the amendment would limit an insurer's compensation deduction for any officer, employee, director or other service provider (e.g., a consultant) to $500,000 per year, but such limitation would only apply to insurance companies that have 25% or more of their premium income attributable to the minimum coverage standards stated in the committee's bill. In addition, and perhaps most notably, there is no exception for performance-based compensation and the deduction limit is designed to encompass deferred compensation.

The amendment's deduction limit draws from the deduction limitation Congress imposed on recipients of assistance under the Troubled Asset Relief Program (TARP). Since passage of the Emergency Economic Stabilization Act (EESA) last year, commentators have predicted that its executive compensation restrictions would spread beyond TARP assistance recipients. This amendment evidences that such prediction may prove to be true.

The Senate Finance Committee's bill will have to be reconciled with other health care reform legislation, so the health insurer deduction limitation may not survive in its current form. However, companies should take note that executive compensation remains a target of congressional interest.

The most recent version of the Senate Finance Committee's health care reform bill is available here.

UK DEVELOPMENTS

FSA Sets Out Its Policy on Short Selling

On October 1, the UK Financial Services Authority (FSA) published FS09/04, a feedback statement to DP09/01, its February 2009 discussion paper (see the February 13 edition of *Corporate and Financial Weekly Digest*). In FS09/04, the FSA sets out its policy approach to short selling and addresses the responses to DP09/01 and market developments since its publication.

The FSA does not intend its current disclosure regime (disclosure of net short positions of 0.25% or more of the issued share capital of UK financial services companies or companies carrying out a rights issue) to apply permanently and intends at a future date to replace it with a permanent regime, which will apply to short positions in all UK issuers.

Since DP09/01 was published, the Committee of European Securities Regulators (CESR) has issued proposals for a short selling disclosure regime. CESR proposals include public disclosures of significant short positions at the level of 0.5% and private disclosures to regulators at the lower level of 0.1% (see the July 10 edition of *Corporate and Financial Weekly Digest*).

To read FS09/04, click here.

FSA Publishes Liquidity Requirements Rules

On October 5, the UK Financial Services Authority (FSA) published PS09/16. This Policy Statement follows from the FSA's consultation on strengthening liquidity standards, which began in December 2008 (see the December 5, 2008, edition of *Corporate and Financial Weekly Digest*) and contains final rules on the liquidity requirements applicable to regulated firms. The new rules are designed to enhance firms' liquidity risk management practices. Specific new rules include:

- an updated quantitative regime coupled with a narrow definition of liquid assets;
- over-arching principles of self-sufficiency and adequacy of liquid resources;
- enhanced systems and controls requirements;
- more frequent reporting requirements; and
- a new regime for foreign branches that operate in the UK.

The FSA stated that it will not tighten quantitative standards before economic recovery is assured. It plans to phase in the quantitative aspects of the regime in several stages, over an adjustment period of several years. The qualitative aspects of the regime will be put into place by December 2009.

The FSA considers that it has made the structure of its new regime sufficiently flexible to allow the FSA to modify it so as to reflect any new international standards introduced in the short to medium term.

To read PS09/16, click here.

FSA Publishes Feedback to Turner Review

On September 30, the UK Financial Services Authority (FSA) published a response to the feedback it has received on the Turner Review and the related discussion paper DP09/2, both published on March 18 (as reported in the March 20 edition of *Corporate and Financial Weekly Digest*). The Turner Review, led by Lord Turner, the FSA Chairman, considered the underlying causes of the financial crisis and recommended a regulatory response stressing the importance of future regulation and supervision based on a different approach.

The response sets out the FSA's analysis of the feedback received and reports on the progress made since March in implementing changes and in achieving international agreement. Generally, the feedback received agreed with the analysis set out in the Turner Review and the broad approach it proposed. The majority of respondents offered clear support for the analysis of causes, the main recommendations and the FSA's supervisory approach as detailed in the Turner Review and the discussion paper.

The feedback raised the following key issues:

- Respondents agreed upon the need for an international approach when looking at policy options.
- Respondents raised concerns that any measures implemented by the UK alone could damage London's competitiveness in the global market.
- Large firms were opposed to increasing requirements for systemically important firms.
- Respondents stated an impact assessment of the "whole package" of reform is needed.

The issue of most concern for respondents was the need for international consistency in formulating and implementing the regulatory policy response to the global financial crisis.

In the foreword to the response, Lord Turner stated that "wider debate has continued on the overall approach to financial regulation and the FSA's own thinking has continued to evolve". The FSA considers that some issues which were covered only to a limited extent in the Turner Review now require a more detailed analysis. As a result, the FSA intends to publish a further discussion paper in October which will focus on key areas, including:

- Systemically important firms—the Group of Twenty Finance Ministers and Central Bank Governors has called for higher prudential standards for systemically important firms, and thus the FSA intends to address

in particular the issues related to how to identify and deal with such firms, what policy tools are available and how they might be applied.

- Cumulative impact of capital and liquidity reforms—There is a need for a comprehensive analysis of the combined impact of the various elements of regulatory reform which have been proposed or are under consideration. These elements include more robust capital and liquidity requirements, changes to trading book capital and countercyclical capital. The changes will have a significant impact on leverage and maturity transformation in the banking systems, and thus the FSA will have to consider methodologies for making trade-offs between the costs of intermediation and financial stability.

The full text of the FSA's response can be found here.

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