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Corporate and Financial Weekly Digest

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SEC/CORPORATE

SEC Increases Oversight of Credit Rating Agencies

On September 17, the Securities and Exchange Commission adopted and proposed rules to strengthen SEC oversight of the 10 credit rating agencies currently registered as Nationally Recognized Statistical Rating Organizations (NRSROs). The purpose of these rule changes is to improve the quality and enhance disclosure of credit ratings, as well as limit systemic reliance on credit ratings in SEC regulations, rules and forms.

Changes adopted by the SEC include rules requiring credit rating agencies to provide greater information on ratings histories, and to require that credit rating agencies provide competitors access to the underlying data for structured finance products so that other rating agencies may offer unsolicited ratings on these products. The SEC also adopted amendments to certain rules and regulations to remove references to NRSRO ratings in SEC rules, using other standards, such as certain liquidity and credit risk thresholds, to measure the quality of securities. Further rule changes to delete credit ratings references in SEC rules were proposed for public comment.

Additionally, the SEC proposed rules requiring issuers to disclose information about scope and limitations of a credit rating and whether the issuer obtained preliminary ratings from other credit rating agencies. This proposal is aimed at increasing public awareness of "ratings shopping." Other proposed rules included an amendment requiring NRSROs to file annual compliance reports and disclose sources of revenue and potential revenue-related conflicts. The SEC is also seeking public comment on a proposed amendment to subject NRSROs to liability under the Securities Act of 1933 when a rating is used in a registered offering by eliminating a current protection of NRSROs as "experts" in such situations.

The text of the proposed and final rules will be posted on the SEC's website.

Click here to read the SEC's press release regarding the adopted and proposed rules regarding credit rating agencies.

Click here to read Chairman Mary Schapiro's opening remarks regarding such rule changes.

For information on legislation proposed by the U.S. Treasury Department to tighten government oversight of credit rating agencies, click here to read the July 24 edition of *Corporate and Financial Weekly Digest*.

LITIGATION

First Amendment Protections Do Not Apply to Fraudulent Stock Tip

The Court of Appeals for the Fourth Circuit affirmed the District Court of Maryland's decision in favor of the Securities and Exchange Commission in a civil enforcement action for securities fraud under Section 10(b) of the Securities Exchange Act of 1934, against an investment newsletter publisher, publisher's editor in chief and publisher's parent company (defendants). The action arose out of a "Super Insider Tip Email" (Email) circulated by the defendants in which the defendants promised to provide inside information to potential investors, purportedly learned from an executive of a uranium-enrichment services provider (Company), in exchange for $1,000.

The Email stated that upon the payment of the aforementioned fee, the defendants would inform an investor of the specific date on which a major international agreement between the United States and Russia, which was anticipated to lead to substantial profits for the Company, would be concluded. It was anticipated that the Company's stock price would rise when the agreement was consummated and that any investor with knowledge of that date would be able to secure significant profits. However, unbeknownst to the investors who paid the fee, the defendants did not possess the inside information concerning the international agreement that they claimed to have and, in fact, the agreement was not consummated when they predicted.

On appeal, defendants argued, among other things, that the First Amendment to the U.S. Constitution required that their statements recommending the Company's stock be scrutinized under the heightened protections afforded to statements by the media as recognized by the Supreme Court in *New York Times v. Sullivan*. If this stricter standard were to apply, the SEC would have been required to prove by "clear and convincing evidence" that the defendants' false statements were made with actual malice. In rejecting the defendants' argument, the Fourth Circuit found that while the government could not label certain speech as fraudulent in order to restrict free speech, the First Amendment does not shield statements that are actually fraudulent, such as those made by defendants. (*SEC v. Pirate Investor LLC*, No. 08-1037, 2009 WL 2949091 (4^{th} Cir. Sept. 15, 2009))

Securities Fraud Claims Against Outside Director Dismissed

A district court in the Southern District of Florida dismissed a class action complaint asserting claims for securities fraud under Section 10(b) of the Securities Exchange Act of 1934 against a wireless service provider's outside director, Nicholas Peraticos. The complaint asserted that Peraticos, along with his co-defendants, made material misstatements in press releases and documents filed with the Securities and Exchange Commission. In particular, the complaint alleged that Peraticos signed the wireless service provider's 2005 Form 10-K, which allegedly omitted material facts concerning alleged mismanagement, arrests and other bad acts by the company's officers, as well as Peraticos' own purported mismanagement of a foreign business he owned.

In granting Peraticos' motion to dismiss under Fed. R. Civ. P. 9(b) and 12(b)(6), the district court found that the allegations against Peraticos failed to meet any of the elements of a Section 10(b) claim. Most glaringly absent from the complaint were allegations sufficient to establish that Peraticos had the requisite scienter with respect to the alleged omissions. In this regard, the court held that the complaint did not allege with any detail what information Peraticos knew about the alleged bad acts or what duty he had to disclose them. (*In re Pegasus Wireless Corporation Securities Litigation*, No. 07-81113, 2009 WL 2997006 (S.D. Fla. Sept. 21, 2009))

BROKER DEALER

FINRA Proposes Consolidated Rule for Communications with the Public

The Financial Industry Regulatory Authority called for public comment on its proposed new FINRA Rule 2210. This new rule would replace current National Association of Securities Dealers Rules 2210 and 2211, the Interpretive Materials that follow NASD Rule 2210, and portions of Incorporated NYSE Rule 472. The proposal, among other things, eliminates the current definitions of "advertisement," "sales literature," "institutional sales material," "public appearance" and "independently prepared reprint" found in NASD Rule 2210. New FINRA Rule 2210 would include only three categories of communications in their place, namely, "institutional communications," "retail communications" and "correspondence." The proposed new Rule would also result in certain changes to the existing review, approval, recordkeeping and filing requirements found in the current rules. The comment period for the proposal expires on November 20.

Read more.

ISE Proposes Rule Change Regarding Exposure of Reserve Orders

The International Securities Exchange, LLC (ISE) filed a proposed rule change with the Securities and Exchange Commission to adopt an interpretation to its rules related to the exposure of reserve orders. The purpose of the proposal is to adopt an interpretation to ISE Rule 717(d) and (e) to specify that the exposure requirement contained in these paragraphs is satisfied with respect to the non-displayed reserve portion of a reserve order if the displayable portion is displayed at its displayable price for one second.

A reserve order is an order for which only a portion of the full size is included in ISE's disseminated quotation. The displayed size is executed according to ISE's regular priority rules, and is refreshed with additional volume from the non-displayed portion of the order. The non-displayed portion of the reserve order is available for execution only after the displayed quote is fully exhausted. Under the proposed interpretation, after entering a reserve order, a member may enter a contra-side order for its own account or a contra-side order that was solicited from another broker-dealer that would execute against the displayable and non-displayed portions of the order as long as the displayable portion of the order was displayed on the ISE (i.e., the price of the order is at the ISE best bid and offer) for at least one second. The proposed rule change became effective upon filing.

Read more.

CFTC

Senate Banking Subcommittee Chairman Proposes New Comprehensive Derivatives Bill

On September 22, Senator Jack Reed, Chairman of the Banking Subcommittee on Securities, Insurance and Investment, introduced the Comprehensive Derivatives Regulation Act of 2009 (CDRA). The CDRA is intended to provide a comprehensive regulatory regime for derivatives products, and includes the following elements:

- Provides jurisdiction to the Securities and Exchange Commission over all securities-related derivatives, which would include credit default swaps and all security futures (including broad-based security index futures contracts), and provides jurisdiction to the Commodity Futures Trading Commission over all other derivatives. The CFTC would retain jurisdiction over Treasury and interest rate derivatives.
- Requires central clearing of standardized over-the-counter derivatives, including credit default swaps.
- Sets capital, margin, registration and recordkeeping requirements for derivatives dealers and other major market participants.
- Expands regulatory authority to set position limits and oversee marketing of derivatives to certain categories of investors.

A press release regarding the CDRA is available here.

NFA Sets Effective Dates for CPO Loan Prohibition and FDM Financial Requirements

The National Futures Association (NFA) has announced effective dates for two sets of recent rule changes.

First, in connection with recent changes to NFA Compliance Rule 2-45 and an accompanying Advisory Notice, commodity pool operators (CPOs) that currently have loan or advance arrangements between the pools that they operate and the CPO, its principals or related entities, must notify the NFA of these arrangements by October 22. The written notice must contain certain specified information, as further described here.

NFA has also set an effective date of November 30 for amendments to NFA Financial Requirements Sections 11 and 12 and related changes to its Interpretive Notice on Forex Transactions. These amendments revise the net capital requirements for Forex Dealer Members (FDMs) and require all FDMs to collect a customer security deposit (regardless of the FDM's capitalization). A press release regarding these amendments is available here.

BANKING

Credit Quality Declines in Annual Shared National Credits Review

According to the four U.S. federal and thrift banking agencies in a report on Shared National Credits (SNC) issued on September 24, credit quality declined sharply for loan commitments of $20 million or more held by multiple federally supervised institutions. The credit risk of these large loan commitments was shared among U.S. bank organizations, foreign bank organizations (FBOs), and nonbanks such as securitization pools, hedge funds, insurance companies and pension funds. Credit quality deteriorated across all entities, but nonbanks held 47% of classified assets in the SNC portfolio, despite making up only 21.2% of the portfolio. U.S. bank organizations held 30.2% of the classified assets and made up 40.8% of the SNC portfolio.

The 2009 review covered 8,955 credits totaling $2.9 trillion extended to approximately 5,900 borrowers. Loans were reviewed and categorized by the severity of their risk—special mention, substandard, doubtful, or loss—in order of increasing severity. The lowest risk loans, special mention, had potential weaknesses that deserve management attention to prevent further deterioration at the time of review. The most severe category of loans, loss, includes loans that were considered uncollectible.

Key findings are available here.

The SNC program was established in 1977 to provide an efficient and consistent review and classification of SNC, which includes any loan and or/formal loan commitment, and any asset such as real estate, stocks, notes, bonds and debentures taken as debts previously contracted, extended to borrowers by a federally supervised institution, its subsidiaries and affiliates that aggregates to $20 million or more and is shared by three or more unaffiliated supervised institutions. Many of these large loan commitments are also shared with foreign banking organizations and nonbanks, including securitization pools, hedge funds, insurance companies and pension funds. In conducting the 2009 SNC review, agencies reviewed $1.2 trillion of the $2.9 trillion credit commitments in the SNC portfolio, or 41% of the credits by dollar volume. The 2009 SNC sample was heavily weighted toward non-investment grade and criticized credits. The results of the review are based on analyses prepared in the second quarter of 2009 using credit-related data provided by federally supervised institutions as of December 31, 2008, and March 31, 2009.

The entire report is available here.

Reimbursement for Providing Financial Records; Recordkeeping Requirements for Certain Financial Records

The Federal Reserve Board on September 24 issued a revision to Regulation S, which sets the rates and conditions under which a government agency must reimburse a financial institution for costs incurred in producing customer financial records under the Right to Financial Privacy Act.

The revision, which becomes effective January 1, 2010, changes Regulation S in several ways. Most significantly, the personnel fees chargeable for searching and processing document requests are increased substantially. The amendments also encourage electronic document productions by not allowing a $0.25 per page fee to be charged by a financial institution for printing electronically stored information without the requesting agency's consent. The amended regulation also includes a mechanism for automatically updating the labor rates found in the regulation every three years, and makes other technical changes to the rule.

Read more.

ANTITRUST

DOJ and FTC Announce Review of Horizontal Merger Guidelines

The Department of Justice (DOJ) and Federal Trade Commission (FTC) have announced that they will hold a series of workshops to solicit public comment in connection with their review of the Horizontal Merger Guidelines. This review could lead to the first major revision of the Guidelines in 17 years. The DOJ and the FTC created the Guidelines in 1968 to provide a transparent analytical framework for conducting antitrust reviews of mergers and acquisitions. The Guidelines have gone through multiple revisions since that time, the last in 1992. The agencies plan to solicit public comment at workshops to be held in New York, Chicago, San Francisco and Washington, D.C., in December 2009 and January 2010.

Christine Varney, head of the DOJ's Antitrust Division, explained that the review was appropriate in light of the legal and economic developments in the United States over the last 17 years. According to Varney, "Having guidelines that offer more clarity and better reflect agency practice provides for enhanced transparency and gives businesses greater certainty when making merger decisions, resulting in a more competitive marketplace that benefits consumers." Furthermore, the FTC has posted questions on its website designed to promote discussions of the current guidelines and what revisions may be necessary. The agencies are seeking comments from attorneys, academics, economists, consumer groups and any other interested parties.

Click here to read the press release from the Department of Justice.

EXECUTIVE COMPENSATION AND ERISA

Department of Labor Criminalizes Late Contributions to Retirement and Health Plans

The new Assistant Secretary of Labor of the Employee Benefits Security Administration, Phyllis Borzi, recently announced a new Department of Labor (DOL) Employee Retirement Income Security Act enforcement initiative to criminalize failures to forward participant contributions to retirement and health plans.

DOL regulations require employers to transfer employee salary deferrals to the plan as soon as administratively feasible. The regulations also contain a "latest possible transfer date" of the fifteenth business day of the month following the month in which such compensation was withheld from the employee's paycheck. If salary deferrals are transferred after the latest possible transfer date, they are presumed to be late contributions. However, in most cases, the DOL would not consider transfers on, or just prior to, the latest possible transfer date as timely made. Instead, the DOL requires salary deferrals to be transferred to the plan as soon as reasonably possible, which in many cases is within one or two days after issuance of the paycheck.

If an employer transfers salary deferrals later than when it otherwise reasonably could have, the contributions are usually considered late by the DOL. This late contribution is a breach of fiduciary duties that could subject the employer to civil penalties. If a late contribution occurs, the employer should report the late contributions on the plan's Form 5500. In addition, the employer should make an additional plan contribution for any lost earnings on the late contributions and may, but is not required to, submit the correction to the DOL under the DOL's voluntary fiduciary correction program. If the employer does not use the DOL's correction program, the DOL may contact the employer and invite the employer to use such program.

Under the DOL's new criminal enforcement initiative, fiduciaries who make late contributions could be subject to criminal prosecution. At this time, it appears that only the most egregious and persistent violators will be prosecuted, and that enforcement will be sought against those who embezzle plan assets, do not transfer the contributions to the plan or knowingly file false Forms 5500.

We have noticed an increase in DOL benefit plan audit activity, and, in our experience, the DOL has questioned contribution delays that are as short as just a few days from the applicable payroll date. Based on this DOL announcement and the increased DOL audit activity, we recommend that employers review their procedures for withholding plan contributions from employees' pay and transferring such amounts to benefit plans. All employers should be able to (a) justify the timing of their salary deferral transfers and (b) respond to a DOL agent's request for support of any delay in transferring employee salary deferrals.

For more information about the DOL's ERISA enforcement effort and results, click here.

UK DEVELOPMENTS

FSA Chairman Continues to Push for Regulatory Reform

On September 22, Lord Turner, the Chairman of the UK Financial Services Authority (FSA), gave a speech in which he emphasized that the momentum for regulatory reform needs to be maintained and restated his belief that if a more robust global capital and liquidity regime for banks is not implemented now, a similar crisis to that of 2008-9 may occur in the future.

Lord Turner described the current financial crisis as having been "cooked up in trading rooms where not just a few but many people earned annual bonuses equal to a lifetime's earnings of some of those now suffering the consequences." He went on to describe it as "the worst crisis for 70 years" and said that a worse outcome was "only averted by quite exceptional policy measures."

Lord Turner said that he maintained his belief that the City of London should continue to be a major provider of wholesale financial services to the rest of the world. However, he also reiterated that some financial innovation is not valuable, some trading activity is not useful, and a larger financial system is not necessarily a better one. The financial industry has an ability to "generate unnecessary demand" for its services, as "more trading and more financial innovation can under some circumstances create harmful volatility against which customers have to hedge, creating more demand for trading liquidity and innovative products."

Lord Turner stated that the banking industry needed to restore trust in the vital role that it performs. Banks should be refocusing on their core social and economic functions of providing savings, credit and payment products to customers, instead of focusing on over-complex products that are "of no real use to humanity." This may mean that banks will be lower return, but also lower risk, investments: "Bank investments might become more boring, but after the last year, there's a lot to be said for boring."

The FSA's response to the crisis has concentrated on ensuring that banks have more capital and liquidity both through domestic requirements and international agreements. But recently, public concern has been more focused on the debate surrounding bonus levels. When commenting on this, Lord Turner said that the FSA has led the world in introducing rules that focus on reducing risk.

He concluded by advising that the Financial Stability Board's forthcoming report to the G20 will state that it is essential that banks prioritize using profits to rebuild their capital base, support lending and reduce risks rather than to pay high bonuses. Lord Turner believes that regulators have a legitimate interest in banks' aggregate bonus payments where these have implications for their financial resources position.

Click here to read the full speech.

FSA and UK Treasury Issue Joint Response to EU Commission's Consultation on OTC Derivatives

On September 24, the UK Financial Services Authority (FSA) and the UK Treasury (collectively, the UK Authorities) released a response to the European Commission's July 3 consultation on ways to reduce the risks of derivative markets (see the July 10 edition of *Corporate and Financial Weekly Digest*).

The UK Authorities welcomed the proposals by the Commission for enhancing the resilience of the over-the-counter (OTC) derivatives markets. They agreed with the Commission's view that these markets have exhibited weaknesses, specifically in terms of counterparty risk management and market transparency, and that appropriate steps should be taken to strengthen these aspects in order to safeguard financial stability.

The UK Authorities outlined key steps which in their view will strengthen the OTC derivatives markets. They state that by ensuring that market participants have access to an appropriately robust, resilient and transparent market, authorities can help to improve confidence and financial stability both in the OTC derivative markets and the broader financial sector. The UK Authorities:

i. support the Commission's drive for further standardization of contract and economic terms. By using operational capital charges which are proportionate to the operational risks, the cost impact on non-standardized contracts will further encourage the use of standardized contracts.
ii. strongly support the greater use of central counterparty (CCP) clearing arrangements in OTC derivatives markets for products which are "clearing-eligible." CCPs could offer a number of value-added services, such as the provision of additional market information which would encourage market participants to make greater use of CCP clearing.
iii. take the view that bilateral collateralization arrangements where market participants are unable to directly access CCP clearing, or are using non "clearing-eligible" contracts, remain important. These arrangements must be subject to robust risk management, which should include: regular (preferably daily) valuation and margin call processes; strong legal and operational frameworks; and appropriate capital requirements.
iv. share the Commission's view that some market participants do not have adequate access to trade information. They support moves to address this, however they also noted that careful consideration will need to be given to how such a regime is implemented and how to ensure data accuracy.

The full response can be found here.

EU DEVELOPMENTS

European Commission Adopts Legislative Proposals Designed to Strengthen EU Financial Supervision

On September 23, the European Commission announced that it had adopted a package of draft legislation designed to significantly strengthen the supervision of the financial sector in Europe. The proposals are based on the de Larosière report on the future of European supervision and regulation. The June 2009 EU Summit endorsed the new supervisory framework and called for the rapid adoption of the necessary legislative texts.

The proposals aim to:

- Address risks to financial stability throughout the EU
- Create consistent supervision and enforcement throughout the EU
- Ensure early identification of risks in the financial system
- Achieve effective cooperation in emergencies, and dispute resolution among supervisors

Under the proposals, the following new bodies will be created:

- European Systemic Risk Board (ESRB)—a "macro-prudential" supervisor which will monitor and assess risks to the stability of the financial system as a whole. The ESRB will be tasked with providing early warning of systemic risks that may be building up and, where necessary, recommendations for action to deal with these risks.

- European System of Financial Supervisors (ESFS)—a "micro-prudential" supervisor for the supervision of individual financial institutions. It will consist of a network of national financial supervisors working in tandem with three new European Supervisory Authorities (a European Banking Authority (EBA), a European Insurance and Occupational Pensions Authority (EIOPA), and a European Securities and Markets Authority (ESMA)). ESFS will absorb and replace the existing Committees for the banking securities and insurance and occupational pensions sectors: the Committee of European Banking Supervisors (CEBS), Committee of European Insurance and Occupational Pensions Committee (CEIOPS) and the Committee of European Securities Regulators (CESR). In addition ESFS will be tasked with the following:

- Developing proposals for technical standards, respecting better regulation principles
- Resolving cases of disagreement between national supervisors
- Ensuring consistent application of relevant EU rules
- A coordination role in emergency situations

The ESMA will also exercise direct supervisory powers over Credit Rating Agencies.

Click here for more information on financial services supervision and committee architecture.
Click here for more information on the new legislative proposals.

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