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Corporate and Financial Weekly Digest

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SEC/Corporate

SEC Announces Roundtable on IFRS

On February 13, Securities and Exchange Commission Chairman Christopher Cox announced that senior SEC staff members from the Office of the Chief Accountant, the Division of Corporation Finance and the Office of International Affairs will host a roundtable discussion on the "roadmap" for eliminating the need for non-U.S. companies to reconcile financial statements prepared pursuant to International Financial Reporting Standards (IFRS) to U.S. GAAP in filings with the SEC. Conrad Hewitt, SEC Chief Accountant, and John W. White, Director of Corporation Finance, will moderate the roundtable, which will address the effect of implementing the roadmap (and permitting the use of both U.S. GAAP and IFRS) on the capital raising process, issuers, and investors in the U.S. capital markets. Mr. Cox noted that IFRS reporting has been mandatory in the European Union since 2005 and nearly 100 countries currently use, or have a policy of convergence with, IFRS.

http://www.sec.gov/news/press/2007/2007-19.htm

SEC Seeks to Curtail Suits Against Accounting Firms

At the February 9 annual "SEC Speaks" conference in Washington, D.C. sponsored by the Practicing Law Institute, the Securities and Exchange Commission's Chief Accountant, Conrad Hewitt, stated that the SEC is examining whether, and to what extent, to limit the liability of accounting firms from large damage awards in cases brought by investors and companies.

The concern is that even a single judgment against one of the "Big Four" accounting firms could put the firm into bankruptcy and result in even greater concentration. Chief Accountant Hewitt noted that five European Union countries have already found ways to limit auditor liability and the European Commission has issued a policy paper advancing the view that the biggest firms should be given new legal protection against damage claims. Some countries have put a monetary cap on legal liability, while others have adopted limits based on the size of the client corporation or the fees generated by the company being audited.

On February 12, SEC Commissioner Christopher Cox stated that the consolidation in the accounting industry had prompted both Congress and the SEC to consider ways to "prevent the demise of another firm" and it is in the interest of investors and issuers that there be "healthy competition in the profession."

Industry groups have been pushing Congress to adopt some of the

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changes, but so far have not garnered significant support, and critics complain that the remarks from the SEC portend a retrenchment from the post-Enron reforms as those efforts gain traction.

SEC Clarifies Position on Preliminary Proxy Statement Executive Compensation Disclosure

On February 12, the Securities and Exchange Commission provided some guidance regarding the new executive compensation disclosure requirements in proxy statements this year. The guidance states that the Commission will not request a revised preliminary proxy statement nor deem the preliminary filing deficient such that the 10 calendar day waiting period prior to a Company filing a definitive proxy statement does not begin to run, so long as (i) the omitted executive and director compensation disclosure is included in the definitive proxy statement; (ii) the omitted disclosure does not relate to the matter or matters that caused the company to have to file preliminary proxy materials; and (iii) the omitted disclosure is not otherwise made available to the public prior to the filing of the definitive proxy statement.

http://www.sec.gov/divisions/corpfin/guidance/execcomp402interp.pdf
Item 1.04

Broker Dealer

Investment Advisers Allowed to Use a Waiver of Liability Clause

In Heitman Capital Management, LLC, February 12, the staff of the Securities and Exchange Commission reversed its previous position that hedge clauses purporting to limit an adviser's liability to acts involving gross negligence or willful malfeasance are in violation of Sections 206(1) and 206(2) of the Investment Advisers Act of 1940 because they may lead unsophisticated clients into believing they have waived non-waiveable rights even if the hedge clause provides that rights under federal or state law cannot be waived.

The new standard is whether, depending upon all of the surrounding facts and circumstances, such a waiver operates as a fraud or deceit on the client. When a client is unsophisticated in the law, factors the SEC staff would consider include: (i) was the clause written in plain English; (ii) was the hedge clause individually highlighted and explained during an in-person meeting with the client; and (iii) was enhanced disclosure provided the client to explain instances in which the client may still have a cause of action. The presence and sophistication of an intermediary assisting the client in his dealings with the investment adviser and the nature and extent of the intermediary's assistance to the client are additional factors to be taken into consideration.

http://www.sec.gov/divisions/investment/noaction/2007/heitman021207.pdf

CBOE Proposes Listing Credit Default Options

The Securities and Exchange Commission has published for comment a Chicago Board Options Exchange proposal to list and trade options on credit defaults. Each option would specify an entity that could be the issuer or guarantor of a debt obligation and the reference obligation. Upon the occurrence of a failure to pay default on the reference obligation or any other debt referenced in the referenced obligation on or prior to the expiration date of the option, the holders with a long position would receive $100,000 per contract, and holders of short positions would pay $100,000 per contract. Other events of default

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would be specified by the CBOE when listing an option that would trigger such payments. Payments would be made by, and collected by, The Options Clearing Corporation. If an option expired prior to a default, the payment obligation would be $0.

Each option class could be for up to 10.25 years from the date trading starts. Expiration of a class would be on the third Friday of March, June, September or December.

For a credit default option to be listed, the obligor must be registered with the SEC under Section 12 of the Securities Exchange Act, and its stock must meet the eligibility requirements for options on it to be traded on the CBOE.

Position limits for a credit default option would be 5,000 contracts (pay or receive $500,000,000). Margin would be 100% of the current market value for long positions and 100% of the settlement amount ($100,000) for short positions but only 20% in the case of a "qualified customer." A "qualified customer" is a person or entity that owns and invests on a discretionary basis not less than $5,000,000 in investments. Margin may be satisfied by depositing cash, marginable securities or a bank issued, irrevocable letter of credit expiring no sooner than the expiration date for the option class being margined.

Credit default options would trade in increments of $.05 ($50 per contract).

http://a257.g.akamaitech.net/7/257/2422/01jan20071800/edocket.access.gpo.gov/2007/pdf/E7-2477.pdf

Banking

Agencies Seek Public Comment on Proposed Supervisory Guidance for Basel II

The federal bank and thrift regulatory agencies announced yesterday that they will seek public comment on three proposed supervisory guidance documents related to the September 2006 notice of proposed rulemaking (NPR) on new risk-based capital requirements in the United States for large, internationally active banking organizations.

The September 2006 NPR detailed the agencies' proposal for implementing the new capital framework issued by the Basel Committee on Banking Supervision in 2004 (Basel II). The proposed U.S. Basel II capital framework would be mandatory for large, internationally active U.S. banking organizations and optional for other institutions. The Basel II NPR includes requirements that banking organizations would need to satisfy to calculate their risk-based capital under the proposed new capital framework. The proposed supervisory guidance provides information to assist bankers, as well as supervisors, in addressing the Basel II qualification requirements.

Two of the proposed documents issued yesterday relate to the Basel II advanced approaches for calculating risk-based capital requirements: the advanced internal ratings-based (IRB) approach for credit risk and the advanced measurement approaches (AMA) for operational risk. These guidance documents have been updated since they were previously issued for public comment in 2003 and 2004. The third document proposes guidance on the Basel II supervisory review process for assessing capital adequacy and is being issued for the first time.

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The proposed supervisory guidance documents are being issued by the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision. The documents will be published shortly in the *Federal Register*.

http://www.federalreserve.gov/boarddocs/press/bcreg/2007/20070215/attachment.pdf

OTS and OCC Issue Spate of Consumer Guidance Information

Last week, as part of the Consumer Protection Week series, the Office of Thrift Supervision (OTS), which regulates the nation's savings banks, unveiled a consumer information brochure on the purchase and use of gift cards. The brochure, entitled “Consumer Fact Sheet: Buying, Giving, and Using Gift Cards,” advises consumers regarding gift cards issued by financial institutions. The brochure may be accessed at http://www.ots.treas.gov/docs/4/480923.pdf

The OTS also issued a consumer information brochure on how consumers can resolve complaints with financial institutions. The brochure is available at http://www.ots.treas.gov/docs/4/480924.pdf

Finally, the OTS stressed the importance of monitoring one's credit reports. The material may be found in the “Consumer and Compliance/Consumer Inquiries” section of the OTS website at www.ots.treas.gov

In addition, the Office of the Comptroller of the Currency (OCC), which regulates the nation's national banks, also made available consumer protection tips via its website. The website may be found at http://www.occ.treas.gov/consumer/ncpw.htm

Both banks and savings banks need to be familiar with the guidance that their regulators are giving the public.

United Kingdom Developments

UK DEVELOPMENTS

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Theft of Laptop Leads to $1.9 Million Fine for Nationwide

On February 14, the UK Financial Services Authority announced that it had fined Nationwide Building Society £980,000 (approx. $1.9 million) for a breach of FSA’s Principle 3 (Systems and Controls) by failing adequately to assess the risks relating to information security and take reasonable care to ensure that it had adequate procedures to manage those risks, including the risks that electronic equipment containing customer information might be lost or stolen. Further, Nationwide had inadequate controls in place to ensure that its procedures would be followed. The Principle which Nationwide was held to have breached provides that “A firm must take reasonable care to organize and control its affairs responsibly and effectively, with adequate risk management systems.”

Nationwide is the UK's largest building society (broadly equivalent to a U.S. savings and loan association). It has over 11 million customers. In August 2006 a company laptop was stolen from the home of a Nationwide employee. The laptop contained confidential customer information which the FSA concluded could have been used to further financial crime. The FSA’s November 2004 Information Security Report *Countering Financial Crime Risks in Information Security* specifically highlighted the need for firms to have incident management procedures commensurate with the size of their operations.

The FSA found that Nationwide's failure to implement robust systems and controls regarding the use and storage of customer information on portable storage devices potentially put its customers at an increased risk of being victims of financial crime in the event of loss or misuse of the data. Although Nationwide reported the loss of the laptop to the police, the Information Commissioner, and to the FSA, the FSA concluded that Nationwide's failure to respond quickly and appropriately in the first three weeks following the theft of the laptop in this case increased the opportunity for the information to be used in a way which might result in financial crime.

The FSA’s findings included the following:

- Nationwide failed adequately to consider the wider risks to customer information from Nationwide systems being compromised and, as a result, it failed to put in place appropriate controls and monitoring mechanisms to mitigate these risks. The failure to manage or monitor downloads of very large amounts of data onto portable storage devices meant that Nationwide had limited control over information held in this way or how it was used, increasing the risk that it could be used to further financial crime.
- Nationwide’s systems and controls were such that, when the laptop was stolen, Nationwide was not aware that it contained confidential customer information. For a period of three weeks after the theft of the laptop Nationwide failed to take any steps to investigate whether it contained such information.
- The cumulative impact of the failings represented a significant risk to the FSA objective of reducing the extent to which it is possible for regulated firms to be used for a purpose connected with financial crime

In particular Nationwide:

- failed adequately to assess the risks in relation to the security of customer information;
- had procedures in relation to information security which failed adequately and effectively to manage the risks it faced;
- failed to implement adequate training and monitoring to ensure that its information security procedures were disseminated and understood by staff;
- failed to implement adequate controls to mitigate information security risks, to ensure that employees adhered to its procedures and to ensure that it provided an appropriate level of information security; and
- failed to have appropriate procedures in place to deal with an incident involving the loss of customer information and, as a result, Nationwide did not respond appropriately and in a timely manner to establish the risks to its customers of financial crime arising from the theft of the laptop.

By agreeing to settle at an early stage of the FSA's investigation, Nationwide qualified for a 30% discount under the FSA's executive settlement procedures. Without that discount the fine would have been £1.4 million (approx. $2.7 million).

http://www.fsa.gov.uk/pubs/final/nbs.pdf

Litigation

SEC Supports Heightened Standards Governing Investors' Claims

In an *amicus curiae* brief, the Securities and Exchange Commission urged the Supreme Court to vacate the Seventh Circuit's decision in *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588 (7th Cir. 2006), on grounds that the Circuit Court misinterpreted the heightened pleading standards governing securities fraud claims imposed by the Private Securities Litigation Reform Act (PSLRA). The SEC asserted that the Seventh Circuit's holding, that plaintiffs need merely to allege sufficient facts such that a "reasonable person" could infer that defendants acted with the intent to commit securities fraud, was flawed. The SEC argued that pursuant to the PSLRA, a "reasonable inference" of scienter is plainly insufficient. Instead, plaintiffs must allege facts creating a "strong inference" that defendants acted with a culpable state of mind. Furthermore, the SEC argued that the Seventh Circuit impermissibly declined to consider facts within plaintiff's Complaint that supported a plausible inference that defendants did not intend to commit fraud.

http://www.sec.gov/litigation/briefs/2007/tellabsbrief.pdf

Federal Court Dismisses RICO Claim

The District Court for the Southern District of New York dismissed a RICO conspiracy claim against defendants because plaintiff failed to allege an agreement to commit the predicate acts in furtherance of a RICO violation, which the Court stated was "the most basic element of a RICO conspiracy claim." The Court further held that even if plaintiff had adequately alleged an agreement, plaintiff must allege a "pattern of racketeering activity" -- at least two acts of racketeering within a span of ten years. The Complaint's allegations that one defendant made a single misrepresentation on numerous occasions was insufficient to meet this requirement because, the Court held, "plaintiff makes it appear as if they are each separate predicate acts, when in fact, they are nothing more than reaffirmations of the original misrepresentation." (*M'Baye v. New Jersey Sports Productions, Inc.*, 2007 WL 431881 (S.D.N.Y. Feb. 7, 2007))

CFTC

Guidance for Preparing FCM Annual Financial Reports Published

The Commodity Futures Trading Commission's Division of Clearing and Intermediary Oversight has issued a guidance letter to assist registered futures commission merchants (FCMs) and their accountants in preparing and filing required FCM audited annual financial reports.

http://www.cftc.gov/files/tm/tmfcmguidanceletter2006.pdf

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purpose of avoiding tax penalties that may be imposed on the taxpayer.

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