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TARP Update

Congress Releases Second TARP Tranche; G30 Outlines Major Financial Reforms

Daniel F. C. Crowley, Karishma Shah Page

Congress failed to block release of the second $350 billion tranche of the $700 billion Troubled Asset Relief Program (TARP), which was created by the Emergency Economic Stabilization Act of 2008 (EESA; P.L. 110-343, at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_public_laws&docid=f:publ343.110.pdf; H.R. 1424, at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_bills&docid=f:h1424enr.txt.pdf). The use of these funds was subject to Congressional disapproval by joint resolution enacted within 15 calendar days after the Treasury Department certified its intention to use the funds. On January 12, the Bush Administration, at the request of then President-elect Obama, formally sought release of the second $350 billion tranche. The Senate effectively approved the funds when it defeated S.J. Res. 5, a Republican resolution to disapprove the funds, by a vote of 52-42 on January 15 (to view S.J. Res. 5, visit http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:sj5pcs.txt.pdf). Notably, on January 22, the House approved the companion resolution, H.J. Res. 3, which would have rejected the release of the TARP funds, by a vote of 270-155 (to view H.J. Res. 3, visit http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:hj3eh.txt.pdf).

The House vote was largely symbolic, but it does reflect Congress' strong dissatisfaction with TARP implementation to date. On January 21, the House passed H.R. 384, the TARP Reform and Accountability Act of 2009 (http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h384eh.txt.pdf), by a vote of 266-160. Introduced by House Financial Services Chairman Barney Frank (D-MA), H.R. 384, as amended, would place numerous conditions on the TARP program and its beneficiaries, such as:

- Setting conditions on TARP recipients, including executive compensation restrictions, providing the Treasury Secretary with the authority to apply new executive compensation restrictions retroactively to TARP beneficiaries;
- Requiring reporting, data collection, and analysis of use of TARP funds;
- Authorizing Treasury to place observers in board meetings of "assisted organizations" (a newly defined term);
- Increasing the size of the Financial Stability Oversight Board and providing the Board with the authority to overturn any policy determination made by the Treasury Secretary by a 2/3 vote; and
- Requiring the Treasury Secretary to commit at least $100 billion, but not less than $40 billion, to foreclosure mitigation.

It is not clear whether the Senate will act on the legislation. However, a recent letter from National Economic Council Director Lawrence Summers to House Speaker Nancy Pelosi (D-CA) and Senate Majority Leader Harry Reid (D-NV) indicates that the Obama Administration has agreed in principle to many of the provisions contained in the legislation (view the letter at http://change.gov/newsroom/entry/letter_from_lawrence_h._summers_to_congressional_leaders/). Key elements of the plan include:

- Placing conditions on TARP recipients, including limits on executive compensation, dividend payments, stock repurchases, and acquisitions of healthy financial companies;
- Requiring reporting on and analysis of TARP funds use;
- Extending credit to consumers, homeowners, small businesses, and local governments; and
- Developing a foreclosure mitigation program, including a possible change to bankruptcy laws.

A number of new TARP programs have been developed to address the continuing credit market crisis. After Congressional negotiations stalled in December, President Bush announced an auto bailout package (http://www.treas.gov/press/releases/hp1333.htm), consisting of a $17.4 billion short-term bridge loan to General Motors and Chrysler. The loan is contingent on the auto companies showing that they are financially viable by March 31, 2009 and also contains conditions allowing the government to block transactions over $100 million, restricting dividends, and limiting executive compensation. Subsequently, Treasury announced a $6 billion package to GMAC and a $1.5 billion loan to Chrysler Financial under the newly created Automotive Industry Financing Program (http://www.treasury.gov/initiatives/eesa/program-descriptions/aifp.shtml).

On January 2, the Treasury Department released guidelines for the Targeted Investment Program ("TIP") (http://www.treas.gov/press/releases/hp1338.htm). TIP was used by the Federal Reserve and Treasury in the Citigroup package (http://www.treas.gov/press/releases/hp1358.htm) announced in November. On January 16, Treasury, the Federal Reserve, and the FDIC announced assistance to Bank of America (http://www.treas.gov/press/releases/hp1356.htm). In addition to a $118 billion loan guarantee, the deal includes a $20 billion preferred stock purchase through TIP, and requires that Bank of America comply with enhanced executive compensation restrictions and implement a mortgage loan modification program.

On January 14, the Treasury Department issued Capital Purchase Program ("CPP") application guidelines (http://www.treas.gov/press/releases/hp1354.htm) for subchapter S corporation banks; applications are due on February 13, 2009. Unlike other CPP programs that provide government support through preferred stock purchases, CPP support for S Corporations will come through the issuance of subordinated debt at a rate of 7.75 percent for the first five years and 13.8 percent thereafter.

Finally, discussions continue on broader financial service industry reforms. On January 15, the Group of Thirty ("G30") issued a report entitled Financial Reform: A Framework for Financial Stability (http://www.group30.org/pubs/pub_1460.htm). The G30 Working Group on Financial Reform that issued the report is chaired by former Federal Reserve Chairman Paul Volcker, one of President Obama's economic advisors and Chairman of the President's Economic Recovery Advisory Board. Mr. Volcker has stated that he will make the recommendations to President Obama and that the report is "a reasonable indication of the direction in which we might go."

The G30 report recommends a massive, globally coordinated restructuring of the legislative and regulatory system that governs the financial services industry. Building on the momentum created by other recent proposals, such as the Treasury Department Blueprint for a Modernized Financial Regulatory Structure (http://www.treas.gov/offices/domestic-finance/regulatory-blueprint/), the Group of 20 Financial Markets and the World Economy Summit Declaration (http://www.whitehouse.gov/briefing_room/), and the Government Accountability Office Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System (http://www.gao.gov/new.items/d09216.pdf), the G30 report's core recommendations include:

- Requiring that all systemically significant financial institutions be subject to prudential oversight;
- Improving the effectiveness of prudential regulation by increasing international coordination and enhancing resources available to regulators and central banks;
- Strengthening institutional policies and standards, with a particular focus on governance, risk management, capital, liquidity, credit and counterparty exposure, and leverage; and
- Increasing transparency and realigning risks associated with financial markets and products.

A detailed analysis of the G30 report is provided in our recent alert, Group of Thirty Issues Roadmap for Financial Reforms (http://www.klgates.com/newsstand/Detail.aspx?publication=5241).

Executive Compensation

Monitoring Compliance with Executive Compensation Limits Under the Emergency Economic Stabilization Act

Raymond P. Pepe

On January 16, 2009, the U.S. Treasury Department modified the interim final rules regarding executive compensation, originally adopted on October 20, 2008, to establish additional recordkeeping and reporting requirements, and issued a revised version of the executive compensation guidelines applicable to financial institutions participating in programs for Systemically Significant Failing Institutions, which adopt similar requirements. The Treasury acted in response to the Government Accountability Office's December 2, 2008 report *Troubled Asset Relief Program: Additional Actions Needed to Better Ensure Integrity, Accountability and Transparency*, which called for the adoption of additional measures to monitor compliance with the executive compensation limits established by the Emergency Economic Stabilization Act.

The executive compensation limitations in the Emergency Economic Stabilization Act apply to a financial institution's chief executive officer and chief financial officer, plus the next three most highly compensated executive officers. These limitations, which originally applied only to institutions from which non-auction sales of distressed assets were made, now also apply to institutions receiving capital under the Treasury's Capital Purchase Program. The compensation limits require that the compensation committees of participating financial institutions (1) conduct reviews of compensation arrangements to ensure that they do not encourage unnecessary and excessive risks that threaten the value of the financial institution; (2) mandate the clawback of any bonus or incentive compensation paid based on statements of earnings, gains, or other criteria that are later proven to be materially inaccurate; and (3) prohibit excessive golden parachute payments. The limits also make compensation payments in excess of $500,000 non-deductible for federal income tax purposes.

The January 16, 2009 rules make the following modifications to the October 20, 2008 interim final rules:

- Financial reports and registration statements of financial institutions whose securities are registered with the SEC must include in their compensation committee reports a certification of compliance with the limitations. In contrast, the October interim final rules required the compensation discussion and analysis in an issuer's annual report to certify compliance without directly linking compliance certification to the activities of corporate compensation committees.
- The clawback provisions have been expanded to apply not only to compensation paid during the time the Treasury holds a debt or equity position in a financial institution, but also to any incentive compensation to which a senior executive officer obtains a legally binding right to payment during the Treasury holding period.

- Within 120 days of the closing date of an agreement between a financial institution and the Treasury under the Capital Purchase Program, the principal executive officer of the financial institution is required to certify to the chief compliance officer of the TARP that the firm's compensation committee within 90 days after the closing date reviewed the incentive compensation arrangements of senior executive officers with the senior risk officers of the institution to ensure that the compensation arrangements do not encourage unnecessary or excessive risks that threaten the value of the institution.
- Within 135 days of completion of the first year in which an institution participates in the Capital Purchase Program, and each year thereafter during which the Treasury holds a debt or equity position in the institution, the principal executive officer must identify the institution's senior executive officers subject to compensation limits and provide a certification to the chief compliance officer of the TARP that:
  - the compensation committee has met at least once during the most recently ended fiscal year and reviewed the risk management policies and practices of the institution and its senior executive compensation arrangements with the senior risk officers of the institution to ensure that the compensation arrangements do not encourage unnecessary or excessive risks that threaten the value of the institution;
  - any payments based upon materially inaccurate financial statements or performance metrics have been recovered;
  - excessive golden parachute payments have been prohibited; and
  - controls and procedures have been instituted to limit deductions for compensation on federal income taxes to $500,000 for each senior executive officer.
- Records must be kept such that documentation sufficient to substantiate each certification is retained for not less than six years after each certification has been made; maintained in "an easily accessible location" for at least the first two years; and provided to the chief compliance officer of the TARP upon request.

In addition to these modifications to the Treasury rules, Treasury Secretary Timothy Geithner indicated in response to written questions posed by Senator John Kerry that plans are being developed to further require any compensation above a designated limit be paid in the form of restricted stock or another equivalent form of payment that cannot be liquidated or sold until government assistance has been repaid.

SEC

SEC Chair Nominee Sets Forth Regulatory Agenda

Mark D. Perlow

On January 15, 2009, Mary L. Schapiro, President Obama's nominee to chair the U.S. Securities and Exchange Commission ("Commission"), testified before the U.S. Senate Committee on Banking, Housing and Urban Affairs ("Committee") in a hearing to consider whether to recommend her nomination to the full Senate. Her appointment was confirmed by the Committee and the Senate on January 22. During her confirmation hearing, Ms. Schapiro outlined her priorities for the days ahead.

Ms. Schapiro stated that her "first and foremost" priority will be to "move aggressively to reinvigorate enforcement at the SEC" — an implicit repudiation of the direction that SEC enforcement has taken under Chairman Christopher Cox. Under Mr. Cox, the size of the enforcement staff has declined in recent years, and the Commission has instituted additional layers of review for the approval of an investigation. In addition, it issued guidance that limited the circumstances under which monetary penalties can be imposed upon corporations, noting that in many cases penalties have the effect of harming the corporation's innocent shareholders. The SEC also instituted a pilot program requiring the Commission's pre-approval for the enforcement staff to negotiate monetary penalties in settlements, with the Commission first approving an acceptable range for the penalties. Critics contend that these measures have hamstrung and demoralized the enforcement staff, while defenders argue that they have restored balance to an overly aggressive program. In either case, Ms. Schapiro's chairmanship most likely will result in more aggressive enforcement.

Second, Ms. Schapiro articulated her vision of the SEC's mission as the "investor's advocate," focused on "investor protection, transparency, accountability and disclosure." She expressed a desire to preserve these missions in the coming regulatory overhaul, which seems to concede that the SEC would serve as a regulator of business conduct but not as a prudential regulator of safety and soundness. The U.S. Treasury's Blueprint for a Modernized Financial Regulatory Structure, proposed in March 2008, advocated consolidating the many federal financial regulators into three – a market stability regulator, a prudential regulator, and a business conduct regulator, and this broad vision (if not the specifics of the Treasury's proposals) has gained currency among the Congressional leadership. Ms. Schapiro may have thus signalled that she will not fight to regain what the SEC has already in fact lost, the power to impose capital, liquidity and other prudential standards on systemically important broker-dealers. Indeed, she implicitly endorsed regulatory consolidation when she expressed her view that one reason why regulators did not uncover the alleged Madoff fraud was the current "stovepiped" approach to regulation. Nonetheless, she pointed out to a largely sympathetic Committee that the SEC's core functions — examinations of investment companies and advisers and securities firms, regulation of corporate disclosure, exchange regulation and oversight — need to be preserved in any combined agency.

Ms. Schapiro also said that the SEC's approach to regulating credit rating agencies should be reconsidered. These firms have garnered much criticism for allegedly allowing their standards to slip in overrating many of the asset-backed securities that now clog the balance sheets of financial institutions. In particular, the business model of these firms has come under attack: because the issuer of the security pays the rating agency, critics, including the SEC itself, have alleged that this conflict of interest compromised the independence and methods of the ratings agencies. Ms. Schapiro said that two ideas in particular merit attention – first, requiring that the rating agencies receive their compensation from small transaction or listing fees rather than from the issuers of securities, and second, establishing a dedicated regulator with powers modelled after those of the Public Company Accounting Oversight Board to set standards and conduct comprehensive examinations.

Ms. Schapiro also advocated mandatory SEC registration and regulation of hedge fund managers. While she acknowledged that the SEC does not currently have this authority, since the agency's effort to impose a hedge fund registration rule was struck down by the DC Circuit Court of Appeals, Ms. Schapiro recognized that Congress will likely soon expressly grant the SEC this authority. Ms. Schapiro said that the agency will begin working on proposals that will govern hedge fund disclosures and provide for "better and stronger checks and balances." Even before Congress enacts any legislation, such rules could be applied to hedge fund managers currently registered with the SEC.

Ms. Schapiro indicated that the SEC would move forward with shareholder proxy access, an issue with a long and contested history. In 2004, then-SEC Chairman William Donaldson prompted the Commission to propose a complicated rule that would have allowed shareholders that crossed certain ownership percentage and longevity thresholds to place a limited number of director nominees on an issuer's own proxy. However, business groups strongly opposed the rule, and Donaldson stepped down before it could be adopted. In 2007, pressured by a Second Circuit Court of Appeals ruling that questioned the SEC staff's interpretation of the SEC proxy rules, the Commission under Chairman Cox adopted a rule permitting issuers to omit access proposals from their proxy materials, which engendered opposition from some institutional shareholders' groups. Ms. Schapiro pointed out that many other leading non-U.S. markets mandate proxy access, and she stated her preference for "the U.S. to enter that club." However, she signalled that she would not force through a proposal, only that she was going to immediately begin discussing with other Commissioners a proxy access proposal along Donaldson's lines.

Ms. Schapiro testified that she will re-evaluate the SEC's current path towards the adoption of International Financial Reporting Standards

("IFRS"), thereby moving away from U.S. Generally Accepted Accounting Principles. Chairman Cox made the globalization of capital markets a theme of his tenure, and he pushed the SEC to adopt a "roadmap" to the adoption of IFRS, subject to the completion of certain "milestones." Ms. Schapiro stated that she would not be bound by this roadmap, and indeed she expressed concerns that make clear that the SEC will move slowly on the issue. In particular, she questioned the independence of the International Accounting Standards Board, which governs IFRS, and pointed out that the Sarbanes-Oxley Act requires U.S. public companies to operate under standards promulgated by an independent authority. She also noted that conversion to IFRS would be extremely expensive and thus more burdensome during a recession, and her comments indicated concerns that IFRS, which are principles-based (rather than rules-based, as is U.S. GAAP), were not detailed enough to be effective. Each of these concerns mirrors public criticisms of IFRS by opponents of their U.S. adoption.

She similarly indicated that the SEC will reconsider whether to grant "mutual recognition" to other countries' securities exchanges and broker-dealers. One of Chairman Cox's initiatives on globalization, mutual recognition would recognize that certain countries have market regulatory schemes equal in effectiveness to that of the U.S. Exchanges in these countries would be allowed direct access to U.S. customers, and their broker-dealers would be permitted to operate in the U.S. and transact with U.S. customers, in each case without registration with or regulation by the SEC. Advocates of mutual recognition argue that it would eliminate unnecessary obstacles to international investing, whereas critics argue that mutual recognition would eliminate the superior investor protections under the U.S. regulatory regime. Ms. Schapiro sided with the critics and questioned whether mutual recognition was "headed in the right direction."

Finally, Ms. Schapiro testified that she will rebuild the SEC's Office of Risk Assessment ("ORA") and that she wants risk assessment to "permeate everything the SEC does." In particular, she pointed out that, given the limited number of SEC examiners, risk assessment would enable them to focus on the issues of greatest importance. Chairman Donaldson created ORA in response to the market timing and late trading scandals in the mutual fund industry in 2003-2004, but Chairman Cox gave it less emphasis and fewer resources. It is worth remembering that Chairman Donaldson created ORA in part to organize and give direction to a profusion of industry-wide, issue-focused but partially redundant "sweep" examinations that were burdening the fund and brokerage industries and wasting SEC staff resources. Ms. Schapiro seemed to be signalling that ORA will perform a similar disciplining function, but it remains to be seen whether it will also inaugurate another era of large-scale sweep examinations.

Ms. Schapiro's testimony indicates both that she has a clear idea where she wants to lead the SEC and that she is skilled at building political support for her agenda. As a result, the securities and investment industries are almost certainly facing an era of tougher SEC enforcement and revitalized examinations, while the internationalization of SEC rules will be made a lower priority. The SEC will also seek to increase the regulation of hedge funds and credit rating agencies. While the extent of any regulatory reform is still unknown, these initiatives reflect the views of the large majority in Congress that these regulatory regimes need fixing and leave aside broader questions as to the need for a qualitative change of the SEC's mission.

State Securities

State Securities Regulators - Stepping Up Enforcement Examinations and Investigations in the Wake of Madoff and Industry Migration Trends

David N. Jonson

The North American Securities Administrators Association ("NASAA") started the new year off with an ambitious agenda at its annual Winter Enforcement Conference on January 8-11, in Coronado, California. The conference, which is open only to state, federal and FINRA enforcement attorneys and investigators, featured panels on Enforcement Trends, Enforcement Best Practices, Broker-Dealer Sales Tactics, and Enforcement Implications of the Financial Crisis. The attendees also met to discuss strategy and tactics in six specialized NASAA enforcement groups: Enforcement Technology, Enforcement Trends, Special Project Development and Coordination, Attorney Investigator Training, Litigation Forum, and Enforcement Zones.

State securities regulators, who have regulated the securities industry since before federal securities laws and the SEC were created by Congress during the New Deal, have always been mindful of the erosion of their regulatory power by federal initiatives advocated by both the SEC and the securities industry itself. Although the securities industry's clout in Washington today is arguably at its weakest level in decades, the states are also aware that any new financial services regulatory scheme from Washington could still result in a diminution of state authority. Accordingly, even though recent multi-state regulatory enforcement actions in the areas of research analyst conflict of interests and auction rate securities have been widely viewed as successful by investors, consumer groups and some influential members of Congress, the states clearly do not intend to stray too far from the kitchen while a new regulatory pie is being baked.

To continue demonstrating their value during this time of regulatory change, state securities regulators will continue to focus on local cases with a common national theme (*e.g.*, auction rate securities and senior citizen issues). However, since the states have also detected an unprecedented number of registered representatives departing broker-dealers to form smaller, state-registered investment advisory firms, the states have also indicated that they will dramatically increase the number of proactive examinations, investigations and enforcement actions against such firms.

There are several reasons for the states' increased interest in these new investment advisers. As an overarching factor, the effects of the Madoff matter cannot be understated. No state securities regulator, many of whom serve at the pleasure of statewide elected officials, wants to have to explain how or why they missed clues or leads that, if properly investigated, would have shut down a would-be Madoff in their jurisdiction. Therefore, future state examinations and investigations - regardless of whether or not a whistleblower provides a roadmap of where to look - will be far more thorough than in the past. As a result, subjects of these inquiries should expect to find that responding to such matters will involve considerably more time and expense than they may have grown accustomed to in prior years.

Second, state regulators are very concerned that since the majority of the new advisers may not be accustomed to handling compliance and other administrative details themselves, and because adequate compliance takes time and money and may be less of a priority than client development, state regulators theorize that these advisers are more likely to be deficient in carrying out such duties. Some states will even be taking the unusual step of conducting introductory examinations of newly registered advisory firms.

Third, some regulators believe that most of the representatives who left broker-dealers to form their own advisory firms may not have been in the upper echelon (or "top producers") at their former firms, and now, under pressure to pay their own way, may be more desperate to generate business through questionable advice or investment opportunities that they would not have attempted to solicit while at their prior firms. (Interestingly, some state regulators - especially those who considered the term "top producer" to be questionable when viewed from the client's perspective - took a more charitable view of the motives of the lower-producing representatives who recently became state-registered advisers.)

State securities regulators have identified new, state-registered investment advisers as the latest "at risk" group who will bear the brunt of their regulatory and investigative scrutiny. Given the deterrent effect and favorable publicity that can be generated from taking strong enforcement actions, the states can also be expected to continue availing themselves of the full array of media outlets on both the local and national level.

Mortgage Banking

FTC Consent Decree Alleges Mortgage Lender Failed to Ensure the Protection of

Consumer Information Provided to a Third Party

David A. Tallman

A recent Federal Trade Commission ("FTC") action highlights the need for renewed focus, particularly by mortgage lenders, on the protection of borrowers' personal financial information, including information made available to strategic partners. On December 16, 2008, the FTC issued a final consent decree against a mortgage lender, Premier Capital Lending, Inc., alleging that the lender failed to adequately protect the non-public personal financial information of borrowers that it had provided to a third party. The FTC claimed that by permitting a strategic partner to access consumer credit reports without verifying the third party's data security policies and procedures, the lender failed to comply with the FTC's Safeguards Rule. The FTC also alleged that the lender committed a deceptive act in violation of the FTC Act, because boilerplate language in its privacy policy contained "false or misleading" statements regarding its information security practices.

The consent decree concerned a company that finances the acquisition of manufactured homes. In March 2006, the lender permitted the principal of a manufactured home seller to use a company log-in to obtain consumer reports for prospective home purchasers that could be referred to the company for mortgage financing. The manufactured home seller obtained credit reports on eighty-three consumers using these credentials. In July 2006, an unauthorized person hacked into the manufactured home seller's computer. The hacker used the log-in credentials to obtain over three hundred new consumer reports on individuals who were not customers of either the lender or the manufactured home seller. The hacker was also able to access all of the eighty-three consumer reports that the seller had legitimately obtained. While the lender promptly notified the three hundred non-customers of the data security breach, it allegedly did not realize that the hacker had accessed the eighty-three additional consumer reports until more than a year later. These customers were not notified of the breach until September 2007.

According to the FTC, the lender failed to maintain reasonable and appropriate information security procedures. Among other allegations, the FTC claimed that the lender never visited the seller's workplace, performed a security audit on the seller's computer network, or assessed the seller's data security policies. Further, the FTC alleged that the lender never reviewed its own account for obvious signs of unauthorized activity, such as an unusual number of consumer report requests or blatant irregularities in the information used to make the requests. The FTC also claimed that after the breach occurred, the lender failed to maintain adequate procedures to assess the full scope and nature of the data security breach.

In the current market environment, financial institutions are increasingly permitting third parties to access borrower information in order to provide loss mitigation services, offer refinancing opportunities to distressed borrowers, track loan portfolio performance, or explore new business opportunities. The settlement suggests that the FTC may continue to aggressively enforce the financial privacy protections contained in Title V of the Gramm-Leach-Bliley Act against lenders and other financial institutions. Mortgage lenders and servicers should consider developing and implementing information security programs that include robust auditing and oversight, both internally and with respect to strategic partners and third-party service providers.

For more information, please see: http://www.klgates.com/newsstand/Detail.aspx?publication=5226. Copies of the consent decree and related documents are available from the FTC at: http://www.ftc.gov/os/caselist/0723004/index.shtm.

FSA

FSA Action Suggests Need for Financial Services Firms to Take Effective Anti-Corruption Compliance Measures

Robert V. Hadley and Matt T. Morley

On 5 January 2009 the FSA imposed a penalty of £5.25 million on the insurance brokerage firm Aon Limited because the firm lacked adequate systems and controls to address the risk that third parties would make corrupt payments to assist Aon in winning business in overseas jurisdictions. See http://www.fsa.gov.uk/pubs/final/aon.pdf. The FSA's Final Notice alleged that due to these failures, the firm had made sixty-six "suspicious payments" totalling more than US$5 million. The Final Notice, which Aon consented to, states that the firm's procedures failed to require adequate training of relevant personnel as to bribery and corruption risks, adequate due diligence prior to the retention of third party representatives, and appropriate monitoring of those relationships going forward. In addition, Aon's supervisory committees were not provided with adequate information or otherwise did not assess whether the firm's corruption risks were being effectively managed.

The FSA's action is particularly notable for several reasons.

- While the FSA is not directly empowered with jurisdiction over domestic or foreign corruption offenses, which are ordinarily the responsibility of the police or the Serious Fraud Office ("SFO"), the FSA has a specific statutory objective to prevent financial crime. The Final Notice makes clear that Aon was fined for breaches of FSA Principle 3 ("A firm must take reasonable care to control its affairs responsibly, with adequate risk management systems"). Conceivably, the FSA could also act in such cases under Principle 1 ("a firm must conduct its business with integrity"). Of course, a firm is likely to more readily agree to a public statement of a systems and controls failure than to acting without integrity, but, for the FSA, the level of fine, the publicity, and the resulting deterrent value of the FSA action remains the same.
- Aon already had in place a policy that prohibited corrupt payments such as the ones that came to light. Yet, as US law enforcement authorities have so often emphasized with regard to the US Foreign Corrupt Practices Act, a "paper program" is not enough, and firms must also take additional steps, such as training, due diligence, monitoring and auditing, in a meaningful effort to assure compliance.
- Aon promptly self-reported to the Serious and Organised Crime Agency ("SOCA") and the FSA its discovery of the questionable payments. The firm went on to conduct its own internal review of its anti-bribery systems and controls, and all payments to third party representatives for the previous six years. Aon implemented all recommendations resulting from this review, and took disciplinary action against personnel found to have been involved. Aon co-operated fully with the FSA's investigation. While these steps, and the cost involved, were taken into account by the FSA when assessing/agreeing the financial penalty imposed, the firm did not avoid sanctions.

Margaret Cole, the FSA's Director of Enforcement, said that the fine "sends a clear message to the U.K. financial services industry that it is completely unacceptable for firms to conduct business overseas without having in place acceptable anti-bribery and corruption systems and controls". Ms. Cole added that the FSA "has an important role to play" in U.K. steps against overseas corruption.

There are at least two important messages being sent by the FSA by its action against Aon. First and most clearly, the case makes clear that the FSA expects regulated firms to have effective anti-corruption compliance measures in place – not simply a policy prohibiting corrupt payments, but coordinated efforts to require training of relevant personnel; due diligence on agents and other intermediaries acting on the firm's behalf; monitoring and auditing compliance with the policy; and disciplinary action where violations of the policy occur. Firms that fail to take these steps face potential sanctions under Principle 3.

Beyond this, the Aon case sets the precedent that in the eyes of the FSA regulated firms are required to self-report potential overseas corruption violations to the FSA. FSA Principle 11 provides that "a firm must deal with its regulators in an open and cooperative way and must disclose to the FSA appropriately anything relating to the firm of which the FSA would expect notice." We know the FSA's position from the Aon case, notwithstanding the FSA's lack of criminal jurisdiction over such conduct, and that such matters are discloseable under Principle 11 also follows from the fact that firms are authorised by the FSA and individuals are approved by the FSA on the basis of their being "fit and proper."

Disclosure of such matters may also be driven by the obligation of persons in the regulated sector (very broadly the financial services industry) to inform the SOCA where there is a suspicion of money laundering under the Proceeds of Crime Act 2002. U.K. prosecutors regard any revenue from a contract obtained through a corrupt payment or offer of payment as the proceeds of crime, so that possession or any dealing with such funds is potentially a money laundering offence. Accordingly, the risk of a failure to disclose an offence or the need to set up a defence of SOCA's consent by disclosure to SOCA arises in almost every case where there is a suspicion of corruption. Once the need or obligation to make a report to SOCA is triggered, a regulated firm would be taking a serious risk by not also disclosing to the FSA under Principle 11.

Overseas corruption is a hot topic in England and Wales, and the SFO has also taken recent steps to increase enforcement activity, increasing its manpower dedicated to looking at these matters by over 50% in 2008. Last year saw the first U.K. convictions for overseas corruption, with the conviction of the head of the British company CBRN in connection with security services contracts in Uganda (http://www.guardian.co.uk/uk/2008/sep/23/ukcrime.law). The SFO also reached a settlement with the construction company Balfour Beatty, in which that company admitted to historic accounting irregularities in some of its African operations. Balfour Beatty paid a civil fine of £2.5million and was not subjected to criminal prosecution. This case can be seen as a model for the SFO's efforts to create a culture of self-reporting and to increase deterrence in the overseas corruption field. In this way, the SFO can be seen to be taking enforcement steps without running the risk of a failed prosecution.

Both the SFO's settlement with Balfour Beatty and the FSA's approach to Aon bear a strong resemblance to efforts by the US Securities and Exchange Commission and the US Department of Justice to pursue violations of their anticorruption statute, the US Foreign Corrupt Practices Act. The great majority of such cases are resolved by violators consenting to the entry of court orders finding legal violations and imposing significant financial penalties as well as disgorgement of profits, as in the recent case involving Siemens AG and the imposition of more than $1 billion in fines. As in the Siemens case, a further condition of these kinds of settlements is the creation of remedial programmes and the installment of external monitors, at the company's considerable expense, empowered to review the firm's anti-corruption programmes for several years and report back to law enforcement authorities. Self-reporting of potential violations is also encouraged by US authorities, who state that the consequences of violations will be less severe for those who come forward voluntarily.

It remains to be seen whether the SFO's resolution of the Balfour Beatty case will provide a model for future cases, but in the financial services arena, the die seems to have been cast by the Aon case by the rather straightforward application of the FSA's Principles to require regulated firms to implement anti-corruption compliance programs.

U.K. Banking

U.K. Banking Stabilisation Measures - January 2009 Update

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1. Introduction

Since the introduction of the stabilisation measures we reported in the previous edition of this newsletter, the global economic downturn has intensified, prompting the U.K. government to announce further efforts to combat financial instability and support economic recovery. The new measures both extend and supplement the Special Liquidity Scheme, the Bank Recapitalisation Scheme and the Credit Guarantee Scheme described in the previous edition. They do not have any immediate impact upon the draft legislation we reported previously.

2. Updates on Existing measures

2.1 Special Liquidity Scheme ("SLS") and Discount Window Facility

Upon the closure of the SLS at the end of this month, an alternative source of long-term liquidity will be provided under the discount window facility. This is an existing facility provided by the Bank of England ("BoE") which ordinarily provides liquidity for periods not longer than 30 days and operates on similar principles to the SLS. Under the new proposals, maturity periods of one year will be available with the aim of allowing banks to access longer-term liquidity support on demand. The 30-day facility will continue to be available.

2.2 Credit Guarantee Scheme ("CGS")
The deadline for issuing debt to be guaranteed by this scheme is extended from 9 April 2009 to 31 December 2009. All other aspects of the scheme will remain the same.

2.3 Bank Recapitalisation Scheme
Under this scheme, the U.K. government invested approximately £20bn in the Royal Bank of Scotland plc ("RBS"). The government is converting the £5bn of this stake that are held in preference shares into ordinary shares, thereby increasing its common holdings from 58% to nearly 70%. This conversion will reduce by approximately £6bn the amount of preference dividends that RBS is required to pay each year to the U.K. government. In return, RBS has committed to maintaining lending to large corporations, small businesses and homeowners at 2007 levels and to increase its lending activities by £6bn over the next year. These commitments reflect the government's concern to protect the wider economy from the underlying lack of credit in the financial sector.

2.4 Financial Services Authority ("FSA") on Capital Ratios
The FSA has given additional guidance on its expectations regarding capital ratios for banks. No new requirements are currently being proposed, as the FSA considers that the recent recapitalisation exercise undertaken by certain banks has created a sufficient capital buffer to withstand losses and facilitate new lending. The guidance introduces the concept of counter-cyclical measures so that during good years banks build a capital 'buffer' on which they can draw in harder times. The Basel Committee is now working to develop this principle and it is possible that the regulatory framework may be adapted in the longer term.

2.5 Northern Rock
There has been concern that the timetable set by the government for Northern Rock to repay its loans was requiring it to reduce its mortgage lending too quickly. This reduction was working against the government's desire to expand mortgage lending, and so the deadlines for repayment by Northern Rock have been extended.

3. New Measures

3.1 Additional credit guarantee scheme
As well as extending the deadline of the CGS, the government has proposed a new guarantee scheme, commencing in April 2009, for certain triple-A rated asset-backed securities. Eligible securities may be backed by mortgages and corporate/consumer debt and must have transparent structures. Eligibility for institutions will be by the same criteria as the CGS. Further details on this proposal are expected in the next few months.
The rationale for this scheme is, in part, the need to maintain banks' mortgage lending capacity. Typically, mortgage-backed securities have supported a third of mortgage lending in the U.K., and the government hopes that a guarantee scheme which supports the market in these securities will help to maintain banks' capacity for such lending activity.

3.2 Asset Purchase Facility
The U.K. government is allocating a fund of £50bn to be used by the BoE to purchase certain high-quality private sector assets, including corporate bonds, syndicated loans and asset-backed securities. The programme will come into effect from 2 February 2009, and purchases will be funded by the issue of Treasury bills. The BoE will be authorised to use this facility for monetary policy purposes such as meeting the inflation target. Further details of how this facility will operate are expected before the end of January.

3.3 Asset Protection Scheme ("APS")
The U.K. government, for a fee, will provide banks with insurance against future credit losses on their riskiest assets. The government will assess the likely performance of assets under consideration in order to set the level of probable loss and the fee to be charged. The APS will then cover a substantial part of any loss sustained over and above this probable loss, i.e., the exceptional loss. In addition, in order to incentivise participating institutions to minimise their losses, the institution will also have to bear a proportion (for example, 10%) of the exceptional loss. The scheme is available to U.K.-incorporated authorised deposit takers with more than £25bn of

eligible assets. It intends to target the assets most affected by current economic conditions with a view to reducing uncertainty about the value of such assets. In order to support wider economic recovery, participants will have to provide a commitment to the government to maintain lending to creditworthy borrowers in a commercial manner. Further details of the scheme are expected to be issued by the end of February.

4. Conclusion

The theme running through this latest package of measures is an effort to limit the effect of the financial crisis on the wider economy. In the aftermath of the collapse of a number of high street retailers, and as monthly unemployment increases reach levels last seen in 1991, this objective is understandable. However, it remains to be seen whether the government's proposals will succeed in protecting the wider economy or whether troubles on the high street are already beyond the reach of such protection.