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From the Editors

In the past several weeks, we have witnessed a series of extraordinary events in the financial markets that will change and shape the markets and the financial industry for years to come. In response to these events, K&L Gates has formed a cross-disciplinary Global Financial Markets Group that pulls together a number of our firm's practices, including securities, banking, investment management, hedge funds, mortgage banking and consumer finance, broker-dealer, legislative, litigation, government enforcement, commodities, derivatives, tax, creditors' rights and insurance coverage. In addition to representing clients on issues related to the financial crisis, we will be publishing a regular newsletter that will report on significant developments and provide an analysis of why those developments are important. This is the inaugural issue and we hope that you find this newsletter informative, unique and comprehensive. If there are others in your organization who would like to obtain an electronic copy of the newsletter, go to the K&L Gates Newsstand to register for the newsletter. (<http://www.klgates.com/newsstand>)

Financial Services Reform

Efforts to Stem the Financial Crisis Likely to be Followed by Significant Reform of Financial Services Regulation

Daniel F. C. Crowley and Patrick G. Heck

Recent Policy Responses

The recent public policy responses to the credit crisis have been geared toward restoring liquidity in the credit markets, enhancing transparency, and prohibiting certain trading practices. Foremost among these measures has been H.R. 1424, the Emergency Economic Stabilization Act of 2008 ("EESA" or "the Act"), in response to the Department of the Treasury's ("Treasury") request for authority to spend up to \$700 billion to purchase illiquid assets. The Act is intended to improve the capital positions of financial institutions and allow them to once again extend credit. Other stop-gap measures by the regulatory agencies, as discussed elsewhere in this newsletter, have been geared toward reducing volatility and restoring orderly markets.

EESA, which was passed by the House and signed by President Bush on Friday, October 3, 2008, authorizes up to \$700 billion for the Treasury for a troubled asset relief program (TARP) to purchase, and a Troubled Assets Insurance Financing Fund to insure, illiquid financial instruments.

The Act allows Treasury to immediately use \$250 billion, with an additional \$100 billion if the president certifies such a need. The president would have to provide a written request for the remaining \$350 billion, which could be subject to expedited congressional approval.

The Act

- Creates the Financial Stability Oversight Board, comprised of the Fed Chairman, the Secretaries of Treasury and HUD, the FHFA Director, and the SEC Chairman.
- Creates various reporting and oversight requirements.
- Waives FAR and provides for streamlined contracting procedures.
- Establishes a Congressional Oversight Panel in the legislative branch to “review the current state of the financial markets and the regulatory system.”
- Places limits on senior executive compensation for some participating financial institutions.
- Requires Treasury to develop programs to reduce foreclosures and encourage lenders to modify mortgage terms.
- Prohibits use of the Exchange Stabilization Fund for future money market guarantee programs.
- Authorizes the SEC to suspend mark-to-market accounting (FAS 157).
- Increases the federal budget debt ceiling to \$11.315 trillion.
- Temporarily increases the FDIC insurance limit from \$100,000 to \$250,000.

The text of the Act and a section-by-section analysis may be found on the House Financial Services Committee website:
<http://financialservices.house.gov/>.

EESA Tax Provisions

EESA also contains a number of important tax provisions that have not received a great deal of attention. There are three tax provisions related to the rescue plan:

1. *Extension of exclusion of income from discharge of qualified principal residence indebtedness.* Generally, when homeowners have parts of their mortgages forgiven, they immediately owe income taxes on the amount of indebtedness forgiven. To prevent homeowners from facing higher tax bills, the housing relief bill passed by Congress earlier this year allowed homeowners caught up in the mortgage crisis to avoid paying tax on forgiven mortgage debts through 2009. EESA will extend through 2012 the housing bill provision that forgives income from the cancellation of indebtedness. The proposal does not extend the relief to home equity loans. The Joint Committee on Taxation estimates that this provision will cost \$362 million over ten years.
2. *Gain or loss from sale or exchange of certain preferred stock.* Federal law limits the allowable investments for banks, and many community banks therefore invested in Fannie Mae and Freddie Mac preferred stock – which became worthless when the government bailed out those companies. EESA includes a proposal to allow financial institutions or financial institution holding companies to treat their Fannie and Freddie losses as ordinary losses. Applying to any preferred stock that was owned on September 6, 2008 or sold between January 1 and September 6, 2008, this provision will allow banks to claim the book benefit of the loss on their tax returns, therefore reducing the need to obtain additional capital from the FDIC or investors. Policy makers believe that this proposal should also prevent some community banks from becoming insolvent. The Joint Committee on Taxation estimates that this provision

- will cost \$3.045 billion over ten years, with \$2.7 billion of the cost occurring in 2009.
3. *Special rules for tax treatment of executive compensation of employers participating in the troubled assets relief program.* The EESA contains non-tax measures aimed at limiting executive compensation and “golden parachute” severance packages overall for companies and executives participating in the buyout. Additionally, EESA modifies the tax treatment of executive compensation and severance packages. The deductibility of executive compensation for companies participating in the troubled asset relief program will be cut in half – from the \$1 million level in current law – to \$500,000. Performance-based compensation is included in the \$500,000 limitation. Companies will also lose deductions currently available for excessively large severance packages. Executives receiving severance packages will continue to face a 20 percent excise tax on payments once they reach an excessive threshold, and that tax will now be due if the executive leaves for reasons other than a standard retirement for which they are eligible – not just if the company changes hands, as in current law. The Joint Committee on Taxation estimates that the amount of revenue gain from these provisions is indeterminate as it will depend on how the underlying troubled asset program is implemented.

In addition, the Act extends dozens of expired or expiring tax provisions (the so-called “tax extender package”), including the Alternative Minimum Tax and disaster relief, energy tax incentives and a host of other provisions. Several of these provisions might be of interest to the financial services community. For example, the package includes: 1) broker reporting of a customer’s basis in securities transactions; 2) an extension of tax-free distributions from IRAs to certain public charities through 2009; 3) an extension of the exception under Subpart F for active financing

income through 2009; 4) an extension of the look-through treatment of payments between related CFCs under foreign personal holding company income rules; and 5) the modification of the tax treatment of offshore nonqualified deferred compensation for certain tax indifferent parties. The package does not include a further delay in the implementation of the worldwide interest allocation rules.

Finally, in addition to the various tax provisions listed above, the package contains a provision that would lower the tax preparer standard for undisclosed positions from “more likely than not” to “substantial authority” (the same standard that currently applies to taxpayers) with the exception for tax shelters (reportable transactions to which section 6662A applies).

The Long View

In the slightly longer term, these unprecedented market events will likely lead to the most significant revisions to the legal and regulatory framework for financial services since the Great Depression.

- *Revamping the structure of financial services regulation.* Beginning in January 2009, the 111th Congress will consider comprehensive legislation to restructure the regulation of financial services. A primary consideration will be the respective roles of the Treasury, the Federal Reserve Board, the SEC and the CFTC with respect to oversight of the capital markets. Some of the proposals under consideration were outlined in the Treasury’s March 2008 “Blueprint for a Modernized Financial Regulatory Structure.”
- *Regulation of previously unregulated products and entities.* Current discussions also include new reporting and other regulatory requirements for a broad array of financial products and market participants that have, until now, been subject to relatively little regulation, including commodities, derivatives, hedge funds and sovereign wealth funds. Some products that currently trade over-the-counter may soon be required

to trade on exchanges and, more generally, all market participants with the potential to impact the economy will almost certainly be under increased scrutiny.

- Among the other issues that will likely be considered as part of this comprehensive reform effort are:
 - Credit rating agency reforms,
 - Enhanced government agency enforcement authorities, and
 - Recommendations of the Congressional Oversight Panel created by EESA.
- *Tax.* With respect to federal tax issues relating to investments, determination of the appropriate tax rates on capital gains and dividends and the appropriate tax treatment of derivatives, as well as retirement savings incentives, will receive considerable attention.
- *Retirement Plans.* Finally, there will almost certainly be a renewal of efforts to increase disclosure with respect to defined contribution plan fees.

Our Public Policy & Law group is closely monitoring these developments in order to provide insights to and effective advocacy on behalf of firm clients.

Money Market Funds

Industry and Regulators Respond to Extraordinary Pressures on Money Market Funds

Arthur C. Delibert

Recent turmoil in the securities markets, affecting financial companies in particular, has imposed unprecedented stress on money market funds, as some institutional investors have sought to liquefy their holdings at the very moment that many money funds have found it difficult to raise cash. These pressures have resulted in some extraordinary market and regulatory events. Illustrative of the pressures facing the industry and regulators:

- On September 16, The Primary Fund, a money market series of The Reserve Fund, announced that it had “broken the dollar” – i.e., that the mark-to-market value of its portfolio assets had fallen below \$0.995 per share. (http://www.ther.com/pdfs/Press%20Release%202008_0916.pdf) In fact, the fund said, its per-share net asset value had fallen to 97 cents, primarily from holding paper issued by Lehman Brothers, which had filed for bankruptcy on September 15. This is only the second time a registered money fund has broken the dollar, the last such event having occurred in 1994. (Reserve has subsequently reported that the assets available may be higher than 97 cents per share.)

Subsequently, Ameriprise Financial Services filed suit against The Reserve Fund and its manager, alleging that certain large investors had been tipped off about the Fund’s impending problem, allowing those investors to remove their money before the NAV was reduced.

- On September 18, Putnam Investments announced that it was suspending sales of its institutional Putnam Prime Money Market Fund and would liquidate the fund. Within days, Putnam and Federated Investors, Inc. announced that Federated Prime Obligations Fund would acquire the assets of the Putnam money fund and that all shareholders would receive shares of the Federated fund worth \$1.00 per share.

In the face of these pressures, many money funds have resorted to extraordinary measures:

- Many funds have drawn on lines of credit previously arranged through their custodian banks and others. The Federal Reserve made extra cash available to these banks to fund the loans.
- Some funds have made use of their authority under Section 22 of the 1940 Act to withhold payment on redemption orders for up to seven days, rather than the same-day or overnight payment offered in fund prospectuses “under normal circumstances.” Such extensions can be difficult for customers, who expect to have prompt access to assets held in money funds.
- Other funds have used authority reserved in their prospectuses to pay redemptions through the in-kind distribution of portfolio securities. These distributions potentially raise two questions under the 1940 Act:
 1. Funds may have filed with the SEC irrevocable elections under Section 18 of the 1940 Act, allowing them to make redemptions in kind for shareholders seeking redemptions in excess of \$250,000 or 1% of the fund’s net assets, whichever is less, in any 90 day period, but committing them to pay lesser redemptions in cash. Such filings have become less common since 1996, meaning that some funds have greater flexibility in this area.

2. Redemptions paid in kind to shareholders that are affiliates of the fund because they hold 5% or more of the fund’s outstanding securities may raise questions under Section 17 of the 1940 Act, which restricts principal transactions with affiliates. Funds can rely on a 1999 no-action letter issued by the SEC staff, which permits in-kind payments to affiliates provided the fund’s board either approves the transaction or has adopted certain procedures to assure the fairness of such distributions.

There have also been extraordinary actions from the regulators:

- Some money funds have sought permission from the SEC under Section 22(e) of the 1940 Act to suspend redemptions. On September 22, the SEC issued an order (effective as of September 17) authorizing two Reserve Funds to suspend redemptions for an indefinite period, while they engage in an orderly liquidation. (<http://www.sec.gov/divisions/investment/guidance/reservefundmmffaq.htm>)
- On September 19, the Federal Reserve temporarily exempted member banks from provisions of the Federal Reserve Act to permit the banks to purchase asset-backed commercial paper from affiliated money market funds. (<http://www.federalreserve.gov/newsevents/press/monetary/20080919c.htm>)

On September 25, the SEC staff issued a no-action letter permitting such purchases. Such purchases by fund affiliates would normally raise issues under Section 17 of the 1940 Act. Rule 17a-9 permits fund affiliates to purchase securities from money market funds if they are no longer “eligible securities” under Rule 2a-7 – i.e., if they have deteriorated in quality. The no-action letter permits such purchases even if the security is still eligible.

- On September 19, the Treasury announced a program of money market fund insurance. Funds wishing to apply for the insurance must do so by Wednesday, October 8. (<http://www.treasury.gov/press/releases/hp1161.htm>)

According to the announcement, Treasury is establishing this program under existing authority, using the \$50 billion Exchange Stabilization Fund. Treasury's authority may be limited somewhat by the Economic Stabilization Act which, as of this writing, is still under consideration by Congress. The insurance initially will be available for a period of three months, at which point Treasury may renew it for a total period of up to a year, but participating funds would be required to pay an additional fee.

The insurance applies only to assets in a fund on September 19, the day the program was announced. This limit was apparently adopted at the urging of the banking industry, which was concerned that if money fund insurance were available for unlimited amounts of new assets flowing into the funds, large deposits would flee the banks. The program is available only to funds registered under both the 1933 Act and the 1940 Act.

Funds wishing to apply to the program must obtain approval of their boards of directors, as the application requires that the board, including a majority of independent directors, determine that "entering into" the Guarantee Agreement, as well as "fulfillment of its obligations ... are in the best interests of the Fund and its shareholders." Fund boards must take into consideration a number of factors before entering into such an Agreement.

Short Selling Regulations

Recent Short Selling Regulations and Their Potential Impact on Financial Markets

Kay A. Gordon and Mark D. Perlow

In response to the recent extraordinary events in the U.S. and worldwide markets, during the past two weeks the Securities and Exchange Commission ("SEC") adopted a series of emergency regulatory measures regarding short sales of securities. First, on September 17 and 18, 2008, the SEC issued orders temporarily banning short sales in certain financial stocks and requiring certain institutional money managers to report their new short sales of certain publicly traded securities on new Form SH (collectively, the "Emergency Orders"). The SEC also amended Regulation SHO and Rule 10b-18 under the Securities Exchange Act of 1934 to prohibit "naked" short selling—the short sale of securities that one has not already borrowed—and adopted a new antifraud rule, Rule 10b-21, aimed at manipulative and deceptive practices in short selling. In addition, the SEC chairman announced enforcement initiatives aimed at preventing "naked" and "manipulative" short selling. The SEC has taken these actions in the hope that they would help to restore fair and orderly markets and curtail declines in securities prices. On October 1, the SEC extended all of these emergency measures until October 17. However, the ban on selling certain financial stocks provided that it would expire after the effectiveness of the EESA. Therefore, the ban expires on Wednesday October 8 at 11:59 p.m.

On September 21, the SEC amended the Emergency Orders to expand (1) the list of issuers in whose securities the SEC has temporarily banned short selling, (2) the scope and duration of certain market maker exceptions, and (3) the types of securities exempted. The SEC also stated that institutional investment managers' short sale disclosures would be non-public for two weeks

after filing. The SEC adopted these amendments to address the current and anticipated technical and operational issues raised by the Emergency Orders, as well as to coordinate with similar actions restricting short sales by foreign regulators.

In addition to the actions of the SEC, the U.K. Financial Services Authority and the French, German, Australian and many other regulators have adopted similar restrictions on short selling and, in certain cases, increased short selling disclosure requirements in an effort to restore market integrity and stability in these extreme market conditions. Consequently, the policy level response to the perceived threat and the uncertainty generated by naked short selling was global, if not globally coordinated, in practice making it difficult for any manager to engage in forum shopping.

Many financial institutions, lawmakers and regulators have supported the SEC's ban and limits on short sales, based on their concern that short sellers have contributed to the current market turmoil by spreading false information and using manipulative trading tactics. In contrast, many hedge fund managers and other investors have objected to these measures, suggesting that risk management failures and poor business strategies are to blame for the current market instability. They have argued that short selling provides liquidity and an important price discovery mechanism in the market and that the inability of managers to engage in short selling with respect to certain securities may adversely affect the markets both in the long and short terms. Critics of the ban also point out that a temporary SEC order banning naked short selling in July failed to prevent the decline of stock prices while it was in effect.

The increased disclosure obligations have also given rise to concerns that managers will have to disclose proprietary methods and that companies whose securities are being sold short would retaliate against these managers when the managers' short positions are publicly released.

The short selling ban may have also been particularly damaging to certain quantitative funds, which were left unable to implement their disclosed and intended strategies. In addition, short sellers were also constrained on another front: many institutional investors that lend portfolio stock holdings have been recalling their stock, and some have suspended their stock lending programs altogether, which has made it harder or more expensive to borrow certain stocks. Some industry participants believe that short sellers will adjust to the ban by switching to other instruments that are not subject to the ban, e.g., single stock futures and options, whose price movements will ultimately be reflected in the prices of the affected stocks.

Short Selling and Manipulation Investigations

Manipulation Tied to Short Selling a Top Enforcement Priority

Brian A. Ochs

On September 19, 2008, the SEC announced a "sweeping expansion" of its ongoing investigation into possible market manipulation in connection with short selling in the securities of financial institutions.

(<http://www.sec.gov/news/press/2008/2008-214.htm>) The investigation is focused on broker-dealers, hedge fund managers, and institutional investors with significant trading activity in financial issuers and with positions in credit default swaps.

As part of the investigation, the SEC is invoking its authority under section 21(a) of the Securities Exchange Act of 1934 to require certain information in the form of sworn, written statements. According to published reports, the first of these demands was sent out on September 22 to more than two dozen hedge fund managers, requiring information relating to AIG, Goldman Sachs, Lehman Brothers, Merrill Lynch, Morgan Stanley, and

Washington Mutual. The SEC seldom invokes its section 21(a) power in enforcement investigations — usually opting to subpoena documents and testimony instead — and the fact that the Commission is doing so in this instance indicates the speed and seriousness with which the SEC plans to pursue these investigations.

The SEC's expanded investigation promises heightened scrutiny of two issues which have been the subject of enforcement focus since early this year: the dissemination of false rumors to the marketplace as part of short selling schemes and abusive "naked" short selling.

False rumors and short selling

- Last April, the SEC brought its first case alleging that a trader engaged in market manipulation by selling a company's stock short at the same time that he intentionally disseminated a false rumor that had a depressing effect on the stock price. See *SEC v. Paul S. Berliner* (April 24, 2008). (<http://www.sec.gov/litigation/litreleases/2008/lr20537.htm>) Other investigations are in progress, as well as an industry-wide sweep examination undertaken in conjunction with FINRA and the NYSE, that is focused on whether broker-dealers and investment advisers have reasonable controls and procedures to prevent the intentional creation or dissemination of false information. (<http://www.sec.gov/news/press/2008/2008-140.htm>)
- Given the prevalence of rumors of all types in the investment community, and how quickly rumors can spread, a key challenge to the SEC in any investigation will be to determine who is responsible for disseminating false rumors and whether those persons acted intentionally and with knowledge that the rumors were false.
- At the same time, the SEC's focus on firm procedures indicates that the SEC will be looking to bring enforcement actions not only

against individuals who are responsible for creating or disseminating false rumors, but also against any broker-dealers or investment advisers in the rumor chain that the SEC determines had lax oversight.

- Complicating matters is the fact that, on September 18, New York Attorney General Andrew Cuomo announced his own investigation into allegations of short selling in financial securities based upon false information. NYAG involvement not only increases pressure on the SEC to bring cases in this area, but is also a direct and formidable threat to the individuals and entities under scrutiny. Unlike SEC Enforcement staff, New York's Assistant Attorneys General have considerably fewer levels of bureaucracy to wind through before they can bring a case - as they have repeatedly demonstrated in matters involving market timers, insurance brokers, lenders, ratings agencies, and purveyors of auction-rate securities, to name a few. Contrary to popular belief, Section 352 et seq. of NY General Business Law (aka the "Martin Act") is not without its jurisdictional limitations and defenses, but it is nonetheless a potent starting point for the NYAG. Subpoenas issued thereunder must be handled with considerable caution.

"Naked" short selling

- SEC Chairman Christopher Cox has observed that naked short selling can "turbocharge" false rumor/manipulation schemes. (<http://www.sec.gov/news/speech/2008/spch072408cc.htm>)
 - Generally, the SEC defines naked short selling as "abusive" when the seller does not have shares available for delivery and intentionally fails to deliver stock within the standard three-day settlement cycle.
- On September 18, 2008, the SEC adopted Rule 10b-21, which had been proposed in March 2008 to address the problem of short

sellers who deceive broker-dealers or others about their intention or ability to deliver securities in time for settlement. The rule formed part of the SEC's response, in the current financial crisis, to concerns about possible false rumors and abusive naked short selling of financial institutions and other issuers.

- Rule 10b-21 prohibits any person from submitting an order to sell an equity "if such person deceives a broker or dealer, a participant of a registered clearing agency, or a purchaser about its intention or ability to deliver the security on or before the settlement date, and such person fails to deliver the security on or before the settlement date."
(<http://www.sec.gov/rules/other/2008/34-58572.pdf>)
- In adopting the rule, the SEC noted that while, in its view, naked short selling as part of a manipulative scheme was already prohibited under general antifraud provisions, Rule 10b-21 is intended to highlight the specific fraud liability of persons who deceive other participants about their intention or ability to deliver securities in time for settlement.

Of course, when short selling is facilitated by deceptive practices – such as intentionally spreading false rumors or misleading other participants about an intention to deliver stock – there is little doubt that the SEC can bring a case for securities fraud. Another example of deceptive practices might be the use of nominee accounts or similar efforts to disguise the identity of the short seller. But what if short selling is done in the open, with no accompanying acts of deception, albeit in large amounts and with the intent to drive a company's stock price down?

- The SEC takes the position that even open trading, when done for a manipulative purpose (so-called "open market

manipulation"), is fraudulent. See, e.g., *SEC v. Masri*, 523 F. Supp. 2d 361 (S.D.N.Y. 2007). Thus, the Division of Trading and Markets has cautioned that "short sales effected to manipulate the price of a stock are prohibited" as an "abusive" short sale practices.

(<http://www.sec.gov/spotlight/keyregshoissue.s.htm>)

- Courts have taken varying positions on whether "open market manipulation," without other deceptive conduct, can give rise to a cause of action. However, in a recent opinion dealing with aggressive short selling by purchasers of "toxic convertible" securities, the U.S. Court of Appeals for the Second Circuit held that "short selling – even in high volumes – is not, by itself manipulative. ... To be actionable as a manipulative act, short selling must be willfully combined with something more to create a false impression of how market participants value a security." *ATSI Communications, Inc. v. Wolfson*, 493 F.3d 87 (2d Cir. 2007).

Given the Second Circuit precedent, in any future cases directed at aggressive short selling, the SEC will likely seek to allege other deceptive conduct in addition to short sales. However, in light of the SEC's need to demonstrate a strong response to the current crisis, the Commission can also be expected to press its theory that short selling, even if unaccompanied by any other deceptive practices, is unlawful if done for the purpose of depressing a company's stock.

Credit Default Swaps

Fannie / Freddie Takeover Leaves CDS Investors PO'd

Gordon F. Peery

When Fannie Mae and Freddie Mac were placed into conservatorship on September 7,

2008, several leading dealers uncontroversially agreed that a bankruptcy credit event had occurred on credit derivative transactions referencing either of those institutions. The occurrence of a credit event gave protection buyers the right to settle the transaction in exchange for a payment to compensate it for the loss of market value of specified deliverable obligations of the reference entity. As it has done in the case of previous credit events on widely traded reference entities, the International Swaps and Derivatives Association (“ISDA”) has introduced an auction protocol to facilitate settlement of transactions by providing for cash settlement as an alternative to physical settlement.

A controversy arose over whether the principal-only component of debt securities issued by Fannie Mae and Freddie Mac (“PO Strips”) should be included in the list of deliverable obligations that could be valued for purposes of settlement. This was an important issue for transaction counterparties because the buyer of protection on a credit default swap has no obligation to mitigate loss and is entitled to select the qualifying obligations that are “cheapest to deliver,” i.e., that have fallen most in value. Unusually for a reference entity’s obligations following a credit event, most Fannie Mae and Freddie Mac debt obligations traded at or above par after the credit event occurred when it became clear that the United States would guarantee all debt securities of Fannie Mae and Freddie Mac on an equal basis.

Protection buyers would have benefited from the inclusion of PO Strips in the list of deliverable obligations because those obligations continued to trade below par following the credit event, reflecting that the market value of stripped securities depends not only on the issuer’s perceived creditworthiness but also on broader market factors such as interest rates and inflation. On cash settlement of a credit derivative transaction, a protection buyer would have been entitled to receive a payment equal to the difference between the notional amount of the transaction and the

market value of the PO Strip selected for valuation. ISDA’s board of directors concluded that Fannie Mae and Freddie Mac PO Strips cannot be delivered in settlement of credit derivative transactions because they do not technically constitute “borrowed money” as defined in the 2003 Credit Derivatives Definitions. This conclusion is based in part on the fact that as a stripped security a PO Strip represents only part of a repayment obligation, and is also based on the conclusion that a PO Strip is not issued as a “bond” or “note” by the relevant issuer but is rather a product of the book-entry rules for obligations of each GSE in book-entry form on the Federal Reserve Banks’ book-entry system because the stripping of debt securities into interest and principal components occurs after their “issuance.”

Insurance Regulatory Developments Affecting Credit Derivatives

On September 22, 2008, the New York State Department of Insurance issued Circular Letter No. 19, which sets forth best practices for financial guarantee insurers. Circular Letter No. 19 announced new guidelines that, for the first time, will establish that some credit default swaps that have previously not been subject to state regulation as insurance products will be deemed to constitute “the doing of an insurance business” within the meaning of Section 1101 of the New York Insurance Law. The new guidelines, which will be effective January 1, 2009, establish that a credit default swap will be considered an insurance contract when the buyer owns or is reasonably expected to own the reference obligation. In essence, a party who owns the reference obligation for a credit default swap will be presumed to have entered into the transaction in order to obtain indemnification for loss on that obligation. Under the new guidance, credit default swaps would be subject to regulation and will be issuable only by entities licensed to conduct insurance business. The guidance does not extend to so-called “naked swaps,” which are

not insurance and cannot be regulated by state insurance authorities.

Fair Value Accounting

SEC and FASB Relax Fair Value Rules

Mark D. Perlow

On September 30, the SEC Office of the Chief Accountant and the FASB staff provided guidance on fair value under FAS 157, addressing when internal assumptions can be used to measure fair value, when to use broker quotes, and when transactions in disorderly or inactive markets represent fair value. FAS 157, which became effective in November 2007, defines fair value as the price that would be obtained in an orderly transaction between market participants in the principal or most advantageous market.

The SEC's guidance came in response to banking industry complaints that the emphasis under FAS 157 on such market valuations for financial assets was forcing banks to write down performing assets to "fire sale" or distressed prices, compelling them to sell more assets to raise capital and thereby depressing prices further in a downward spiral. Many supporters of FAS 157, including investors' groups, expressed the view that market values gave a more accurate picture of the health of financial institutions than values based on cost or cash flow models.

The SEC rarely involves itself in FASB policy making, and its action is clearly an attempt to reach a compromise between the two positions: the SEC relaxed the interpretation of some of FAS 157's market valuation provisions but did not suspend market valuation, as some have requested.

Some of the key elements of the SEC/FASB guidance are:

- Distressed or forced liquidation sales are not orderly transactions, and thus the fact that a

transaction is distressed or forced should be considered when weighing the available evidence. Unfortunately, the only further guidance that the SEC and the FASB give is that "determining whether a particular transaction is forced or disorderly requires judgment." However, by placing this determination in the realm of judgment, the SEC can still second-guess the firm that follows in good faith a strong, well-documented, consistent and independent process.

- FAS 157 sets forth a three-tier framework for disclosure of fair values, where Level 1 prices derive from trades in an active market, Level 2 prices derive from observable inputs, or prices in related markets, and Level 3 prices derive in part or whole from unobservable inputs such as models. The SEC's guidance states that, in some cases, using internal assumptions and unobservable inputs (e.g., an internal discounted cash flow model) may be more appropriate than using observable inputs (e.g., prices in markets for similar but not identical securities). For instance, if the observable inputs (say, prices in related markets) require too many adjustments and the internal model is more accurate, under the guidance the Level 3 price would be more appropriate. Before the SEC's guidance, many market participants interpreted this disclosure hierarchy as implying that Level 3 prices were less appropriate than Level 2 prices.
- Broker quotes are not necessarily fair value if there is no active market in the security, defined as a market in which transactions occur with sufficient frequency and volume to provide pricing information on an ongoing basis.
- A significant increase in the bid-ask spread or the existence of a relatively small number of bidders are indicators that may suggest that a market is inactive.

- Broker quotes based on models warrant less weight than those based on market transactions.
- Whether a broker is giving an “accommodation” quote (i.e., one not binding on the broker) “should be considered”, which probably means that such quotes deserve less weight in pricing judgments.

Bank Control

Federal Reserve Relaxes Definition of Control under Bank Holding Company Act

Edward G. Eisert and Rebecca H. Laird

On September 22, 2008, the Board of Governors of the Federal Reserve issued a new policy statement on equity investments in banks and bank holding companies (the “Policy Statement”). The Policy Statement was widely seen as a response to complaints by private equity firms seeking to make recapitalizing equity investments in troubled banks that the existing guidelines posed too great a risk of subjecting them to regulation as bank holding companies. In certain respects, the Policy Statement liberalizes and clarifies the guidelines that the Federal Reserve has applied since 1982 in determining whether a company controls a bank, bank holding company, or whether a bank or bank holding company controls another company such as a non-banking firm. At the same time, the Policy Statement reemphasizes the Federal Reserve’s belief that whether an investor has a controlling influence over a banking organization or a non-banking firm depends on all of the facts and circumstances of each case.

The primary indicia of control addressed in the Policy Statement are: (1) director representation (one and, in some cases, two directors, would be permissible); (2) total equity (in some cases up to one-third of total equity would be permissible); (3) the extent and

subject matter of consultation with management (for example, advocacy regarding strategic decisions is permitted, but not “if accompanied by explicit or implicit threats to dispose of shares in the banking organization or to sponsor a proxy solicitation as a condition of action or non-action by the banking organization or management”); (4) business relationships (relationships are permitted that are “quantitatively limited and qualitatively nonmaterial, particularly in situations where an investor’s voting securities percentage in the banking organization [is] closer to 10 percent than 25 percent”); and (5) and the existence of covenants granting the investor approval or veto rights with respect to strategic decisions and management (“covenants that substantially limit the discretion of a banking organization’s management over policies and decisions suggest the exercise of a controlling influence”).

Despite its helpful guidance, the Policy Statement does not eliminate the concerns of private equity firms and other investors that wish to take larger equity stakes in, and have greater influence over, banking organizations than permitted under the prior guidance. For example, without more, there is a significant risk that a minority investor could be deemed to control a banking organization if it holds the largest percentage of equity, particularly if its combined ownership of voting and non-voting stock exceeds twenty-five percent. Private equity firms also must consider whether the greater latitude provided by the Policy Statement does, in fact, provide sufficient comfort (absent consultation with the Federal Reserve) for them to increase their targeted equity stake and board representation in a banking organization, particularly if their investment programs contemplate having significant influence over corporate strategies and material business decisions.

Lehman Prime Brokerage Assets

Lehman Brothers UK Insolvency Ties Up Prime Brokerage Assets

Edward Smith

On September 15, 2008, Lehman Brothers and its UK subsidiaries — Lehman Brothers International (Europe), Lehman Brothers Ltd, LB Holdings PLC, and LB UK RE Holdings Ltd — declared bankruptcy. On the same day, partners in PricewaterhouseCoopers LLP were appointed joint administrators of the UK entities.

The administrators' role will be to wind down the UK Lehman companies in an orderly manner. Administration is a procedure intended to either rescue an insolvent company or to realise a better value from its assets than on a liquidation. To do so, the administrators will take over the running and management of the companies. Administration introduces a statutory moratorium, or stay. This means that no action can be taken or continued against the companies or their property, without the consent of the administrators or the leave of the Court. Importantly, contractual set-off and close-out netting provisions will not be affected by the moratorium.

Administration does not, in itself, terminate contracts to which the Lehman entity is party. However, contracts may contain automatic insolvency termination clauses which permit the counterparty to terminate the contract on insolvency or the appointment of an administrator.

Many of Lehman's prime brokerage clients have tried to terminate their prime brokerage agreements ("PB Agreements") in order to crystallise their position and gain some certainty. However, the standard Lehman documentation is one-sided and, in many cases, does not permit the client to terminate on Lehman insolvency or default. Equally, the close-out provisions may favour the Lehman entity — the client may not be entitled to

exercise set-off unless and until all amounts owing to the Lehman entity have been settled.

In many cases PB clients have transferred collateral (in the form of cash or securities) to the Lehman entity. Many of the PB Agreements that we have reviewed provide that title to collateral passes to the Lehman entity and permits the Lehman entity to charge, transfer or sell the collateral. Any requirement to treat the collateral as "client money", in accordance with FSA rules, has usually been waived. In such cases, it is likely that the client has given up its proprietary rights in the collateral. Instead it will only have an unsecured claim in the administration for delivery of collateral "equivalent" to the original collateral. The value of the client's unsecured claim will depend on how much money is ultimately available for distribution. In some circumstances clients may be entitled to lodge a claim for compensation with a statutory fund. However, the tests for eligible applicants are prescriptive and the maximum amount of compensation is relatively small.

As a result, many PB clients have found that their assets are tied up at a Lehman entity and can only be claimed through the administration process. If, however, a Lehman entity has provided custodial services to a PB client, the client has a priority claim on those assets, and steps can and should be taken to contact the administrators to procure the return of the client's assets.

CFTC: Swap Dealer Reporting Requirements

CFTC to Propose New Rules Affecting Swap Dealers' Trading and Trade Reporting

Charles R. Mills and Lawrence B. Patent

Responding to Congressional pressure to improve the transparency of futures market activity of swap dealers and index traders, the

CFTC will be issuing rule proposals that could, among other things, increase swap dealers' futures trading reporting obligations and impose new terms for them to qualify for exemptions from regulatory limits on the number of futures positions they may hold. The proposals are intended to effectuate recommendations contained in a CFTC staff report released September 11, 2008, including the following:

- ***CFTC to separately report swap dealer futures position.*** The CFTC issues a weekly Commitments of Traders Report, which provides a breakdown of each Tuesday's open interest for futures markets in which 20 or more traders hold futures positions required to be reported by CFTC rules. This information is currently sorted into categories of "commercial" and "non-commercial" traders, with swap dealers' futures transactions included in the "commercial" category. The anticipated rule proposal would for the first time report swap dealers under a separate "swap dealer" classification.
- ***Swap dealers may be required to report client information.*** One of the provocative, albeit still opaque aspects, of the rulemaking will be to propose the creation of a supplemental CFTC market report that will disclose information regarding the particular types of trading by the swap dealers' counterparties.
 - The staff describes the contemplated report as one designed to "look through from swap dealers to their clients and identify the types and amounts of trading occurring through these intermediaries, including index trading." Details about the scope, content and source of information for the supplemental report must await the CFTC's proposing release, but the descriptions in the staff report suggest that swap dealers may be required to gather and report discrete information about the relationship between the swap transactions and the counterparties' futures market positions.
 - This could put swap dealers in the perhaps undesirable position of requiring clients to disclose to them otherwise sensitive, confidential proprietary trading information that clients would not otherwise disclose. It also would create a seemingly incongruous regimen that makes entering into swap transactions that otherwise are fully excluded from the reach of the Commodity Exchange Act a triggering event for gathering and reporting on clients' futures market positions, at least on an aggregate basis.
- ***Changes to the hedge exemption for swap dealers.*** The CFTC also instructed the staff to develop an advance notice of proposed rulemaking to solicit comments on whether the current exemption from regulatory limits on the number of open futures contracts a trader may hold that is accorded to hedge positions should be eliminated for swap dealers and replaced with something different. The CFTC will solicit comment regarding whether exemption from position limits for swap dealers should be governed by a new "risk management" exemption that would require a swap dealer to agree to:
 1. report to the CFTC and applicable self-regulatory organizations whenever certain "non-commercial" swap clients reach certain position levels in related exchange-traded futures contracts and/or
 2. certify that none of a swap dealer's "non-commercial" swap clients exceed specified position limits in related exchange-traded contracts.

This proposal, too, could be problematic for swap dealers by making them the "cop on the block" to police their clients' futures positions, even when the swap dealer does not carry those

positions for the client and does not otherwise have independent access to the information.

Mortgage Banking and Consumer Credit

Second Circuit Rules on Federal Preemption for Third Party Agents of National Banks

Nanci L. Weissgold and Philip M. Cedar

The United States Court of Appeals for the Second Circuit held that the National Bank Act (“NBA”) limits the ability of states to regulate tax preparers that facilitate tax refund anticipation loans (“RALs”) for national banks. The decision in *Pacific Capital Bank, N.A. v. Blumenthal* is of particular interest to any federally regulated lender (national bank, federal savings association, or operating subsidiary of either) that relies on third party agents (including brokers) to source loans or other bank products.

At issue was a Connecticut statute that capped interest rates on RALs. National banks were exempt from the law by its terms (and federal law would have preempted it for national banks anyway), but the Connecticut Attorney General concluded in a legal opinion that a tax preparer or other party that facilitated an RAL with an interest rate in excess of the statutory cap violated the statute, even if the lender was a national bank.

The court held that federal law preempted the interest rate limitation for facilitators of RALs made by national banks, at least in connection with RALs made through the arrangement at issue in the case, finding that “the natural effect” of enforcing the interest rate limits against facilitators that assist national banks offering RALs “would . . . be either to prevent a facilitator from assisting such national banks with respect to RALs or to cause it to refuse such assistance unless the national banks agreed to forgo their NBA-permitted rates and limit themselves to the lower rates specified by” the

Connecticut law. The court concluded that “[i]f a state statute subjects non-bank entities to punishment for acting as agents for national banks with respect to a particular NBA-authorized activity and thereby significantly interferes with national banks’ ability to carry on that activity, the state statute does not escape preemption on the theory that, on its face, it regulates only non-bank entities.”

The court’s reasoning could extend past the RAL context to other situations where states try to regulate parties that arrange loans for federally regulated lenders. For example, this decision calls into question whether recently enacted state laws that prohibit mortgage brokers from arranging loans that do not meet certain underwriting standards could be applied to brokers when they are arranging loans for federally regulated lenders.

HUD/VA/GSE Developments

Moratorium on Risk-Based Premiums for FHA-Insured Loans

In July 2008, HUD shifted its mortgage insurance premium structure to a risk-based structure based on a combination of borrower credit scores and loan-to-value ratios. In response to the FHA Modernization provisions of the Housing and Economic Recovery Act of 2008, however, HUD is now required to implement a one-year moratorium on its new risk-based premium structure. HUD recently released Mortgagee Letter 2008-22, which, effective October 1, 2008, rescinds the Department’s risk-based premium guidance and sets forth new requirements for up-front and annual mortgage insurance premiums for FHA-insured loans. The Mortgagee Letter also provides guidance with regard to the use of borrower credit scores to assess a borrower’s credit risk. For instance, FHA has determined that borrowers with decision credit scores below 500 and with loan-to-value ratios at or above 90 percent are not eligible for FHA-insured mortgage financing. Such a provision appears to be HUD’s attempt to salvage some

parts of its now-rescinded risk-based premium insurance program.

(<http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/08-22ml.doc>)

Borrower Downpayment Requirement Increases for FHA-Insured Loans

Until the recent enactment of the Housing and Economic Recovery Act of 2008, FHA guidelines required borrowers to make a 3% cash investment in the transaction, which could include a downpayment and borrower-paid closing costs. This requirement will change effective January 1, 2009, and HUD recently released Mortgagee Letter 2008-23 to provide guidance to mortgage lenders regarding these changes. Notably, for all new FHA case number assignments on or after January 1, 2009, the Mortgagee Letter advises that a borrower must make a 3.5% cash downpayment, and closing costs may not be used to meet the minimum amount. Moreover, given the 3.5% downpayment requirement, the appropriate loan-to-value ratio for all purchase-money mortgages will be 96.5%. Thus, to determine the maximum mortgage amount for which FHA borrowers are eligible, lenders will be required to apply the 96.5% figure to the lesser of either (i) the appraiser's estimate of value; or (ii) the contract sales price for the property (minus any required adjustments, such as seller concessions above 6% of the sales price).

(<http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/08-23ml.pdf>)

Broker Advisors No Longer Permitted in HECM Transactions

The Housing and Economic Recovery Act of 2008 also enacted provisions affecting Home Equity Conversion Mortgages ("HECM"), which are FHA-insured reverse mortgage loans. One such provision requires that all parties that participate in the origination of HECM loans must be approved by HUD.

While this language itself does not appear to be groundbreaking, its effect is sure to change the way many HECM loans are currently originated - namely, with the assistance of non-approved advisors. In response to the Housing and Economic Recovery Act of 2008's HECM requirements, HUD recently issued Mortgagee Letter 2008-24, which effectively outlaws the use of non-FHA-approved advisors in connection with HECM transactions. It does so by rescinding Mortgagee Letter 2008-14, which HUD issued in May 2008. Beginning with case number assignments made on or after October 1, 2008, only FHA-approved mortgagees may participate and be compensated for the origination of HECM loans. As a result, the use and compensation of "advisors" in connection with the origination of HECM loans may no longer be permissible.

(<http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/08-24ml.doc>)

Freddie Mac Underscores Requirements Related to Quality Control Reviews

On September 4, 2008, Freddie Mac released an Industry Letter to its approved sellers and servicers as a reminder of Freddie Mac's requirements related to post-funding quality control underwriting reviews. Notably, the Industry Letter highlighted many of the timing requirements imposed on seller/servicers. For instance, if a loan is selected for a post-funding quality control review, the seller/servicer must submit the requested loan file to Freddie Mac within 15 days of Freddie Mac's request. If Freddie Mac discovers any underwriting deficiencies with the loan, the seller/servicer has 30 days from the date of Freddie Mac's request to take remedial action. Similarly, if Freddie Mac requires repurchase of a loan following a post-funding quality control review, the seller/servicer must appeal the action or else remit the repurchase funds within 30 days from the date of Freddie Mac's letter requiring repurchase. Freddie Mac emphasizes in the Industry Letter that these requirements are not new ones. Rather, given the

unprecedented times in the mortgage market, Freddie Mac expects to increase its quality control efforts.

(<http://www.freddiemac.com/sell/guide/bulletins/pdf/090408indltr.pdf>)

State Developments

Illinois Imposes Default and Foreclosure Reporting Requirements on Servicers

Many state regulators, such as those in New York and North Carolina, have begun imposing reporting requirements on mortgage servicers so that they can get a handle on the severity of loan delinquencies, defaults, and foreclosures, and perhaps an early warning before those borrowers get into trouble. With little prior notice, Illinois regulators joined those states, announcing new biannual reporting obligations on loan servicers. In addition to asking for statistical information about modifications, the reporting form asks servicers to provide narrative descriptions of such things as the servicers' proactive loss mitigation steps, "including calls and mailings to borrowers" and "participation at community outreach events." The first of these reports is due this week.

- Default & Foreclosure Report - Filing Deadline: Oct. 1, 2008
- Loan Servicer Questionnaire - Due: Sept. 30, 2008

Massachusetts Applies Community Investment Regulations to Mortgage Lenders and Brokers

Community-type reinvestment provisions are common fare for depository institutions, but that has not been true for non-depository lenders, such as mortgage lenders and brokers. That has now changed in Massachusetts, where community investment regulations applicable to mortgage lenders and mortgage brokers became effective on September 5, 2008. The regulations implement a new provision of that state's licensing law, which was passed as part of the state's response to the foreclosure crisis.

The statute and implementing regulations subject Massachusetts mortgage lenders and

brokers to standards that are very similar to those set forth in the federal Community Reinvestment Act of 1977 ("CRA").

Mortgage lenders and mortgage brokers will be assessed on their record of meeting the mortgage credit needs of borrowers in Massachusetts, including low- and moderate-income neighborhoods and individuals. The assessment will be based upon a lending test and a service test — but not an investment test — that are similar to those applicable to banks. A licensee's community investment rating will affect the procedures for it to obtain approvals of any applications, including license renewals, establishment or renewal of any branch, and mergers and acquisitions.

The consequences of a poor record under the new regulations for a mortgage lender may be far greater than a poor CRA record for a bank. A poor record could possibly result in non-renewal of a license, which would force a mortgage lender to cease lending operations in Massachusetts.

(http://www.mass.gov/?pageID=ocamodulechunk&L=4&L0=Home&L1=Government&L2=Our+Agencies+and+Divisions&L3=Division+of+Banks&sid=Eoca&b=terminalcontent&f=dob_209cmr54&csid=Eoca)

While the federal government continues to struggle with the foreclosure crisis, states are adopting a variety of approaches to slow down foreclosures in their communities. New Jersey is the latest to join the ranks of more than ten other jurisdictions that have enacted such laws during 2008, but the New Jersey law takes a novel approach by extending the introductory rate of an adjustable rate mortgage for 3 years.

Effective September 15, 2008, AB 2780, the Save New Jersey Homes Act of 2008 applies to certain borrowers with adjustable rate mortgages who have received a foreclosure notice with respect to their principal residence and whose introductory rate or rate reset terms meet defined criteria. To be eligible for this three-year rate relief and the statutory suspension of foreclosure proceedings, the

borrower must, among other things, certify that he or she does not have sufficient income to pay the monthly payments after the rate resets, and agree to repay all deferred interest at the time the mortgage is paid off. The Save New Jersey Homes Act of 2008 requires creditors to send written notices containing prescribed language and carries significant penalties for willful violations of its terms.

(http://www.njleg.state.nj.us/2008/Bills/AL08/86_.PDF)

State Foreclosure Prevention Working Group Issues Data Report #3

The State Foreclosure Prevention Working Group, a multi-state group made up of state attorneys general and state banking regulators, recently issued its third report on the performance of subprime mortgage servicing, calling the evidence “profoundly disappointing.”

Over the past year, the Working Group has been collecting data from servicers on a monthly basis. Their latest report finds:

- that the majority of seriously delinquent borrowers are not on track for any loss mitigation,
- the use of short sales is increasing while loan modifications are on the decline,
- 20% of loan modifications made in the past year are currently delinquent, and
- foreclosure rates remain high.

According to the Working Group, “[s]ervicers appear to have reached the ‘low hanging fruit’ of subprime loans facing interest rate resets, while not developing effective approaches to address the bulk of subprime loans which are in default before interest rate resets.” This has led to property value declines and additional losses on mortgage loan foreclosures, according to the report. Given the number of ARM loans facing reset over the next two years, the Working Group predicts another wave of preventable foreclosures.

With the exact terms of a federal bailout plan uncertain at the time of this writing, this report may fuel a more aggressive implementation of a foreclosure mitigation program at the federal level should a bailout plan be enacted. A copy of the report is available at <http://www.csbs.org/Content/NavigationMenu/Home/StateForeclosurePreventionWorkGroupDataReport.pdf>.

Criminal Investigations: Attorney-Client Privilege

DOJ Opens Criminal Investigations Under New Guidelines for Prosecuting Corporate Entities

Michael D. Ricciuti

Perhaps not surprisingly, the FBI and DOJ have joined a host of other federal and state authorities and opened investigations stemming from the credit crisis. On September 29, 2008, both Freddie Mac and Fannie Mae separately announced that, in connection with a federal criminal investigation regarding accounting, disclosure and corporate governance matters, they had received federal grand jury subpoenas from the United States Attorney’s Office for the Southern District of New York. Both have pledged cooperation. Reportedly, the FBI is also looking into Lehman Brothers, AIG and 22 other institutions.

The opening of such investigations was predictable. Less predictable is whether DOJ will find evidence of criminal activity — particularly in an area as complex as mortgage financing.

The New Guidelines

Leaving aside the likely results of these probes, the investigations come at something of a turning point for DOJ. A little over a month ago, on August 28, DOJ revised its Principles of Federal Prosecution of Business

Organizations (the “Principles”), which are part of the United States Attorneys’ Manual (“USAM”), the guidebook for all federal prosecutors. (See the DOJ’s press release at <http://www.usdoj.gov/opa/pr/2008/August/08-odag-757.html>; the relevant USAM provisions can be found at http://www.usdoj.gov/usao/eousa/foia_reading_room/usam/title9/28mcrm.htm.)

In the revision (henceforth the “2008 Principles”), DOJ retreated from its widely-criticized position that federal prosecutors could demand that corporations — and by extension, individuals — waive the attorney-client privilege and work-product protection as a necessary precondition in earning credit for cooperating with DOJ, a point of major dispute with the legal community at large. This policy change, likely forced by Congress’ threats to mandate just such a reversal, is significant. Most critically, in cases handled by DOJ, the new policy largely re-establishes the right of a corporation to confer with its attorneys without fear that the attorney-client privilege which protects those communications from disclosure will be sacrificed. That said, it remains to be seen how the changed guidance will work in practice as these new Principles are tested in the crucible of high-profile investigations growing out of the current crisis.

Federal prosecutors have broad discretion in deciding whether to charge a corporate entity with a crime. Companies may be held criminally liable for the conduct (or omissions) of their agents committed within the scope of their duties and intended, at least in part, to benefit the corporation. Thus, as a matter of law, the crimes of any employee in the organization, regardless of whether he or she occupies a high or low position on the organization chart, may be attributable to the company and the company can be charged criminally for them. Whether DOJ seeks to bring a federal criminal case against the corporation in circumstances like these is a matter of discretion, which in turn depends upon

the corporation’s cooperation as measured under the Principles.

The 2008 Principles contain several significant changes to DOJ policy guidance on charging companies with criminal conduct.

- ***Prohibition on requesting privilege waivers.*** The 2008 Principles no longer require waiver of the attorney-client privilege or work-product protection to qualify for cooperation credit. Indeed, the 2008 Principles prohibit prosecutors from requesting attorney-client and work-product waivers. But they do permit those prosecutors to request that corporations produce facts, however they are gathered; “credit for cooperation will not depend on the corporation’s waiver of attorney-client privilege or work-product protection, but rather on the disclosure of relevant facts.” In other words, the 2008 Principles recognize that companies may voluntarily choose to waive the work-product and attorney-client privilege protections in providing facts, but they are not required to do so, and prosecutors cannot expressly seek an attorney-client waiver in making such a request.
- ***Indemnification of employees.*** The 2008 Principles provide that prosecutors generally should not consider whether corporations indemnify their employees for legal fees incurred in defending themselves in criminal investigations or prosecutions, nor should prosecutors ask corporations to refrain from advancing attorney’s fees or providing counsel to employees under investigation or indictment. Such practices should only be questioned by prosecutors if they are part of an effort to obstruct justice — such as “if fees were advanced on the condition that an employee adhere to a [false] version of the facts.”
- ***Joint defense agreements.*** The 2008 Principles state that a corporation’s involvement in a joint defense agreement — an agreement by which potential defendants share information regarding the defense

without losing the attorney-client privilege protecting the shared information from disclosure — “does not render a corporation ineligible to receive cooperation credit, and prosecutors may not request that a corporation refrain from entering into such agreement.” The 2008 Principles add, however, that the government may properly request the corporation not share “sensitive information about the investigation that the government provided to the corporation” with others to get cooperation credit.

It is unclear whether the sometimes fine line between a government request for facts and one that seeks a waiver of the privilege will be adhered to in practice by prosecutors. In practical terms, companies and their lawyers involved in investigations into the credit crisis must be careful to preserve the attorney-client privilege and work-product protections, as the 2008 Principles put the burden of preserving these confidences on them. Doing so may be critical – waiver of the privilege in producing information to the government in a criminal investigation is almost always considered by courts to be a waiver as to all other parties, including parties in civil actions. Corporations facing criminal exposure are thus well advised to consult as early as possible with qualified criminal counsel to assist them in navigating these still-dangerous waters.

State Securities Regulators

State Securities Regulators Seem Confident of a Place at the Table

David N. Jonson

In mid-September, the North American Securities Administrators Association (“NASAA”) held its 91st Annual Conference in Las Vegas. Securities regulators, industry experts and political commentators appeared on several panels before almost 400 attendees and discussed topics ranging from risk/reward

analysis to how the next administration will regulate the financial services industry to the future of global financial services.

The general consensus of these panelists was that the financial services industry and federal regulators had failed on a number of levels, and for a number of reasons, to understand and manage the increasing amounts of risk being taken by market participants who had been driven to excesses by unduly focusing on short-term profits and compensation rather than long-term value creation. Panelists repeatedly blamed federal financial and securities regulators for failing to exercise their authority over the financial services industry.

State securities regulators, however, largely escaped the panelists’ criticism because they had quickly coordinated their enforcement efforts and reached settlements in matters of national import, such as Auction Rate Securities, which traditionally would have been spearheaded by federal regulators such as the SEC. By demonstrating their value and proactivity at the very same time that federal regulators have been considered to be lacking, the states have all but ensured themselves a place at the table as a new financial regulatory scheme is crafted in the coming months. Flush with their recent successes, state securities regulators can be expected to be more assertive in 2009 and beyond in matters of national importance, such as annuities, brokered CDs, reverse mortgage schemes and virtually any investment promotion affecting America’s increasing population of senior citizens. As NASAA’s president Fred Joseph said in his inaugural speech, invoking The Blues Brothers, “We can’t be stopped. We’re on a mission.”

Truth in Lending Act

Seventh Circuit Court of Appeals Rejects Class-wide Rescission Under Truth in Lending Act for Mortgage Loan

Irene C. Frediel

On September 24, the Seventh Circuit Court of Appeals in *Andrews v. Chevy Chase Ban*, 2008 WL 4330761 (7th Cir. Sept. 24, 2008), joined two other federal appeals courts and the California Court of Appeals in holding that a class action may not be maintained for rescission of mortgage loans under Section 1635 of the Truth in Lending Act (“TILA”), 15 U.S.C. §§ 1601, *et seq.* (See also *McKenna v. First Horizon Home Loan Corp.*, 475 F.3d 418 (1st Cir. 2007); *James v. Home Constr. Co. of Mobile, Inc.*, 627 F.2d 727 (5th Cir. 1980); *LaLiberte v. Pacific Mercantile Bank*, 53 Cal. Rptr. 3d 745 (Cal. Ct. App. 2007), cert. denied, 128 S. Ct. 393 (2007)). The *Andrews* decision is likely to have an immediate impact on pending cases seeking class-wide TILA rescission against creditors and loan assignees both within the Seventh Circuit and elsewhere, as plaintiffs’ class action attorneys have placed this issue front and center in the debate over what remedies are properly available to borrowers who obtained high-risk mortgage loans. Unquestionably, class-wide rescission of tens of thousands of mortgage loans would result in substantial liability to any entity against which a judgment is entered.

Over the last year, more than 40 class actions have been filed on behalf of thousands of borrowers in California federal courts seeking damages and class-wide rescission of pay-option adjustable rate mortgage loans. These loans are at the core of the current mortgage crisis. None of the courts handling these cases has yet to decide whether the classes should be certified or whether class rescission under TILA is appropriate.

In support of its decision against a class-wide rescission remedy, the *Andrews* court noted,

among other reasons, that rescission requires a complete “unwinding [of] the transaction in its entirety and thus requires returning the borrowers to the position they occupied prior to the loan agreement.” When a consumer exercises the right to rescind, the lender’s security interest in the real property becomes void and the lender is obligated to take steps within 20 days after receipt of notice to reflect termination of the security interest. The consumer will not be liable for, among other charges, finance charges; thus, the creditor must return any money or property given to anyone in connection with the transaction. When the creditor has complied with these obligations, the consumer must then repay the loan proceeds to the creditor. Thus, the court concluded that this “purely personal” and “highly individualized remedy” involves a “transactional unwinding” process that makes it “an extremely poor fit for the class-action mechanism.”

With the *Andrews* decision, the Seventh Circuit is now the third federal appeals court to reject class-wide rescission as a remedy available under TILA, making it more likely that courts in other jurisdictions, including California, will adopt this ruling. For a more detailed discussion of the *Andrews* case, go to <http://www.klgates.com/newsstand/Detail.aspx?publication=4944>.

Auction Rate Securities Investigations

SEC and FINRA Focusing on Individuals in Auction Rate Securities Investigation

Michael J. King

In testimony before the House Financial Services Committee (“Committee”) on September 18, 2008, Linda Thomsen, Director of the SEC’s Enforcement Division, and Susan Merrill, FINRA Executive Vice-President and Chief of Enforcement, said that they were investigating individuals in connection with the

sale of auction rate securities (“ARS”) and that they would bring enforcement actions against individuals if their ongoing investigations revealed misconduct. Their prepared remarks may be found at <http://www.sec.gov/news/testimony/2008/ts0918081ct.htm> and <http://www.finra.org/Newsroom/Speeches/Merrill/P117018>. Their complete testimony may be viewed at http://www.house.gov/apps/list/hearing/financialsvcs_dem/hr091808.shtml. Committee Chairman Barney Frank convened the hearing in order to examine the continuing crisis in the market for ARS and to explore potential resolutions.

In August, the SEC announced preliminary settlements in principle with four broker-dealers (Citigroup, UBS, Wachovia, and Merrill Lynch) that will make available more than \$40 billion in liquidity to purchasers of ARS. Specific charges were not announced, but they will relate to alleged misrepresentations concerning safety and liquidity in the sale of ARS. During the September 18 testimony, Ms. Merrill announced that FINRA had also entered into agreements in principle with five broker-dealers to settle charges related to the sale of ARS, pursuant to which the firms would offer to repurchase up to \$1.8 billion of ARS from individual investors and some institutions. FINRA charged the firms with supervisory violations and with using advertising and marketing materials that did not provide a sound basis for evaluating the purchase of ARS. FINRA’s Press Release describing the agreements in principle in more detail can be read at <http://www.finra.org/Newsroom/NewsReleases/2008/P117019>. Both the SEC and FINRA are continuing to investigate conduct at the settling firms and at other firms as well. According to FINRA’s Press Release, 50 additional investigations have been opened and more are expected.

None of the SEC or FINRA actions announced to date have named any individuals. However, in response to Committee member questions

about individual misconduct and accountability, Ms. Merrill stated that FINRA was investigating individual brokers and implied that they could be suspended or barred from the industry if FINRA found that they engaged in misrepresentations or suitability violations in connection with the sale of ARS. In response to separate questions, Ms. Thomsen also said that the SEC’s investigations were ongoing and to the extent that individuals were involved in “bad behavior,” the SEC will pursue actions against them to the extent that they can “establish cases.”

Given the testimony of Ms. Thomsen and Ms. Merrill, and FINRA’s announcement that more investigations will be opened, even firms that are not currently the subject of regulatory inquiries should closely examine the conduct of individuals if the firm has sold a significant amount of ARS. Although, so far, FINRA has only charged violations of advertising and supervision rules, sales practice violations can provide a separate basis for liability for the firm, and, of course, the individual salesperson. Since the potential sanctions identified by Ms. Merrill are severe, firms will certainly want to know if they have salespersons who could face such sanctions.

Any firm that discovers clear misconduct in connection with ARS sales should consider disciplining the employee and making the customer whole, regardless of whether they are currently subject to regulatory scrutiny. If there is a regulatory investigation, individuals may need separate counsel and the firm should review its indemnification and professional liability policies. Firms should also review their compliance and supervisory procedures with regard to sales practices and make enhancements when appropriate. Firms that have closely examined their employees’ activities, taken corrective and remedial action when necessary, and upgraded their compliance and supervisory procedures will be in a better position to deal with regulators whether they are currently involved in a regulatory investigation or become subject to one.

FSA Enforcement

Confronting Market Abuse: FSA Steps Up Criminal Enforcement in 2008

Philip J. Morgan and Robert V. Hadley

A hallmark of enforcement by the U.K. Financial Services Authority (the "FSA") in 2008 has been the effort to establish that abusive behavior is likely to trigger severe personal consequences - so-called "credible deterrence." The FSA is now spreading the message that it is "getting tough" and intends to increase its focus on deterrence through enforcement action.

The FSA has been saying for some time that it intends to boost credible deterrence and engage senior management in particular in relation to its strategic priorities of combating market abuse and insider dealing by three strategies: higher financial penalties; greater focus on enforcement actions against individuals rather than or as well as firms; and the prosecution of criminal cases. Yet many have wondered when the rhetoric would be matched by action. In all of 2007 the FSA imposed just one fine for abuse-related activity. By the start of 2008 the FSA had brought one successful criminal prosecution since its establishment under the current regulatory regime on 1 December 2001. It had prosecuted nobody for the criminal offence of insider dealing.

Now, things appear to be starting to change. The FSA has said that in order to achieve its aim of credible deterrence it must prosecute "a steady stream" of criminal cases. Thus, in January of this year the FSA launched its first criminal prosecution for insider dealing against two individuals, one of whom was an in-house counsel. In July it commenced two more prosecutions, one against a former Cazenove partner. There are said to be several others in the pipeline.

Also, on July 29, 2008, an extensive dawn raid operation was mounted on various addresses by the FSA under search warrants. Eight individuals were arrested. The FSA said that this was in connection with "a major ongoing investigation into insider dealing rings." The FSA does not comment on ongoing investigations, but this was a further clear demonstration of intent.

Individuals, and especially senior management and others in the regulated sector, can be in no doubt that there is at least some risk of criminal prosecution for insider dealing and other market manipulation offences. The risk is not merely of financial penalty imposed on their firm, or even on them personally. Certainly no one can any longer say that the FSA has never prosecuted anyone for such activities. The FSA's aim is that any person with access to inside information or other opportunity to abuse the market should believe that these criminal cases are the first of its "steady stream," and to think clearly that that is not where they wish to swim.

The FSA also will point to other recent actions as evidence of its new, more aggressive posture toward enforcement.

In the past two months, the FSA fined Credit Suisse £5.6 million for the mismarking of certain positions resulting in an overstatement in published accounts corrected some eight days later, and fined a GE Money mortgage brokerage operation £1.1 million for defective systems and controls leading to its not accounting correctly for customer funds, so that, for example, mortgages were overpaid on redemption and clients' money was not applied to their mortgage accounts promptly or accurately (both fines imposed after the FSA acknowledged the full cooperation of the firms and after applying the 30 percent reduction for settling at an early stage of the enforcement process). These cases are examples of the higher financial penalties that the FSA intends to seek.

The FSA fined Land of Leather Limited in May in relation to inadequate systems and controls to prevent the sale of Payment Protection Insurance which was unsuitable for customers' needs, but will stress that it also fined the company's Chief Executive £14,000 (after a 30 percent early settlement reduction) in respect of the same matter. This shows the FSA's willingness to pursue senior management on the basis of senior management's responsibility for a firm's regulatory compliance.

Similarly the FSA extracted an undertaking from Mr. Steven Harrison, an investment manager at a hedge fund, effectively that he stay out of the financial services industry for 12 months (in addition to a financial penalty of £52,500 - after the 30 percent early settlement reduction). The allegation was market abuse in the sense of instructing colleagues to purchase certain bonds while in possession of inside information. The final notice acknowledges that Mr. Harrison's conduct was not deliberate in the sense that he did not consider at the time that he had inside information, but the FSA's position was that he should have recognized that fact. The FSA thus intends to promote deterrence not only by fining individuals, but also by affecting their continued ability to earn their livelihood in the financial services sector.

EU Approvals of Cross-Border Acquisitions

Harmonisation of EU Regulation of Persons Acquiring Financial Sector Firms

Philip J. Morgan

In general, a person seeking to acquire a stake of 10% or more in an EU credit institution, securities firm or insurance firm has to obtain prior approval from the relevant local regulator. However, the current EU directives mandating the relevant approvals process permit Member States to impose additional requirements over those in the relevant directives. This has left

scope for national regulators to adopt protectionist practices such as making unreasonable requests for information during the approvals process, refusing applications or imposing conditions on grounds unrelated to the purpose of the underlying directives.

This problem, which has impeded cross border acquisitions across Europe contrary to the aims of the EU Financial Services Action Plan, is now being addressed by the Acquisitions Directive (2007/44/EC) (the "Directive") which is required to be brought into law in EU Member States by 21 March 2009. The Directive's aim is to facilitate and encourage cross border acquisitions by increasing certainty, clarity and transparency, and Member States are not permitted to impose rules additional to those in the Directive.

The Directive seeks to harmonise the supervisory approvals process by setting out the entire procedure to be applied by regulatory authorities including fixing deadlines, limiting the ability of regulators to "stop the clock" by asking questions, and clearly laying down uniform prudential criteria for the assessment (which are the only criteria that may be applied).

In the UK, the adoption of the new rules is not currently expected to make any very material changes to the current "change in control" regime, although there will be a slight shortening of about a week of the period, currently 3 months, within which the Financial Services Authority must make its decision.

Harmonisation of the rules across the EU should, however, mean that anyone, including those from outside the EU, looking to acquire European financial firms may find that task somewhat more straightforward. This might be expected to trigger, or at least facilitate, a new wave of consolidation in the European banking, insurance and securities industries.

*SEC Rules on Cross-Border Investments***SEC Loosens Regulation of Cross-Border Business Combinations to Benefit Both U.S. and Non-U.S. Investors**

Edward G. Eisert

On September 19, 2008, the Securities and Exchange Commission issued Release No. 33-8957 (the "Release"), adopting final rules implementing significant changes to its regulation of cross-border business combinations and rights offerings by foreign private issuers (the "Cross-Border Rules"). The Cross-Border Rules, adopted after eight years of experience with the current cross-border exemptions, are intended to encourage offerors and issuers in cross-border business combinations and in rights offerings by foreign private issuers to permit U.S. security holders to participate in these transactions in the same manner as other holders. The Cross-Border Rules address certain recurring issues and unintended consequences of the existing exemptions that have impeded their usefulness.

The Release also adopts revisions to the beneficial ownership reporting rules under Sections 13(d) and 13(g) of the Securities Exchange Act of 1934 (the "Exchange Act") to permit non-U.S. entities similar to U.S. brokers, dealers, banks, investment companies, investment advisers and employee benefit plans to use the short form Schedule 13G thereunder to report beneficial ownership of U.S. registered securities, if certain conditions are met (the "Beneficial Ownership Reporting Rules" and, together with the Cross-Border Rules, the "Final Rules"). Reporting beneficial ownership on Schedule 13G is materially less burdensome than reporting beneficial ownership on Schedule 13D under the Exchange Act, as would be required, absent exemptive order or "no-action" relief.

Generally speaking, each set of the Final Rules represents an expansion and refinement of current exemptions and "no-action" positions,

and in some areas, would codify relief previously granted only on an individual basis. The codification of various interpretive positions of the SEC staff makes such relief available as a matter of right, thereby reducing associated burdens and costs. The Final Rules were adopted substantially as proposed.

Although the Final Rules benefit both global investment managers and foreign private issuers, their thrust is primarily to benefit U.S. investors in foreign private issuers and non-U.S. institutional investors in U.S. registered securities. First, from the U.S. investment manager's perspective, the Cross-Border Rules should lessen the burden on foreign private issuers to include U.S. holders in tender offers, exchange offers and business combinations. As a consequence, U.S. holders should be more likely to receive the same treatment as other holders in such transactions and, in turn, this should lessen a concern for U.S. persons investing in foreign private issuers. Second, from the non-U.S. investment manager's perspective, the Beneficial Ownership Reporting Rules should reduce the administrative burden of holding U.S. registered equity securities.

The specific changes adopted in the Final Rules are complex and a detailed discussion of them is beyond the scope of this article. For a more complete discussion of these issues, see Eisert and Berkeley, *Global Investment Managers Benefit Under Revisions to Cross-Border Regulation of Business Transactions and Beneficial Ownership Reporting Rules*, 15 *The Investment Lawyer* 9 (2008).

*Derivatives***Appeals Court Permits Holders of Total Return Swaps to Vote Referenced Stock in Proxy Contest: Creates Reporting Uncertainty for Equity Derivatives Market**

Edward G. Eisert

On September 15, 2008, the Second Circuit Court of Appeals issued a Summary Order in the case brought by CSX Corporation (“CSX”) against The Children’s Investment Fund Management (UK) LLP and 3G Fund L.P. that affirmed the decision of the Southern District of New York not to enjoin the voting of the CSX shares acquired by the defendants in their proxy fight with CSX management. Stating that an opinion would follow, the Second Circuit did not rule on the other issues of the case that are of great significance to the financial community — particularly the treatment of total return swaps (“TRSs”) under the Securities Exchange Act of 1934 (the “Exchange Act”).

The June 11 decision of the District Court found that through the undisclosed use of TRSs, the

defendants had violated Section 13(d) of the Exchange Act and the rules thereunder and enjoined further violations thereof, dismissed all counterclaims, but held that it was “foreclosed” under controlling Second Circuit precedent from enjoining defendants from voting the shares they had acquired from the date of the violation to the trial date.

Thus, the decision of the District Court has called into question a basic expectation of the equity derivatives market: that the long party to a TRS does not acquire beneficial ownership of the referenced securities under the TRS for purposes of Section 13(d), absent a supplemental arrangement outside of the TRS that provides a contractual right to vote or dispose of such securities.

The opinion of the Second Circuit is being anxiously awaited by the financial community, particularly in light of the current market turmoil. For a detailed discussion of the decision of the District Court see the K&L Gates June 2008 Alert at <http://www.klgates.com/newsstand/Detail.aspx?publication=4642>.

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