



FINANCIAL INSTITUTIONS UPDATE

JULY 2005

SCHIFF HARDIN LLP

Attorneys Serving Business Since 1864

SCHIFF HARDIN LLP

6600 Sears Tower
Chicago, Illinois 60606
t 312.258.5500
f 312.258.5600

James F.X. Fahy

312.258.5512
jfahy@schiffhardin.com

Matthew G. Galo

312.258.5643
mgalo@schiffhardin.com

Melissa J. Krasnow

312.258.5510
mkrasnow@schiffhardin.com

Shirley M. Lukitsch

202.778.6477
slukitsch@schiffhardin.com

Ramona Mateiu

312.258.5761
rmateiu@schiffhardin.com

David S. McCarthy

312.258.5653
dmccarthy@schiffhardin.com

Gary L. Mowder

312.258.5514
gmowder@schiffhardin.com

Harold S. Nathan

212.753.7813
hnathan@schiffhardin.com

Peter L. Rossiter

312.258.5579
prossiter@schiffhardin.com

David H. Williams

404.806.2810
dwilliams@schiffhardin.com

Christopher J. Zinski

312.258.5548
czinski@schiffhardin.com

Director Personal Liability After WorldCom and Enron

By Robert J. Regan



Introduction

Now what? That is the question vexing corporate America as it struggles with the fallout from the voluntary settlements by the outside directors in the WorldCom and Enron class action lawsuits. A closer

look at these settlements provides some helpful lessons for directors and their companies in avoiding the mistakes of WorldCom and Enron.

Background - WorldCom and Enron Settlements

As is now well known, the outside directors of WorldCom and Enron agreed to pay millions of dollars out of their own pockets to settle the class action lawsuits. The directors' willingness to assume personal liability was undoubtedly influenced by the following factors:

Bad Facts. WorldCom and Enron each filed for bankruptcy amid allegations of accounting fraud and self-dealing. In both cases, the plaintiffs included public entities focused on holding directors personally liable. Both cases involved securities fraud claims that did not require proof of an intent to defraud. Finally, inadequate insurance under each company's D&O insurance policies upped the pressure to find other "deep pockets."

Bad Press. WorldCom, Enron and other high-profile corporate scandals received non-stop press attention that contributed

to a public perception that directors should bear responsibility for stockholders' losses. Changing that perception at trial would have been a daunting challenge.

Bad Law. Prior to the settlements, a 2003 decision in the Walt Disney case suggested that directors' negligence might constitute a breach of the "duty of good faith," thereby disqualifying directors from protection under the standard Delaware charter provision on exculpation. A 2004 Delaware case involving Emerging Communications emphasized a director's financial expertise in concluding that the director breached his fiduciary duty by approving a going-private transaction, notwithstanding the selling company's engagement of an investment banker and receipt of a fairness opinion.

Bad Climate. The convergence of these forces, together with perceptions of lack of director independence and ineffective oversight, ensnared the WorldCom and Enron directors in what some might call a "perfect storm" for director personal liability.

Impact of WorldCom and Enron

WorldCom and Enron were negotiated settlements, and, as such, they effected no change in basic corporate or securities law principles relating to director conduct or the business judgment rule. Nonetheless, the WorldCom and Enron settlements may have significant practical consequences, including:

- Some individuals may be less likely to

■ WorldCom and Enron continued on next page

■■■
Director conduct in compliance with their fiduciary duties will entitle directors to the protection of the business judgment rule and should likewise provide protection from liability under the federal securities laws.
■■■

■ **WorldCom and Enron** continued from previous page

serve as directors. Other directors may adopt a risk-averse approach to decision-making, focusing on process simply to build a better record in the event of litigation.

- Companies may have to increase director compensation and provide greater protections to safeguard directors from financial exposure.
- Plaintiffs may now routinely insist upon personal contributions from directors, citing WorldCom and Enron as precedent.

Director Responses to WorldCom and Enron

Current Directors. WorldCom and Enron should refocus directors' attention on their duties to stockholders. The duty of care, at its essence, requires directors to pay attention. Directors should do their homework, read critically the materials presented to them, ask questions, and follow up on concerns. Directors should be alert for red flags so that problems can be addressed in a timely manner. Directors should know the business operations, financial performance, prospects and challenges of their companies. Directors should monitor disclosures made by the company as well as disclosures made about the company by analysts and the financial press.

Similarly, directors must remain vigilant about conflicts of interest. The duty of loyalty imposes an obligation on directors to refrain from conduct that would deprive the company or its stockholders of profit or advantage. Post-WorldCom and Enron, there is likely to be little tolerance for a director who places his own interest above the best interests of the company.

Director conduct in compliance with their fiduciary duties will entitle directors to the protection of the business judgment rule and should likewise provide protection from liability under the federal securities laws.

Prospective Directors. Prospective directors should conduct appropriate due diligence before accepting a board seat. They should consider the management's integrity and tolerance for wrongdoing (the "tone at the top"); the company's adherence to the letter and spirit of the law; the quality of the company's legal compliance programs; the risk factors relevant to the company's business and how the company has addressed them; board independence, collegiality and effectiveness; the relationship between the board and the CEO; the quality of communications between the board and management and management and employees; and the board's willingness to seek independent advice and, when appropriate, to challenge management's conclusions and recommendations.

Significant discomfort with the results of this due diligence assessment may suggest that a prospective director should decline a board seat. Prospective directors also must weigh their willingness to devote the time and energy to do the work required of directors in today's world.

Company Responses to WorldCom and Enron

Companies should review the protections in place against director liability, including:

- Confirm that its charter contains, if permissible, a provision eliminating or limiting the personal liability of directors for breach of the duty of care;
- Confirm that its by-laws provide mandatory indemnification and advancement of expenses to directors to the maximum extent permitted under applicable law;

- Consider whether there is any incremental benefit to individual indemnification agreements with directors;
- Review its D&O insurance policy, including the term; the scope and amount of coverage; limitations on coverage; exclusions; severability provisions; renewal rights; rescission risks; the availability of supplemental "Side A" insurance coverage; and the possibility of negotiating more favorable terms at renewal; and
- Confirm that its corporate compliance and governance policies comply with applicable law and stock exchange regulations, represent corporate best practices, and reflect the company's specific circumstances.

Conclusion

The WorldCom and Enron settlements, though the product of an unusual set of facts and circumstances, have contributed to a more challenging environment for directors. They should serve as a forceful reminder to directors of the seriousness of their responsibilities and the implications of the failure to meet those responsibilities. Adherence to the standards of director conduct under applicable corporate and securities laws should mitigate the risk that directors may be forced to make WorldCom/Enron-type payments. ■



Whistling to the Audit Committee: An Internal Investigation Begins

By Christopher J. Zinski

How It Usually Starts.

Here is an imaginary scenario that could have unimaginably bad consequences.

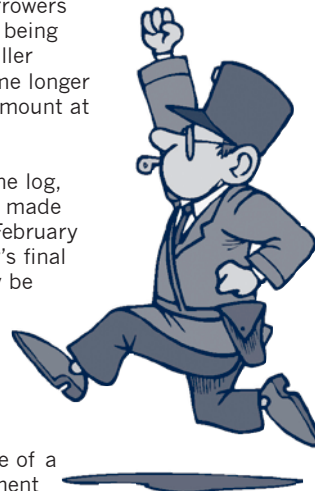
The company's whistle-blower hotline records a soft, muffled voice, but the message is loud and clear: three large lending transactions initiated last year were fraudulent and a bank insider was involved. The caller's speech is halting and guarded, an attempt to conceal the whistle-blower's identity. All three borrowers are fictitious companies with falsified financial statements. The loans are being repaid with part of the principal, providing a facade of legitimacy. The caller suggests that the perpetrators intend to keep payments up for a short time longer and then flee the country with the remainder of the loan proceeds. The amount at risk is in excess of \$7 million.

The names of the borrowers are too difficult to understand from the phone log, however, the voice has provided several crucial clues: all three loans were made through one of the bank's San Diego offices, the time period involved is February through April, and a senior loan officer is involved in the scam. The caller's final point is even more chilling — other offices and more loans could possibly be involved.

A transcript of the hotline message is handed to the chair of the audit committee. What does the audit committee do now?

Investigation Alternatives and the Letter of the Law

Section 301 of the Sarbanes-Oxley Act mandates that an audit committee of a public company establish procedures for the receipt, retention and treatment



■ Whistling continued on next page

■■■■

The whistle-blower's complaint raises serious questions about the bank's internal control system, whether the bank's financial statements are accurately stated and safety and soundness issues.

■■■■

■ Whistling continued from page 3

of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters. That process, in this example, has surfaced the complaint concerning an alleged accounting irregularity to the right forum within the organization – the audit committee. The challenge for the audit committee is to determine how the anonymous complaint should be “treated,” and here the law does not provide a script. The audit committee will have to write its own.

What to Do When the Whistleblower Throws a Curve?

That the caller chose to remain anonymous makes follow up by the committee difficult. A number of companies use an outside service provider, which facilitates follow-up without giving up anonymity. The service provider assigns a code number to the caller and asks for a call-back in, say, two weeks; they then give the caller who does call back any information and message supplied by the company (including “we really want to talk to you and here’s how you can do that comfortably”).

In this imaginary scenario, unfortunately, the company has not invested in the third-party service provider system. Thus, approaching the complainer to glean additional facts or to measure the complainer’s veracity is not an option under these circumstances. Yet clearly the complaint cannot be ignored. It must be investigated, either by relying on an internally-staffed process or a process that relies exclusively on outside, independent advisors.

In this case, the complaint alleges that bank insiders are involved in the fraud but the identities of the individuals involved cannot be discerned from the telephone log. Furthermore, the amount involved — \$7 million — is material to the financial position of the bank, and the tipper suggests that the number may be much larger than this because other fraudulent loans may be involved.

The Need to Go Outside to Determine What, If Anything Happened Inside

The audit committee could set up a team composed of senior officers and other employees to investigate the complaint. For instance, the audit committee could appoint the head of internal audit to lead an inquiry team, which would include the company’s chief legal officer. But given the materiality of the allegations and the claim that bank insiders are involved, the audit committee cannot be sure that the officers and employees leading the investigation are independent.

Indeed the audit committee needs to understand why the internal audit staff missed the problem if the allegations turn out to be true. Moreover, a staff attorney under the supervision of the chief legal officer may have documented the suspect lending transactions. While some types of complaints reported under the company’s whistle-blower policy may lend themselves to internal reviews, this fact pattern suggests that the audit committee should outsource the investigation to independent professionals.

No Question – the Audit Committee Must Question Potential Wrongdoing

The audit committee of a public company will be comprised of independent directors none of whom are employed by the company. These committee members, as directors, owe the company a duty of care. Directors satisfy the duty of care when they act as reasonably prudent persons would under like circumstances. The fact pattern in this scenario would trigger the duty of the company’s directors to make a reasonable inquiry concerning the circumstances alleged in the whistle-blower’s complaint. Conversely, if the audit committee members fail to investigate the complaint in a reasonable manner, they and the full board of directors may be exposed to legal liability

on a breach of fiduciary duty theory. Investigating the complaint satisfies the duties directors owe to the corporation and to its shareholders. But other parties have an interest in the inquiry as well.

External Auditors

The company's external auditors will want a thorough investigation completed. The complaint suggests that the company may have recorded fictitious loans resulting in the overstatement of balance sheet accounts and earnings. If the allegations prove true, the company's prior, audited consolidated financial statements may require restatement. Moreover, the auditors will want sufficient negative assurance that officers of the company were not engaged in illegal acts, otherwise the credibility of the company's internal controls and financial statement integrity are in doubt. An independent, thorough investigation will be necessary to satisfy the external auditor and satisfy the auditor's legal duties. The failure of the audit committee to investigate the matter and the failure of the board of directors to cause management to take remedial action may lead to the auditor's resignation or to report the matter to the SEC.

Bank Regulators

Bank regulators also will want to know whether the allegations are true. The whistleblower's complaint raises serious questions about the bank's internal control system, whether the bank's financial statements are accurately stated and safety and soundness issues. The regulators have broad examination powers and if the company does not thoroughly investigate the allegations in the complaint the bank examiners may conduct their own investigation.

Securities and Exchange Commission

The SEC may be interested in the investigation, particularly if it results in a restatement of the company's prior year's financial statements or material charge-offs. Indeed the policies of the SEC, the National Association of Securities Dealers, and the Department of Justice recommend that companies undertake internal investigations and report the findings to these agencies when credible allegations of wrongdoing surface. Swift action to investigate, disclosing the results to the appropriate government agencies and cooperating with law enforcement will mitigate the risk that the company will face government prosecution or other penalties or sanctions.

Framing the Internal Investigation by Drawing in Qualified External Assistance

The internal investigation will be most effective if the audit committee properly organizes the inquiry at the beginning. The first order of business is to retain a qualified law firm that is independent of the company. In addition to satisfying the independence standard, the law firm should assemble a team of its lawyers who have expertise in banking, criminal and securities law as well background and experience in financial accounting and internal audit.

The audit committee should discuss with the law firm it selects whether a third-party, forensic accounting firm should be added to the investigation team. In addition, in some investigations counsel will recommend employing specialized investigators with sophisticated financial expertise such as former federal law enforcement officers or bank regulators. Under Section 301 of Sarbanes-Oxley, the audit committee has authority to engage independent counsel and advisers as it determines necessary to carry out its duties.

Independent Legal Counsel – Dependent Upon the Audit Committee

The audit committee should work with independent counsel to direct and determine the scope of counsel's investigation. While counsel should have a degree of latitude to go wherever the investigation takes it, the audit committee has a responsibility to manage the cost of the inquiry and be sure that its scope doesn't expand unnecessarily or improperly. In any event, it should be made clear that the law firm reports directly and



exclusively to the audit committee regarding its findings.

Early in the process the law firm should prepare a comprehensive work plan, citing the documents it plans to review and interviews it expects to convene, and the plan should be fully discussed with the audit committee and approved. The audit committee and the full board of directors should be cautioned from the outset that, while the investigation will be comprehensive, it may not be complete in the sense that not everyone involved in the matter will consent to an interview and some information and documents may not be available to the investigators to review. Special counsel's findings, therefore, will be qualified by these scope limitations.

Attorney/Client Privilege – Who Has It and Who Doesn't

One of the threshold issues that independent counsel will discuss with the audit committee is the process for maintaining attorney/client privilege. Documents and advice of counsel can be protected against discovery in any subsequent third-party litigation if the privilege is properly maintained. The key document that any litigant would want if they brought a claim for breach of fiduciary duty or violations of the federal securities laws is the report prepared by independent counsel, because it reviews the facts and reaches a conclusion about wrong-doing. Protecting the investigative report, therefore, is often of paramount concern before the investigation begins. A natural tension, however, is created.

To satisfy the company's auditors, the bank regulators, the SEC, and other government agencies, it may be necessary to reveal the findings of counsel and risk waiving the privilege. Counsel can deal with the tension by delivering its findings in a verbal report to the audit committee. But in the end, if the SEC or the bank regulators want a written report, counsel's options in preserving the privilege may be limited. Furthermore, federal and state prosecutors can tell an organization that failure to waive the privilege is evidence of lack of cooperation that will make prosecution and a substantial penalty more likely — a heavy hammer indeed.

What to Do (or Not to Do) with the Whistle-Blower When the Investigation To — Do's Are Finally Done

In this scenario, the whistle-blower has protected his or her identity. Nevertheless, the audit committee and investigative counsel in the course of their review may believe they have identified the whistle-blower if the individual is an insider. It may also occur that the whistle-blower reveals himself or herself to counsel during the interview process or submits a supplemental complaint revealing the reporting person's identity as it becomes clear that the matter is under investigation.

If it turns out that the complaint presented by the whistle-blower to the audit committee was no more than a misinterpretation by the whistle-blower of unsubstantiated facts (meaning, there really wasn't any fraud involved), senior management in the company may view the whistle-blower as a troublemaker and even some board members may reach this conclusion. Section 806 of the Sarbanes-Oxley Act protects an employee of a public company who blows the whistle on fraud from discharge, harassment, demotion or other forms of discrimination, provided the complainer acted on the reasonable belief that the information which forms the basis for the complaint reflects a violation of any number of laws, including the 1934 Act or federal fraud laws. The bank's problems will be compounded if they punish the whistle-blower for revealing the fraud and the complainer can satisfy the "reasonable belief" standard.

Where the Internal Investigation May Lead

When a complaint regarding an accounting irregularity, fraud or misstatement is filed with the audit committee, the committee has an obligation to determine how to treat the complaint. Depending on the facts and circumstances, the complaint may justify an internal review or the employment of outside counsel and other advisers to conduct an independent, external investigation of the facts. If the committee proceeds with an independent investigation, the committee's priorities must be: hiring a highly qualified law firm, setting an appropriate scope for the investigation, and reaching a reasoned judgment about the importance of preserving attorney/client privilege in the matter. When the internal investigation ends, there are several possible outcomes.

The company could receive a clean bill of health from special investigative counsel or counsel may conclude that the facts raise ambiguities over whether illegal acts did or did not occur. Of course the whistle-blower allegations could be proved true, and the investigation could discover bad facts and clearly illegal activity. Upon receiving counsel's conclusions, however, there can be no doubt but that the audit committee must act on them. Ambiguities may call for further investigation. Bad facts require remedial steps. The company's problems will only be compounded if the investigation recommends action that the audit committee, board or management determine not to take.

Once an investigation begins, the outcome is unknown and the remedial action necessary to correct a problem is unpredictable. But once the whistle-blows, the audit committee needs to investigate and act on the recommendations that follow. ■

Auditor Engagement Letters: Audit Committees Beware

By Lawrence M. Gill

The auditor engagement letter is a work of art. Beauty, however, is in the eyes of the beholder and some beholders have found more problems than beauty in these professional service contracts.

Audit engagement letters are not a matter of happenstance. Before deciding upon a form of engagement letter, auditing firms spend significant time reviewing their existing forms of letter, changes in the auditing environment, litigation trends and client reactions to previous letter forms.

The audit engagement letter serves a number of purposes. The letters satisfy the requirements of auditing standards for an engagement letter. Additionally, the engagement letter serves to record for both the auditor and the client the essential elements of their agreement regarding the terms of the engagement. Given the regulatory environment and the litigious environment in which auditors perform their services, it is no surprise that the engagement letter will also, to the extent possible, provide some measure of protection for the auditor.

One important beholder of engagement letters, the Federal Financial Institutions Examination Council ("FFIEC"), has recently expressed its concern that the auditors' efforts to protect themselves disadvantage their clients and raises serious independence problems. On May 10, 2005 the FFIEC issued a proposed advisory which finds safety and soundness concerns in the limitation of liability provisions and certain alternative dispute resolution provisions of external audit engagement letters. In short, the FFIEC advisory states flatly that financial institutions should not enter into external audit arrangements that include any limitation of liability provisions. The current betting is that the FFIEC will adopt the advisory in substantial part.

The FFIEC is not the only careful beholder of external auditor engagement letters. Careful audit clients carefully scrutinize these engagement letters, as well. In fact, smart auditors desire that their clients examine these letters to ensure a proper understanding between auditor and client.

Financial institutions, especially public companies, should routinely ask counsel to review their audit engagement letters. Counsel will be aware of industry trends and can help safeguard the audit committee from mistakes in defining the auditor/client relationship. Auditors will often choose one client's engagement letter as the model for another's engagement letters. Problems include ambiguity in whether the stated fee covers certain expected services and non-audit services creeping into the core audit work. Identifying specific staffing and timing requirements in the engagement letter should be important to the audit committee as well to ensure a well performed and responsible inspection of the company's financial statements.

Counsel should be able to identify any incorrectly referenced auditing standards, including standards of the Public Company Accounting Oversight Board, in the letter. The bank's lawyer should also counsel the client about the meaning of the situs which the engagement letter has chosen for possible later litigation.

■■■
**Financial
institutions,
especially public
companies, should
routinely ask
counsel to review
their audit
engagement letters.**

■■■

An auditor may remark to a financial institution client that it is a time-consuming and fruitless endeavor to attempt to obtain changes in the engagement letter from “higher-ups.” Sometimes they are right. Auditors will listen to legitimate concerns, however, and in fact the response to those legitimate concerns may result in enhancing the succeeding year’s version of the auditor’s engagement form. Demonstrating diligence in the engagement letter negotiation process will build a case that the audit committee fulfilled its fiduciary duties to the company and its shareholders and is what the bank regulators expect.

Those who have blithely signed engagement letters in the past without any significant review can take some measure of reassurance from the fact that auditors are generally attempting to do the right thing. Nevertheless, the potential for error and the auditor’s bias for self-protection are two good reasons for clients to be cautious in the future. ■

When Financial Institutions Need To Look Into Internal Control Procedures They Look To Schiff Hardin For Independent Counsel

Whistle-blowing employees, financial statement restatements, fraud or the discovery of significant deficiencies or material weaknesses in financial controls — financial institutions and their Audit Committees deal with these kinds of situations all the time. Often, the best way to get to the truth and contain the damage is to engage independent, outside counsel.

A thorough “internal investigation” by experienced counsel can give senior management and the Board the assurance they need that any problems have been understood and fixed. It can also reassure regulators and the bank’s external auditor. In addition, where the issue arises a solid internal investigation can often persuade law enforcement officials not to prosecute the institution for any wrongdoing that is found. Using outside counsel, rather than other inside or outside professionals, makes it possible to protect the results of the investigation under the attorney-client privilege, so they are not available to potential plaintiffs to bring a civil suit.

Schiff Hardin brings to internal investigations its complete set of litigation, banking, and securities regulation skills. Our firm also calls upon particular key perspectives that come from strong practices in labor and employment, employee benefits, white collar crime, fiduciary activities, insurance, lending, real estate and a host of other areas. We also have lawyers who are CPAs and have audit and financial accounting experience from prior careers, as well as past experience serving in federal and state enforcement and regulatory agencies.

If you need help, call Christopher J. Zinski 312.258.5548 or Peter L. Rossiter 312.258.5579. ■

Prepare Now — Gramm-Leach-Bliley Act Broker Exceptions on the Horizon

By Joseph P. Corcoran

Banks should be aware that the Securities and Exchange Commission (“SEC”) is working to adopt final rules, now referred to as Regulation B, to implement the Gramm-Leach-Bliley Act (“GLBA”) exceptions for banks from the definition of “broker” in the Securities Exchange Act of 1934 (“Exchange Act”). These new rules, once finalized, will affect how banks do business.

Regulation B, initially adopted on an interim basis in May of 2001 and then repeatedly suspended, was repropose in June 2004 and can be found on the SEC’s website at (<http://www.sec.gov/rules/proposed/34-49879.htm>). While these rules have not been finalized and banks therefore continue to enjoy a complete exemption from broker registration for their securities activities, the SEC is planning to have final rules in place by September 30, 2005. Although these rules have been very controversial and will most likely will differ from the June 2004 version of Regulation B, banks need to understand the SEC’s perspective on the rule in order to prepare for what may soon emerge.

By way of background, the GLBA eliminated the blanket exemption for banks from the definition of “broker” in the Exchange Act and replaced it with eleven narrower transaction-based or security-based exceptions that allow banks to continue to engage in certain securities activities without SEC involvement. Of the eleven exceptions, these four receive the most attention and generate the most controversy: (1) the third-party brokerage (“networking”) exception, (2) the trust and fiduciary exception, (3) the sweep exception, and (4) the custody exception. These conditional exceptions, which are described in more detail below, allow banks to continue to engage in third-party brokerage arrangements, trust and fiduciary activities, sweep activities, and safekeeping and custody activities without being subject to broker-dealer obligations.

The networking exception in Section 3(a)(4)(B)(i) of the Exchange Act allows banks to continue to partner with broker-dealers to offer brokerage services under certain conditions. In addition to permitting banks to refer customers to brokers for securities transactions, this exception allows banks to continue to pay incentive compensation to unregistered bank employees for such referrals. The GLBA, however, limits this compensation to a “nominal one-time cash fee of a fixed dollar amount.” In addressing this exception, the SEC’s goal has been to limit compensation that would give unregistered bank employees incentives to sell securities. Consistent with this goal, the focus of the SEC’s proposal has been to define “nominal” and interpret “one-time” to limit such incentive payments.

The trust and fiduciary exception in Section 3(a)(4)(B)(ii) of the Exchange Act permits banks, under certain conditions, to continue to effect transactions in a trustee or fiduciary capacity without registering as a broker. In order to qualify for this exception, banks must be “chiefly compensated” for securities transactions, consistent with fiduciary principles and standards, on the basis of: (1) an administration or annual fee, (2) a percentage of assets under management, (3) a flat or capped per order processing fee that does not exceed the cost the bank incurs in executing such securities transactions, or, (4) any combination of such fees. The SEC’s goal in addressing this exception has been to ensure that bank trustees and fiduciaries conducting securities activities outside of the securities laws are compensated as traditional trustees and fiduciaries. In this regard, the SEC has defined the term “chiefly compensated” to limit the

amount of sales-related compensation that a bank can receive when acting as a trustee or fiduciary.

The sweep exception in Section 3(a)(4)(B)(v) of the Exchange Act allows banks to continue to offer mutual fund sweep services linked to deposit accounts under certain conditions. Specifically, this exception allows banks to effect sweep transactions “as part of a program for the investment or re-investment of deposit funds” into any no-load money market fund. The SEC’s focus in addressing this exception has been to define the term “no-load” consistent with its use in the securities laws. Consistent with its usage in the securities laws, the SEC has defined a “no-load” fund to mean a fund that charges no more than 25 basis points against net assets for sales-related expenses and service fees.

The custody exception in Section 3(a)(4)(B)(viii) of the Exchange Act allows banks that hold funds and securities for its customers as part of its “customary banking” activities to continue to perform specified securities-related functions without registering as a broker. In particular, a bank may, among other things, facilitate the transfer of funds or securities in connection with clearing and settling customers’ securities transactions, and “serve as a custodian or provider of other related administrative services” to IRAs, pension, retirement, profit sharing, bonus, thrift savings, incentive, or other similar benefit plans. The SEC’s goal in addressing this exception has been to limit general order taking by banks through their custody departments. In this regard, the SEC has interpreted this exception to prohibit banks from accepting orders from investors to purchase or sell securities other than those specifically permitted in the exception, such as with respect to securities lending and borrowing or investing collateral.

Needless to say, Regulation B has been very controversial. In general, banks believe that the SEC has interpreted the GLBA too narrowly, and that these interpretations will affect or limit existing businesses. On the other hand, the SEC believes that the statute imposed conditions on bank securities activities where none existed before, and that banks need to modify their securities activities accordingly.

It is impossible to predict what the final rules will look like. Banks should start to examine their current securities activities in light of the SEC’s proposed Regulation B in order to be able to respond promptly once a final rule is adopted. We believe the focus of this initial examination should be on banks’ networking, trust and fiduciary, sweep, and custody securities activities.

For example, with respect to networking arrangements with broker-dealers, banks should start examining the amount they pay their unregistered employees for brokerage referrals to see whether and how they differ from the SEC’s proposal. In addition, banks should examine their bonus plans to determine if these plans are based in any way on brokerage referrals. Banks that pay referral fees in excess of the amount prescribed in Regulation B or that have year-end bonus programs based in whole or in part on brokerage referrals should start considering ways to modify these programs should that be necessary under the final version of Regulation B later this year. Schiff Hardin stands ready to assist banks that undertake this process. ■



Compliance Programs — Time for an Update

By Peter L. Rossiter

For every financial institution, compliance with the myriad laws and regulations that apply to financial services is an everyday fact of life. In the early 1990's, many banks or holding companies - especially the larger ones - joined other corporations in adopting "Corporate Compliance Programs," which sought to put a framework around these many compliance activities and tie them together.

They were responding to guidelines adopted by the U.S. Sentencing Commission in 1991, governing the sentencing of organizations in federal criminal cases. The Guidelines gave significant credit to institutions that had in place, at the time of the criminal activity, an "effective program to prevent and detect violations of law." The Guidelines specified the features such a program had to contain in order to qualify. Corporate Compliance Programs were designed to respond carefully to each of the requirements.

The motive was not simply to get a lighter sentence. For a financial institution faced with the possibility of a criminal charge, the size of the fine may be the least of its problems. The most important motive is that law enforcement officials - U.S. Attorneys, local prosecutors, even regulators like the Securities and Exchange Commission - will often decide not to charge at all if the institution can demonstrate that it has in place an effective Compliance Program. The Guidelines give what is probably the best available definition of such a program.

Avoiding a criminal charge against the institution often means avoiding significant reputational damage, so it is well worth the effort to craft and maintain a Compliance Program. This is especially true in the current environment for financial institutions, where many types of problems - ranging from accounting errors to Bank Secrecy Act issues - have become potential criminal cases, not just regulatory concerns. Also, because of this dramatic change in the enforcement climate, Compliance Programs are just as important for smaller and medium sized institutions as they are for larger ones.

Many institutions have also paid attention to case law that puts directors defending against certain breach of fiduciary duty claims in a better position if their companies have effective compliance programs. Some institutions have integrated certain of the new Sarbanes-Oxley requirements, such as maintaining a "whistleblower" complaint system, into their corporate compliance programs. Audit Committees have seen their duties increase substantially under Sarbanes-Oxley, and many Committees have concluded that an effective Compliance Program is a key element in discharging their responsibility to oversee the whistleblower system or legal and regulatory compliance generally.

The Guidelines for sentencing organizations recently changed. The U.S. Sentencing Commission sent to Congress a revised set of guidelines that became effective November 1, 2004. One would expect that to trigger revisions to programs at every institution that had a Compliance Program in place, and to cause others to think about adopting one.

Just as the new Guidelines were coming into force, however, the U.S. Supreme Court was considering challenges to the constitutionality of the entire Sentencing Guidelines. In January 2005, the Court held the Guidelines unconstitutional, because under the Sixth Amendment (right to

jury trial), federal judges could not be required to increase sentences on the basis of facts presented to the judge but not considered by the jury.

Does that mean that institutions should scrap their Guidelines-based compliance programs? Almost certainly not.

For one thing, the Court's split decision had the effect of leaving the Guidelines as something judges must still consider, even though they are not required to follow them. The Justice Department has taken the position that, in the absence of congressional action, the Guidelines should continue to be applied by federal judges.

Most importantly, the Court's decision did not affect in any way the importance prosecutors place on Compliance Programs in deciding whether to charge institutions. Avoiding a criminal charge is the key goal for a financial institution.

If Compliance Programs continue to be important, it is imperative to revisit them in light of the newly revised Sentencing Guidelines. The key changes made in the new Guidelines are:

- Institutions receive credit for an "effective compliance *and ethics* program," reflecting an explicit requirement that the institution promote a "culture that encourages ethical conduct" as well as compliance.
- The Board of Directors must be knowledgeable about the compliance and ethics program and exercise "reasonable oversight."
- There is increased emphasis on the involvement and specific responsibilities of senior management, the formality with which compliance activities are assigned and reported through all levels of the institution, training throughout the company and the resources and access given to compliance personnel.
- Instead of requiring efforts to identify people with a "propensity" for illegal activity, as the old Guidelines did, the new Guidelines focus on persons who have "engaged in illegal activities or other conduct inconsistent with an effective compliance and ethics program."
- There is a specific requirement "to evaluate periodically the effectiveness" of the program.
- The system for reporting potential criminal conduct must also include a means to "seek guidance" with respect to such conduct.
- In addition to imposing discipline for violations, the compliance and ethics program must include "appropriate incentives" to perform in accordance with the program.
- The institution must also periodically assess the risks of criminal conduct, and modify the program to reduce the risks identified in the assessment.

These are major changes, which will require a thorough re-working of most Corporate Compliance Programs. It would also be prudent to couple changes in the Compliance Program with a thorough evaluation of how the Program is actually being implemented, because paper is not enough. Law enforcement officials and prosecutors will give credence only to Compliance Programs that are demonstrably functioning. But the stakes for financial institutions are high, and the task is worth taking on. ■

Branding Or Re-Branding Your Bank?

A Recent U.S. Supreme Court Ruling May Impact How You Play the Name Game

By Clay A. Tillack

As your bank continues to grow or merges or is newly created, you will have a lot in common with your competition, but one thing you obviously won't want to have in common is your name and any trademarks associated with it. A recent U.S. Supreme Court has made protecting your good name tougher.

As background, trademark lawyers like to talk about trademarks as being on a spectrum of distinctiveness. The more distinctive a trademark, the more protection it is afforded. The distinctiveness spectrum is usually divided up by fanciful and arbitrary marks (such as GOOGLE or XEROX) at one end and with suggestive marks next and descriptive marks at the other end of the scale receiving very little protection, at least until they build up consumer recognition.

Since descriptive marks (such as, hypothetically, WONDERFUL BANK), are not inherently distinctive, they will be refused registration unless the applicant can demonstrate that the mark has been used for so long and in such a widespread manner that it has achieved a "secondary meaning" and denotes only a single source for the goods or services in the minds of the consumer.

So, if after many years of continuous and widespread use, a significant number of customers grows to associate WONDERFUL BANK with a particular financial institution, there's a good chance that the Patent and Trademark Office (PTO) will recognize that the words have morphed into a trademark.

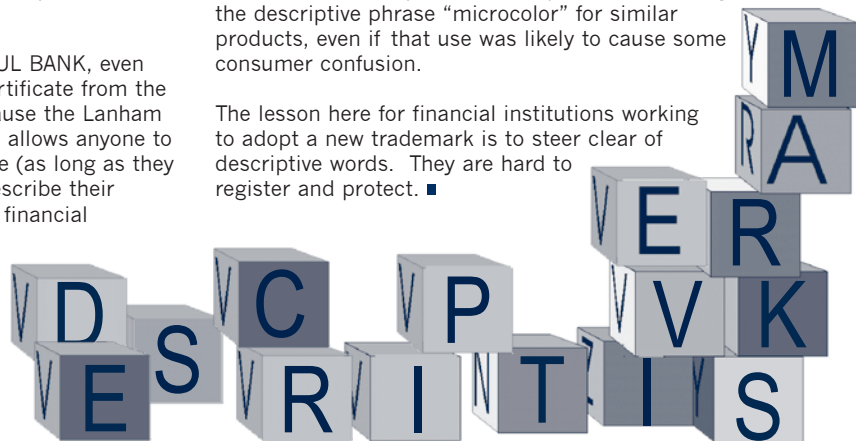
However, the owners of WONDERFUL BANK, even after receiving their registration certificate from the PTO, cannot rest easy. That's because the Lanham Act, the federal law of trademarks, allows anyone to use words in their descriptive sense (as long as they are not used as a trademark) to describe their product. That means that another financial

institution could be entitled to use "WONDERFUL BANK" to describe their financial institution, even though the same term functions as a registered trademark for another bank. So a competitor could launch an advertising campaign using the slogan "Our bank is a wonderful bank."

The defense to a trademark infringement claim brought by the WONDERFUL BANK owner is called "fair use," meaning that it's fine to use English words in their ordinary meaning even if it appears to conflict with a registered trademark. Until recently, the owner of the WONDERFUL BANK could argue that to benefit from the fair use defense, the user of the "wonderful bank" phrase had to demonstrate that his use did not confuse the public. The argument was that even if the mark included descriptive words that others were entitled to use to describe the attributes of their products, the ability to "fairly use" those descriptive words would cease if the would-be user could not also demonstrate that consumers were not being confused by use of both the trademark WONDERFUL BANK and the descriptive phrase on another product.

But in a closely watched decision issued in December 2004, the Supreme Court further eroded the protections afforded the owners of trademarks that include descriptive elements like WONDERFUL BANK. In a case involving the trademark MICROCOLOR for use in connection with permanent cosmetic makeup, the Court held that the owner of the registered trademark that included MICRO COLORS could not prevent a competitor from using the descriptive phrase "microcolor" for similar products, even if that use was likely to cause some consumer confusion.

The lesson here for financial institutions working to adopt a new trademark is to steer clear of descriptive words. They are hard to register and protect. ■





Metropolitan Capital Bancorp, Inc.

**1,057,650 Shares
Common Stock
\$10.00 per share
\$10,576,500**



**METROPOLITAN CAPITAL
BANK**

Organizers

**Michael P. Rose
Frank G. Bailen
Guy B. Jaffe
Richard C. Keneman
Marc J. Knez**

Launched January 25, 2005

**Schiff Hardin LLP represented
Metropolitan Capital in this de novo
bank formation**

Who We Are

Schiff Hardin LLP was founded in 1864, and we are Chicago's oldest large law firm. In the past 141 years we have grown to more than 340 attorneys, with additional offices in Washington, D.C.; New York, New York; Atlanta, Georgia; Lake Forest, Illinois; and Dublin, Ireland. As a general practice firm with local, regional, national, and international clients, Schiff Hardin has significant experience in most areas of the law.

Throughout our firm's history, we have continued to serve the special needs of financial institutions of all sizes and charters. Our Financial Institutions Group attorneys work with international and domestic banking organizations that look to us for representation in both routine and not so routine matters. Whether it is negotiating a bank merger or branch acquisition or rolling out an e-commerce banking strategy, we think hard, we put

client needs first, and we draw on our diverse experience to fashion solutions that help our clients meet their business goals. Our lawyers are experienced in many different disciplines besides financial institutions, such as securities and corporate, commercial litigation, lending, employee benefits, and labor law. We integrate these disciplines so that our financial institution clients experience seamless representation that serves all of their legal needs.

Our deep experience in the highly regulated banking industry and the diversity of our clients present a solid platform for us to solve the problems of any financial institution — bank, savings institution, or trust company. Depository institution holding companies, including bank, thrift, and financial holding companies, have special legal needs, too; counseling these companies is central to our practice. ■

SCHIFF HARDIN LLP

Attorneys Serving Business Since 1864
6600 Sears Tower
Chicago, Illinois 60606

t 312.258.5500
f 312.258.5600

www.schiffhardin.com

©2005 SCHIFF HARDIN LLP

This publication has been prepared for general information of clients and friends of the firm. It is not meant to provide legal advice with respect to any specific matter. Under the Illinois Rules of Professional Conduct, it may be considered advertising material.

FINANCIAL INSTITUTIONS
UPDATE

■ ■ ■ 6600 Sears Tower Chicago, Illinois 60606
SCHIFF HARDIN LLP

We are Chicago's
oldest large law firm
with a strong tradition
of professional service
to savings institutions
and commercial banks.
We offer our clients
the benefit of a
comprehensive law
firm coupled with
industry experience.

FINANCIAL INSTITUTIONS
UPDATE 