

**SPIN DOESN'T WIN WITH REGULATORS**

When issuing press releases advising the public of possible SEC problems, companies need to be careful that their characterizations of the issues do not conflict with those of the SEC. In a recent instance, this conflict led to potential SEC civil action for securities fraud and U.S. Department of Justice involvement because of press releases.

It all began when a large insurance company issued a press release in January 2002 announcing an SEC investigation for allegedly helping a large commercial bank appear stronger by shifting its poorly performing loans to three special purpose entities. The press release stated that the insurance company had not otherwise used this structure.

In a press release issued in September 2004, the insurance company announced that the SEC was considering a civil action against the insurance company for its transactions with the commercial bank. Later that month, the insurance company announced that the

Department of Justice had opened its own investigation into the commercial bank transactions.

The SEC has apparently advised the insurance company that each of the press releases was "false and misleading" because:

- the January 2002 press release did not disclose that the insurance company had entered into five other similar transactions with two other counterparties (the insurance company has argued that those five transactions were different because they did not have "the primary purpose of moving troubled, volatile, or underperforming assets off the balance sheet of the counterparty");
- the first September 2004 press gave the false impression that there were no other transactions being investigated by the SEC and did not name the other two counterparties; and
- The second September release

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suggested the Department of Justice investigation was limited to the commercial bank transactions rather than including the other five transactions.

The Department of Justice separately advised the insurance company that the press releases could be misleading.

**In disclosing ongoing or potential regulatory investigations, companies should balance the need to present their own view (i.e., spin) with the risks posed by the apparently heightened sensitivity of the SEC and the Department of Justice to press releases. ▣**

**BANKS FACE NEW CAPITAL RULES, NEW COMPETITION**



**Large banks may be willing to perform detailed calculations so they can hold less capital and be more competitive**

Larger banks could soon gain a significant advantage in cost of capital under proposed capital rules. Last Wednesday, federal banking regulators issued a computer spreadsheet that will help 30 banks and thrifts determine their capital requirements under the new BASEL II capital rules that become effective in January 2008. (See www.fdic.gov for more information.) The results of this test will guide regulatory drafting of a mid-2005 proposal to adopt BASEL II.

Some larger banks and thrifts

have already decided to opt-in to the BASEL II requirements because its detailed analysis of credit and operational risk could allow the banks to reduce their capital requirements by up to 2.0%.

**A modified, less complex version is expected to be developed for smaller banks. However, competition could become more severe as larger banks use their reduced capital requirement to lower their lending rates. ▣**

## SWIFT AND PUBLIC ACTION IN RESPONSE TO SOX NONCOMPLIANCE

Public companies racing to meet Sarbanes-Oxley internal control



**The SEC has been handing out stiff penalties for SOX noncompliance, and many companies are taking quick and public action to avoid them**

requirements by year-end also face stockholder and regulatory pressure to address corporate problems quickly and decisively. Even then, those companies could still suffer stock price drops and SEC probes.

Recently, SunTrust, which is the nation's eighth-largest banking company, discovered that it had overestimated its auto loan loss reserves for the first half of 2004 by over \$30 million. This caused SunTrust to understate its earnings by more than \$25 million for the first half of 2004. More importantly, its review of loan-loss allowance inconsistencies revealed problems with internal controls, including that certain credit officials provided false minutes of loan meetings to the bank's outside auditor.

In response to these discoveries, SunTrust fired three credit officials, including its Chief Credit Officer, reassigned its controller to a position that does not involve accounting or financial reporting, and disclosed the matter publicly. Despite these efforts, its stock price dropped, and it announced that it will probably not meet the internal controls compliance deadline under Section 404 of Sarbanes-Oxley. SunTrust officials announced that they will be meeting with the SEC this week to discuss the loan loss reserve problem.

**Quick and sometimes punitive action in response to corporate problems is becoming more routine as public companies seek to retain investor confidence and prevent regulatory action. ▣**

### RECENT SEC ACTIONS

The SEC made several important changes and announcements recently:

- **Today, the SEC issued a final rule postponing the last phase of its "accelerated filing" rule for one year.** For many companies, this means that the deadline for filing its 2004 Form 10-K annual report remains at 75 days after year-end. Otherwise, the deadline would have been reduced to 60 days. Also, the Form 10-Q quarterly report filing deadline for 2005 remains at 40 days rather than decreasing to 35 days as scheduled. The shorter filing periods take effect, however, for years ending after December 15, 2005.
- **The SEC again extended the exemption of banks and savings from the definition of "broker" while it continues to evaluate its adoption of Regulation B.** This exemption, under interim SEC rules prompted by the Gramm-Leach-

Bliley Act, allows banks and savings associations to continue their securities activities rather than have to meet certain exceptions or use a broker-dealer in the alternative. The exemption expires March 31, 2005. If adopted, Regulation B would replace the interim rules and its provisions would apply beginning January 1, 2006.

- **Hedge Fund Advisor Registration Now Required.** In a move to increase market transparency and accountability, the SEC voted to require hedge fund advisors with more than \$25 million in assets and with 15 or more investors to register with the SEC as investment advisors beginning February 1, 2006. Also, the minimum threshold required for hedge fund investment was raised from \$1 million to \$1.5 million. More information can be found at <http://www.sec.gov/rules/proposed/ia-2266.htm>. ▣

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