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Corporate and Financial Weekly Digest

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SEC/CORPORATE

PCAOB Proposes Auditing Standards on Communications with Audit Committees, Amendments to PCAOB Interim Standards

On March 29, the Public Company Accounting Oversight Board (PCAOB) published for comment proposed auditing standards related to communications with audit committees. The proposed auditing standards would supersede PCAOB interim standard AU sec. 380, *Communication With Audit Committees*, and AU sec. 310, *Appointment of the Independent Auditor*, and amend a number of other interim standards. Any new standards adopted by the PCAOB will be submitted to the Securities and Exchange Commission for approval. The PCAOB anticipates that the standards will be effective, if approved by the SEC, for audits or fiscal years beginning after December 15, 2010.

<u>Purpose of Proposed Auditing Standards</u>

The purpose of the proposed auditing standards is to improve communications between auditors and the audit committees of public company boards of directors. The new standards are intended to enhance the relevance and effectiveness of communications between the auditor and the audit committee and emphasize the importance of effective, two-way communications between the auditor and the audit committee to better achieve the objectives of the audit. The summary below highlights some of the more significant changes set forth in the proposed standards.

<u>Proposed Standards</u>

- ***Establish a Mutual Understanding of the Terms of the Audit.*** The new standards include a requirement that the auditor and the audit committee establish a mutual understanding of the terms of the audit engagement. The current standards do not provide that such a relationship must specifically be with the audit committee rather than with the client. The proposed standards require the engagement to be recorded in a written engagement letter which includes the understanding of the objectives of the audit and the responsibilities of the auditor and management.
- ***Obtaining Information Related to the Audit.*** The proposed standards require the auditor to make inquiries of the audit committee, or its chair, about risks of material misstatement, including inquiries related to fraud risks. In addition, the proposed standards require the auditor to inquire whether the audit committee is aware of any other matters that may be relevant to the audit, including complaints or concerns raised regarding accounting or auditing matters. The Securities Exchange Act requires audit committees to establish procedures for the receipt, retention and treatment of complaints or concerns raised regarding accounting or auditing matters; requiring that the auditor obtain this information is designed to "encourage more dialogue between the auditor and the audit committee regarding the risks of material misstatement and other matters relevant to the audit."
- ***Overview of the Audit Strategy and Timing of the Audit.*** The proposed standards include a new requirement for the auditor to communicate to the audit committee an overview of the audit strategy, including a discussion of significant risks identified by the auditor.
- ***Accounting Policies and Estimates.*** The proposed standards require the auditor to discuss with the audit committee the auditor's judgments about the quality and acceptability of the company's accounting policies, as well as its evaluation regarding the reasonableness of the process used by management to develop critical accounting estimates.
- ***Corrected and Uncorrected Misstatements.*** The proposed standards require the auditor to provide a schedule of uncorrected misstatements relating to accounts and disclosures that were presented to management, including, among other things, the auditor's basis for determining that the uncorrected misstatements were immaterial.

- ***Timing.*** The proposed standards require that all matters required by the proposed standard be communicated prior to the issuance of the auditor's report.
- ***Other Communication Requirements.*** The proposed standards include a new requirement that the auditor communicate to the audit committee when the auditor expects to modify the opinion in the auditor's report or include an explanatory paragraph, and the reasons therefor.

The PCAOB will be accepting comments until 5:00 PM EDT on May 28.

Click here for the full text of the proposed standards.

BROKER DEALER

FINRA Issues Guidance on Subordinations

The Financial Industry Regulatory Authority in Regulatory Notice 10-15 reminds member firms that pursuant to new consolidated FINRA Rule 4110(e)(1), subordinated notes and loans collateralized by securities (collectively referred to as "subordinations") must be approved by FINRA in order to receive beneficial regulatory capital treatment. Brokers and dealers use subordinations to increase their regulatory net capital. FINRA Rule 4110(e)(1) requires subordinations to meet, in addition to standards set in Appendix D, such standards as FINRA may require to ensure the firm's continued operational capability and financial stability. The Regulatory Notice contains guidance on the submission and approval process for proposed subordinations, as well as required provisions. All subordinations submitted to FINRA for approval must include provisions: (1) for approval and notification requirements, (2) obligating the firm to promptly reduce its business if it is in suspended repayment, and (3) for repayment and return.

To ease the review and preparation burdens associated with subordinations, FINRA provides seven standard forms of agreements, which are available at www.finra.org/subordinations. Firms may use these standard forms, but are not required to. The Regulatory Notice does not affect subordinations previously approved by New York Stock Exchange Regulation or FINRA. Any member firm that wishes to renew or amend a previously approved agreement, however, must follow the guidance set forth in the Regulatory Notice.

Click here to read FINRA Regulatory Notice 10-15.

CFTC

CFTC Creates Separate Bankruptcy Account Class for Cleared OTC Derivatives

The Commodity Futures Trading Commission has amended its bankruptcy rules (17 C.F.R. Part 190) to create a new "account class" for cleared over-the-counter (OTC) derivatives for purposes of calculating customer "net equity" and "allowed net equity" in the event of the bankruptcy of a futures commission merchant. The "cleared OTC derivatives" account class would include only those positions, and associated collateral, that are required to be (1) segregated or set aside in accordance with a rule, regulation or order issued by the CFTC, or (2) held in a separate account for cleared OTC contracts in accordance with the rules or bylaws of a derivatives clearing organization (DCO). The amended rules further provide that, to the extent the CFTC, pursuant to an order issued under section 4d of the Commodity Exchange Act, permits certain cleared OTC derivatives to be held in a customer segregated account, the positions will be treated as futures for purposes of calculating customer net equity. In this regard, the CFTC stated that it would continue to consider petitions for such orders and approve such petitions in appropriate cases.

The new rules do not impose substantive requirements with respect to the treatment of cleared OTC derivative positions and associated collateral. However, the CFTC has directed its staff to draft rules that would impose such substantive requirements.

The CFTC release containing the final rules is available here.

INVESTMENT COMPANIES AND INVESTMENT ADVISERS

Supreme Court Adopts Gartenberg Standard for Advisory Fee Reviews

On Wednesday, the Supreme Court issued an opinion in the matter of *Jones v. Harris Associates L.P.*, which approved the use of the multi-factor standard of review for investment advisory fees charged by investment company advisers first adopted in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982).

The Seventh Circuit's opinion, 527 F.3d 627 (7th Cir. 2008) had created a split in the circuits concerning standards for the review of potentially excessive investment advisory fees charged to mutual funds, closed-end funds, exchange-traded funds and other investment companies. The Seventh Circuit, focused on investor disclosure, stated that the propriety of advisory fees under the Investment Company Act could be challenged only where there was fraud.

Gartenberg requires an investment company board to review specific criteria in determining whether to oppose an advisory fee. The Supreme Court adopted the *Gartenberg* standard as controlling law and rejected the Seventh Circuit's holding in *Harris Associates*. The fiduciary duty standard for investment advisers under Section 36(b) of the Investment Company Act, the Supreme Court held, is that advisory fees must represent "a charge within the range of what would have been negotiated at arm's-length in light of all of the surrounding circumstances." The Court noted that the *Gartenberg* standard operates well with the statutory framework requiring analysis and review of advisory agreements by independent trustees of investment companies. In disposing of this case, the Supreme Court remanded the matter back to the Seventh Circuit for consideration under the *Gartenberg* standard.

Read more.

LITIGATION

Second Circuit Affirms Dismissal of Securities Class Action

The Second Circuit recently affirmed a lower court's dismissal of a securities class action brought against Axonyx, Inc. under Section 10(b) of the Securities Exchange Act of 1934 on the ground that the class plaintiffs failed to plead facts giving rise to a strong inference of scienter.

By way of background, shareholders sued Axonyx and certain of its officers and directors, alleging that the company issued a series of "artificially positive statements about the first Phase III trial of the Alzheimer's drug Phenserine." The investors claimed that Axonyx misrepresented facts regarding the nature, quality, reliability and design of its Phase III trial for Phenserine, and that the purpose of the misstatements was to inflate the stock price of Axonyx. In particular, the shareholder plaintiffs alleged that management purposefully inflated the stock price so that the Chief Operating Officer could sell 30% of his holdings during the class period (at a profit of $1.5 million) and the Chief Executive Officer could sell 5% (at a profit of $766,000).

Any complaint alleging securities fraud must state with particularity the circumstances constituting the fraud. Under *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007), the Private Securities Litigation Reform Act requires the allegations of scienter (i.e., the intent to defraud), to be "more than merely plausible or reasonable—the allegations must be cogent and at least as compelling as any opposing inference of nonfraudulent intent."

The district court found that the investor plaintiffs failed to allege sufficient facts to state a claim that Axonyx and its officers purposely misled investors regarding the Phase III trial for Phenserine and/or the likelihood that it would be successful as a drug to treat Alzheimer's. With regard to the insider stock sales, the district court found that the executives still retained the vast majority of their Axonyx stock holdings and the plaintiffs had not adequately alleged that the sales were suspicious in timing or amount.

The Second Circuit affirmed the lower court's dismissal of the complaint for failure to plead facts giving rise to a strong inference of scienter. In particular, the Second Circuit agreed with the district court's conclusions that the complaint lacked sufficient detail regarding the alleged misstatements regarding defects in Axonyx's Phase III trial for Phenserine. The district court found that the allegations in the complaint supported the defendants' position that Axonyx designed the Phase III trial to the best of its ability and that the company at all times believed Phenserine would prove to be effective at treating Alzheimer's disease. The Second Circuit agreed, finding that "any inference in the complaint of scienter is less compelling than any opposing inference that Axonyx's trial of Phenserine was merely unsuccessful." (*City of Dearborn Heights Act 345 Police & FireR v. Axonyx, Inc.*, No, 09-1773-cv, 2010 WL 1049233 (2d Cir. March 23, 2010))

Amended SEC Claims Against Internet Media Executives Sustained

The U.S. District Court for the Southern District of New York (SDNY) recently sustained, in substantial part, an amended complaint by the Securities and Exchange Commission against the senior executives of StarMedia Network, Inc., an Internet portal that targets Spanish- and Portuguese-speaking markets, for accounting fraud. The SDNY previously dismissed the majority of the SEC's original complaint against the StarMedia executives, but granted the Commission leave to replead.

The SEC's amended complaint alleged that StarMedia and its senior executives improperly and misleadingly accounted for three types of transactions: (1) the "base book" transactions, (2) the "incremental revenue" transactions, and (3) the contingent transaction. The base book and incremental revenue transactions were both forms of barter transactions—two parties trading an equal value of services without any true exchange of cash. In both cases, StarMedia and an affiliated or controlled company each agreed to "purchase" an equal and offsetting amount of advertising from each other. Rather than reporting the transaction as a barter deal, StarMedia reported its advertising "sale" as an ordinary or "true" sale with ordinary revenue. For the contingent transaction, StarMedia recognized the full amount of a $500,000 sale even though it granted the buyer a secret and undocumented right to pay only $10,000 if the buyer was unsatisfied with StarMedia's services.

As to Fernando Espuelas (CEO and Chairman of the Board) and Jack Chen (President and member of the Board), the SEC alleged that the executives violated Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated thereunder, by ratifying disclosures they should have known were misleading in two ways: first, because StarMedia had improperly accounted for the base book and incremental revenue transactions, and second, because StarMedia had failed to report them as barter transactions.

Critically, the court sustained the SEC's amended complaint because the Commission added detailed allegations showing that the executives had full knowledge of what a barter transaction was and that investors considered barter revenue and "true" sale revenue to be qualitatively different. With regard to the contingent transaction, the SEC added new allegations that the CEO and President each had actual knowledge regarding the buyer's undocumented right to pay only $10,000, and that they were aware of the fact that StarMedia recognized the full $500,000, notwithstanding the undocumented agreement. (*Securities and Exchange Commission v. Espuelas*, No. 06 Civ. 2435, 2010 WL 1170664 (S.D.N.Y. March 26, 2010))

BANKING

Treasury to Sell Citigroup Shares

The U.S. Department of the Treasury on March 29 publicly announced its intention to dispose of its approximately 7.7 billion shares of Citigroup, Inc. common stock over the course of 2010, subject to market conditions. The Treasury received these shares of common stock pursuant to the June 2009 Exchange Agreement between the Treasury and Citigroup, which provided for the exchange into common shares of the preferred stock that the Treasury purchased in connection with Citigroup's participation in the Troubled Asset Relief Program Capital Purchase Program.

The Treasury explained that it intends to sell its Citigroup common shares into the market through various means in an orderly and measured fashion, pursuant to a pre-arranged written trading plan. This disposition does not affect the Treasury's holdings of Citigroup trust preferred securities or warrants for its common stock.

Read more.

EXECUTIVE COMPENSATION AND ERISA

New York Department of Labor Warn Act Modifications

New York's "mini-WARN" Act (N.Y. Labor Law Section 860 *et seq*.) has been further revised effective February 12 by emergency regulations issued by the New York State Department of Labor (DOL). The New York State WARN Act was signed into law in August 2008 and, by reason of its more expansive required notice period and application to smaller employers, offers more coverage to affected workers than the federal WARN Act. The recently revised regulations attempt to strengthen worker protection in the face of the depressed employment conditions plaguing the state.

Most significantly, the revised regulations plug a definitional hole in the prior regulations which left "reduction in hours of work" undefined. Under the revised regulations such a reduction is defined to be one that affects at least 25 employees constituting at least 1/3 of the employees at the closed site, or at least 250 employees total regardless of the percentage. A covered relocation is one that affects 25 or more employees. Previously, no threshold number of employees or percentages had been included in the regulation.

Another significant change is that the defined term "date of layoff" has now been revised to mean "the last day an employee is eligible or permitted to work for his/her employer." Because the regulation further states that any payment to the employee subsequent to the date of layoff shall not affect the layoff date, the practical effect of the regulation is to permit the employer to provide affected employees with regular pay and benefits through the 90-day notice period whether or not the affected site remains open, at least to the extent that employees are no longer "eligible or permitted" to work.

There are further significant changes that employers and affected employees should be aware of. The DOL has helpfully posted a redline of changes to the regulations on its website, which can be accessed here.

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