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CORPORATE & FINANCIAL
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SEC/CORPORATE

PCAOB Chairman Considers Audit Firm Rotation

In a wide-ranging speech to the SEC and Financial Reporting Institute's 30th Annual Conference on June 2, James Doty, Chairman of the Public Company Accounting Oversight Board (PCAOB) raised for discussion and review the possibility that the PCAOB may require audit firm rotation.

In his speech, Chairman Doty described a lack of "independence and skepticism" that has surfaced over eight years of inspections of the largest audit firms conducted by the PCAOB. He stated that PCAOB inspectors have reviewed more than 2,800 engagements and "discovered and analyzed hundreds of cases involving... audit failures." Mr. Doty attributes such failures to both a lack of professional skepticism and an "inappropriate mindset" that continues to exist despite auditor independence rules. "Auditors are, after all, paid by the clients they are charged with policing. As in other professions, auditors want to advance in their chosen profession which often means keeping the client happy and growing their business."

Given these concerns, Mr. Doty expects that the PCAOB will issue several policy papers in the near term to stimulate discussion as to whether there should be changes to the standard auditors' report, whether the PCAOB can find ways to enhance audit committees' understanding of the PCAOB's inspection process and, finally, whether audit firm rotation should be mandated.

In support of the latter, Mr. Doty stated "...considering the disturbing lack of skepticism we continue to see, and because of the fundamental importance of independence to the performance of quality audit work, the [PCAOB] is prepared to consider all possible methods of addressing the problem of audit quality—including whether mandatory audit firm rotation would help address the inherent conflict created because the auditor is paid by the client."

While Mr. Doty states that he does not have a "pre-determined idea" of whether the PCAOB ultimately should adopt term limits, he states his goal is to "better insulate auditors from client pressure and shift their mindset to protecting the investment public."

Read more.

BROKER DEALER

FINRA Encourages Firms to Make Reasonable Efforts to Assist Investment Advisers Seeking Information to Comply with Rule 206(4)-5

The Financial Industry Regulatory Authority issued an Information Notice encouraging member firms to make reasonable efforts to assist investment advisers seeking to comply with Rule 206(4)-5 under the Investment Advisers Act of 1940, as amended, which is intended to curb "pay-to-play" practices. In general, the rule prohibits an investment adviser from providing advisory services for compensation to state government clients for two years after the investment adviser or specified employees or executives make contributions to certain state elected officials or candidates. FINRA recognizes that it may be difficult for investment advisers to identify these government investors when, for example, shares in a covered investment company managed by the investment advisers are held through an intermediary. FINRA is encouraging member firms to make reasonable efforts to assist investment advisers seeking to comply with the requirements of Rule 206(4)-5 in these situations.

Click here to read the FINRA Information Notice.

FINRA Reminds Firms of Their Trade Reporting Obligations and Announces New Submission Process for Form T

The Financial Industry Regulatory Authority issued a Trade Reporting Notice reminding member firms of their obligation to report, as soon as practicable, to FINRA's Market Regulation Department on Form T last sale reports of over-the-counter transactions in equity securities for which electronic submission is not possible (such as if the transaction occurred on a holiday or weekend). In the Trade Reporting Notice, FINRA also announced a new process for the electronic submission of Form T. Effective July 5, member firms must submit Form T electronically through FINRA's Firm Gateway, and will no longer be able to submit Form T via email. Member firms may begin submitting Form T data via the new submission process on June 6, though they are not required to until the July 5 effective date.

Click here to read the FINRA Trade Reporting Notice.

CFTC

CFTC to Hold Public Meeting to Consider Dodd-Frank Effective Dates

The Commodity Futures Trading Commission will hold a public meeting on June 14 at its headquarters in Washington, D.C., to consider the effective date of various provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 754 of the Dodd-Frank Act provides that "[u]nless otherwise provided in this title, the provisions of this subtitle shall take effect on the later of 360 days after the date of the enactment of this subtitle [i.e., July 16, 2011] or, to the extent a provision of this subtitle requires a rulemaking, not less than 60 days after publication of the final rule or regulation implementing such provision of this subtitle."

Further information about the meeting is available here.

LITIGATION

Directors' Bonuses Tied to Sale Rendered Them Interested

The Delaware Court of Chancery sustained in part the claims of a plaintiff investor challenging a company's sale of its primary asset based upon allegations that the vote of the individual director defendants approving the sale was tainted by bonuses they received tied to that sale.

In December 2005, individual director defendants of nominal defendant Winmill & Co., Inc., a 22% shareholder in Bexil Corporation, a holding company, voted in favor of a transaction by which Bexil would sell its interest in a third company, its primary asset. In April 2006, Bexil's shareholders approved the sale, resulting in pre-tax proceeds to Bexil of approximately $38.5 million. Two of the individual director defendants who had approved the transaction received bonus compensation directly tied to the sale totaling $2.5 million.

Plaintiff, The Ravenswood Investment Company, L.P. owned or had authority over 7% of Winmill's non-voting shares. It brought direct and derivative claims based on the sale of Bexil's primary asset, claiming that compensation received by the individual director defendants tainted their decision to vote in favor of the sale. Defendants moved to dismiss the complaint pursuant to Court of Chancery Rule 12(b)(6) for failure to state a claim, and Rule 23.1, for failure to adequately allege that demand upon the Winmill board was excused with respect to the derivative claims.

In sustaining the derivative claims challenging the sale, the court reasoned that the $2.5 million received by the individual director defendants, which was substantially contingent upon the deal closing, supported an inference that they voted to approve the sale, at least in part, because of that expected payment. As a result, the court denied the defendants' motion to dismiss Ravenswood's derivative claims of breach of fiduciary duty with respect to the approval of the sale by Bexil. Similarly, the court held that demand on the board was excused because the complaint satisfactorily alleged that two of Winmill's three directors had a material, disqualifying self-interest when they voted in favor of the sale. Finally, the court held that even if Winmill profited from the sale, the transaction could still be found to be unfair to the company because the bonus paid to the directors improperly reduced the benefit the company received. (*The Ravenswood Investment Company, L.P., v. Winmill*, 2011 WL 2176478 (Del. Ch. May 31, 2011))

Delaware Has Jurisdiction over Corporation Based on Claims Arising out of Performance of Predecessor's Contracts

The Superior Court of Delaware recently denied a motion to dismiss for lack of personal jurisdiction, holding that, following a merger, the defendant corporation continued to transact business within Delaware and, in connection with that business, caused injury within the state. As a result, the court determined that the assertion of personal jurisdiction over the foreign defendant was proper.

Defendant Micco World, Inc. is a Georgia corporation and the surviving entity of a merger with Constellation Group, Inc., a Delaware corporation. Plaintiff Universal Capital Management, Inc. entered into two contracts with Constellation whereby it acquired warrants for common stock in Constellation in exchange for providing the company with business management assistance and introductions to potential investors. The investors introduced by Universal invested approximately $600,000 in Constellation. Universal alleged that this funding was misappropriated by the officers of Micco, who were also named as defendants, and that in order to hide their wrongdoing, the defendants provided delayed and inaccurate accountings to Universal.

Universal brought suit against Micco and its officers, alleging numerous tort and contract claims, including claims for fraud and for defamation based on statements made to Micco's investors, including the investors that Universal had found. Defendants moved to dismiss based on lack of personal jurisdiction. Under Delaware's long arm statute, personal jurisdiction may attach to entities transacting business within the state where the plaintiff's injuries arise out of that transaction of business. Although the contracts at issue were entered into by Constellation, Micco's predecessor entity, the court found that Micco continued to transact business pursuant to the contracts after the merger. The court determined that the continued adherence to the terms of Constellation's contracts enabled Micco to derive "substantial revenue from services or things consumed or used" in Delaware. Because Micco allegedly caused injuries to Universal in Delaware in connection with the contracts, the court held that the assertion of personal jurisdiction over Micco was proper. (*Universal Capital Management, Inc. v. Micco World*, *Inc.,* C.A. No. 10C-07-039 RRC (Del. Super. June 2, 2011))

BANKING

Agencies Extend Comment Period on Risk Retention Proposed Rulemaking

Six federal agencies have approved and will submit a *Federal Register* notice that extends the comment period on the proposed rules to implement the credit risk retention requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 15G generally requires the securitizer of asset-backed securities (ABS) to retain an economic interest of no less than 5% in the credit risk of the assets collateralizing the ABS and would not permit transfer of or hedging that credit risk. Section 15G includes a variety of exemptions from this requirement, including an exemption for ABS that are collateralized exclusively by "qualified residential mortgages," as such term is defined by the Agencies by rule. The comment period was extended to August 1 to allow interested persons more time to analyze the issues and prepare their comments. (Originally, comments were due by June 10.) The Agencies stated, "Due to the complexity of the rulemaking and to allow parties more time to consider the impact of the [proposed rule] on affected markets, the Agencies have determined that an extension of the comment period until August 1, 2011 is appropriate."

The proposal was issued by the Office of the Comptroller of the Currency, the Federal Reserve, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, the Federal Housing Finance Agency, and the U.S. Department of Housing and Urban Development.

Read more.

Banking Agencies Seek Comment on New Stress Testing Guidance

On June 9, the Federal Reserve Board, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation (the agencies) announced that they are seeking comment on proposed supervisory guidance regarding stress-testing practices at banking organizations with total consolidated assets of more than $10 billion.

The agencies are issuing the proposed guidance "to emphasize the importance of stress testing in equipping banking organizations to assess the risks they face and address a range of potential adverse outcomes." The guidance outlines general principles for a satisfactory stress testing framework and describes how stress testing should be used at various levels within an organization. The guidance also discusses the importance of stress testing in capital and liquidity planning, and the importance of strong internal governance and controls in an effective stress-testing framework. While the guidance is not intended to provide detailed instructions for conducting stress testing for any particular risk or business area, the proposed guidance aims to describe several types of stress testing activities and how they may be most appropriately used by banking organizations. Based on four principles set forth in the guidance, the uses of a banking organization's stress testing framework should include, but are not limited to, augmenting risk identification and measurement; estimating business line revenues and losses and informing business line strategies; identifying vulnerabilities and assessing their potential impact; assessing capital adequacy and enhancing capital planning; assessing liquidity adequacy and informing contingency funding plans; contributing to strategic planning; enabling senior management to better integrate strategy, risk management, and capital and liquidity planning decisions; and assisting with recovery planning.

While the guidance does not explicitly address the stress testing requirements outlined in the Dodd-Frank Wall Street Reform and Consumer Protection Act, the agencies anticipate that rulemakings implementing these requirements would "be consistent with the principles in the proposed guidance." The agencies also expect the guidance to be consistent with other supervisory initiatives, including those related to capital and liquidity planning. The agencies request comment on the proposed supervisory guidance by July 29.

Read more.

EXECUTIVE COMPENSATION AND ERISA

June 30 Deadline to Amend Cafeteria Plans

The Patient Protection and Affordable Care Act (PPACA) cuts back on which drugs may be reimbursed from flexible spending accounts, health reimbursement arrangements, health savings accounts and Archer medical savings accounts. Such plans are prohibited from reimbursing for medicine or drug expenses incurred after December 31, 2010, unless the item requires a prescription, the item is available over-the-counter but the individual obtained a prescription, or the drug is insulin.

Though this requirement has been in effect since January 1, 2011, the Internal Revenue Service permitted benefit plans to wait until June 30, 2011, to formally amend their governing plan documentation (retroactively) to reflect this new limitation. Failure to amend the plan document by June 30 may result in disqualification of the plan and the taxation of all benefits for all covered employees.

You are encouraged to review your plan document to ensure it has been updated to reflect this change, and to adopt the change by the end of the month if this has not been done previously. Presumably summary plan descriptions already reflect this change, but if not they should also be updated.

A copy of IRS Notice 2010-59, which explains this limitation (and extends until June 30, 2011, the deadline for formally amending the plan document), can be found here.

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