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SEC/CORPORATE

PCAOB Solicits Comments on Proposed Amendments to Improve Audit Transparency

On October 11, the Public Company Accounting Oversight Board (PCAOB) requested public comment on several proposed amendments to PCAOB standards designed to increase transparency of public company audits.

The PCAOB proposed an amendment, as a result of comments received in response to its July 28, 2009 concept release, that would require disclosure of the name of the engagement partner in audit reports for the most recent reporting period's audit, but would not require the engagement partner's signature on the report. The PCAOB believes that this will "enhanc[e] the engagement partner's individual accountability and preserv[e] the firms responsibility for the audit," and requests comments on the issue. The PCAOB also requests comments on whether the proposed rule may increase potential liability or create security risks for the engagement partner.

In connection with this proposed rule, the PCAOB proposed adding a requirement to the Annual Report form required to be filed with the PCAOB to disclose the name of the engagement partner for each audit report already required to be reported on the form. The PCAOB requests comments on this proposed amendment.

The PCAOB also proposed amendments that would require disclosure in the audit report regarding other independent public accounting firms and individuals or entities that are not employed by the auditor but took part in the most recent period's audit, regardless of whether those individuals or entities are affiliated with the auditor.

Under these proposed amendments, if the auditor supervises or assumes responsibility for the other participants in the audit, the audit report would be required to disclose the names and locations of the other participants and the percentage of hours spent on the audit that are attributable to the other participants (excluding the engagement quality review (EQR) and certain other reviews). The audit report would also be required to include a statement that the auditor is responsible for the audits or procedures performed by the other participants and that the auditor has supervised and assumes responsibility for the other participants' work. These disclosure requirements would not apply to certain participants in the audit, including individuals performing an EQR review, specialists in an unrelated field, and certain persons employed or engaged by the company. The disclosure requirements would also cover certain "off-shoring" arrangements, where portions of an audit are performed in offices in a different country than the auditor's headquarters, but would not require disclosure of off-shored work performed by one of the auditor's offices. The PCAOB requests comments on these proposed amendments, including their usefulness to investors, disclosure of off-shoring and other arrangements, disclosure of the percentage of hours worked by other participants, whether the disclosure would affect competition and the threshold for disclosure.

Under the proposed amendments, if responsibility for the audit is divided between the auditor and another accounting firm, the audit report would be required to include the name and location of the headquarters of the other accounting firm. The proposed amendments would also remove the requirement to obtain permission to disclose the name of the other accounting firm. The PCAOB requests comments on this proposed amendment.

The deadline to submit comments on these proposed amendments is January 9, 2012. To read the PCAOB release and the text of the proposed amendments, click here.

SEC's Division of Corporation Finance Issues Cybersecurity Disclosure Guidance

On October 13 the Division of Corporation Finance of the Securities and Exchange Commission issued disclosure guidance to assist registrants "in assessing what, if any, disclosures should be provided about cybersecurity matters in light of each registrant's specific facts and circumstances."

The disclosure guidance provides a list of potential negative consequences and substantial costs that a registrant may incur as a result of a successful cyber attack, including remediation costs, increased cybersecurity protection costs, loss of revenues, litigation and reputational damage. The disclosure guidance suggests that although no existing disclosure requirement explicitly refers to cybersecurity risks, depending on the circumstances and the company's particular situation (the guidance urges registrant's to avoid generic disclosure) the following sections of public filings may be implicated:

- Risk Factors – registrants should consider the probability of cyber incidents occurring and the quantitative and qualitative magnitude of those risks including the potential costs and other consequences that may result. Depending upon the registrant's particular facts and circumstances, and to the extent material, risk factor disclosure may include the aspects of the registrant's operations that give rise to material cybersecurity risks; to the extent registrant outsources functions that are subject to such risks, a description of those functions; risks related to cyber incidents that may remain undetected for an extended period; and a description of relevant insurance coverage.

- Management's Discussion and Analysis of Financial Condition and Results of Operation (MD&A) – the disclosure guidance encourages registrants to address cybersecurity risks and past cyber incidents in their MD&A if the costs and other consequences associated "with one or more known incidents or the risk of potential incidents" represent a material event, trend, or uncertainty that is reasonably likely to have a material effect on the registrant's results of operations, liquidity, or financial condition.

- Description of Business and Legal Proceedings – if incidents have already impacted, or may materially impact, registrant's business or if there are pending material legal proceedings, full disclosure should be made.

- Financial Statement Disclosures – here the disclosure guidance references various accounting principles that may be implicated in the event of a cyber incident, including loss contingencies, cash flow diminution and customer payments and incentives that may result from a registrant seeking to mitigate damages.

The disclosure guidance may be accessed here.

BROKER DEALER

FINRA to Require Electronic Submission of Annual Audit Reports

The Financial Industry Regulatory Authority, Inc. has issued Regulatory Notice 11-46 requiring member firms to submit electronically to FINRA their annual audit reports. This requirement is effective beginning on November 8, for all audit reports filed by member firms with a fiscal year end on or after September 30, 2011. Member firms will be required to submit their annual audit report in electronic form in PDF format via FINRA's Firm Gateway. The Regulatory Notice discusses the details of the electronic submission process, which will replace the current submission of the annual audit reports in hard copy form to FINRA. The Regulatory Notice acknowledges that firms must continue to file annual audit reports in hard copy form with the Securities and Exchange Commission.

Click here to read Regulatory Notice 11-46.

LITIGATION

FINRA May Not Bring Civil Actions to Collect Disciplinary Fines

The U.S. Court of Appeals for the Second Circuit held that the Financial Industry Regulatory Authority lacks the authority to bring court actions to collect disciplinary fines it has imposed on its members.

In 2000, FINRA's predecessor (the NASD) found that member firm Fiero Brothers had violated Section 10(b) of the Securities Exchange Act of 1934. The NASD revoked Fieoro's member status and fined John Fiero, the firm's sole representative, $1 million plus costs. After Fiero refused to pay the fine, FINRA commenced a breach of contract action in New York State court, alleging that Fiero had contractually agreed to pay any disciplinary fines when he signed the NASD registration forms. The New York Court of Appeals dismissed the case for lack of subject matter jurisdiction, and the case was re-filed in federal court.

Noting that the Exchange Act sets forth in detail the powers and rights of self regulatory organizations (SROs) such as FINRA, the Second Circuit found that the Exchange Act does not authorize SROs to bring civil enforcement actions to collect fines imposed on member firms.

In dismissing FINRA's claim, the Second Circuit also found that a 1990 rule adopted by the Securities and Exchange Commission announcing NASD's intent to "seek to reduce such fines to a judgment" was not promulgated under proper procedures and was therefore invalid. The rule sought to change the existing authority for SROs and thus required a notice and comment period, as well as affirmative SEC approval, before becoming effective. Because Congress never intended that FINRA be able to pursue its fines in court, and because the 1990 rule did not effectively grant FINRA that power, its claims were dismissed.

Fiero v. Financial Industry Regulatory Authority, Inc., Nos. 09-1556-cv(L), 09-1863-cv(XAP), 2011 WL 4582436 (2d Cir. Oct. 5, 2011).

Brokerage Firm's Sale of Account Holder's Securities Not a Securities Violation

The U.S. Court of Appeals for the Third Circuit held last week that a brokerage firm's sale of an account holder's securities for failure to meet margins calls was proper, notwithstanding the account holder's claims that his contract with the firm was a forgery.

In 1996, Andrew Walzer signed an options agreement with Muriel Siebert & Co. (MSC) that, among other things, authorized MSC to increase Walzer's margin requirements. After Walzer failed to satisfy margin calls, MSC sold $802,000 worth of his securities. Proceeding pro se, Walzer alleged that the 1996 options agreement was a forgery, and (though less than clear) that MSC violated Section 10(b) of the Securities Exchange Act when it sold Walzer's collateral claiming it had a right to do so under the 1996 options agreement. The Third Circuit held that Walzer could not establish a Section 10(b) claim because he himself did not sell the securities and because he could not establish reliance on the purported misrepresentation.

Walzer v. Muriel Siebert & Co., No. 10-4526, 2011 WL 4625704 (3d Cir. Oct. 6, 2011).

BANKING

Volcker Rule Proposal Issued By Federal Reserve, FDIC, and SEC

On October 11, the Federal Reserve Board and the Federal Deposit Insurance Corporation requested public comment on a proposed regulation implementing the so-called "Volcker Rule" requirements of Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Among other things, Section 619 generally contains two prohibitions. First, it prohibits insured depository institutions, bank holding companies, and their subsidiaries or affiliates (banking entities) from engaging in proprietary trading of any security, derivative, and certain other financial instruments for a banking entity's own account, subject to certain exemptions. Second, it prohibits owning, sponsoring, or having certain relationships with, a hedge fund or private equity fund, subject to certain exemptions.

The proposal, which was developed jointly with the Office of the Comptroller of the Currency, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, "clarifies the scope of the act's prohibitions and, consistent with statutory authority, provides certain exemptions to these prohibitions." The proposal is 298 pages long and contains 394 questions on which comment is invited.

Reaction of the American Bankers Association was swift and critical. New ABA President and CEO Frank Keating commented: "The banking industry fears the oversized nature and complexity of this proposed rule will make it unworkable and will further inhibit U.S. banks' ability to serve customers and compete internationally. Regulators' own estimates indicate banks will have to spend nearly 6.6 million hours to implement the rule, of which more than 1.8 million hours would be required every year in perpetuity. That translates into 3,292 years, or more than 3,000 bank employees whose sole job will be complying with this rule. They will be transferred to a role that provides no customer service, generates zero revenue and does nothing for the economy."

On October 12, the Securities and Exchange Commission voted unanimously to issue the Volcker Rule for comment. SEC Commissioner Paredes supported issuing the rule for comment, but expressed four major concerns:

- The rule curtails market making at the expense of liquidity and capital formation.
- These limitations put domestic banks at a competitive disadvantage to foreign institutions.
- The compliance burden is unrealistic and excessive.
- "Hedge funds" is not defined narrowly enough.

A very brief summary of the proposed rule may be found here. The proposed rule itself may be found here. Comments are due before January 13, 2012.

Financial Stability Oversight Council Issues Proposed Rule on Which Non-Bank Financial Companies Will Be Subject to Regulation

On October 11, the Financial Stability Oversight Council (the Council) approved a second notice of proposed rulemaking (NPR) and proposed interpretive guidance on its authority to require supervision and regulation of certain nonbank financial companies. In response to comments that the Council received on its first NPR, issued in January, the Council is issuing a second notice of proposed rulemaking and proposed interpretive guidance to provide (i) additional details regarding the framework that the Council intends to use in the process of assessing whether a nonbank financial company could pose a threat to U.S. financial stability, and (ii) further opportunity for public comment on the Council's proposed approach to the determination process.

Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) authorizes the Council to require a nonbank financial company to be supervised by the Board of Governors of the Federal Reserve System (the Board) and be subject to prudential standards if the Council determines that (i) material financial distress at the nonbank financial company, or (ii) the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the nonbank financial company, could pose a threat to the financial stability of the United States (the Determination Standards). The Council stated that it "intends to interpret the term "company" broadly. (The Dodd-Frank Act provides that a company is "predominantly engaged" in financial activities if either (i) the annual gross revenues derived by the company and all of its subsidiaries from financial activities, as well as from the ownership or control of insured depository institutions, represent 85 percent or more of the consolidated annual gross revenues of the company; or (ii) the consolidated assets of the company and all of its subsidiaries related to financial activities, as well as related to the ownership or control of insured depository institutions, represent 85 percent or more of the consolidated assets of the company. The Board is charged with interpreting the term "predominantly engaged in financial activities" and has solicited comment with respect thereto.)

Under the Dodd-Frank Act, if a company is selected under either of the two criteria above, it will be subject to reporting requirements of the Office of Financial Research and regulation by the Board, which includes registration, reporting and examination, as well as heightened prudential standards. In addition, such companies will be treated as bank holding companies under Section 3 of the Bank Holding Company Act for purposes of acquisitions. Finally, the Council by a two thirds vote may impose conditions on any activity and may require the company to break up if the company is determined to pose a "grave threat" to U.S. financial stability.

Under the first Determination Standard, the Council may subject a nonbank financial company to supervision by the Board of Governors and prudential standards if the Council determines that "material financial distress" at the nonbank financial company could pose a threat to U.S. financial stability. The Council believes that material financial distress exists when a nonbank financial company is in imminent danger of insolvency or defaulting on its financial obligations. For purposes of considering whether a nonbank financial company could pose a threat to U.S. financial stability under this Determination Standard, the Council intends to assess the impact of the nonbank financial company's material financial distress in the context of a period of overall stress in the financial services industry and in a weak macroeconomic environment.

Under the second Determination Standard, the Council enunciated in its guidelines (attached as an appendix to the proposed rule) six thresholds for consideration under the second Determination Standard:

- Total Consolidated Assets. The Council intends to apply a size threshold of $50 billion in global total consolidated assets for U.S. nonbank financial companies or $50 billion in U.S. total consolidated assets for foreign nonbank financial companies.

- Credit Default Swaps Outstanding. The Council intends to apply a threshold of $30 billion in gross notional credit default swaps (CDS) outstanding for which a nonbank financial company is the reference entity. Gross notional value equals the sum of CDS contracts bought (or equivalently sold).

- Derivative Liabilities. The Council intends to apply a threshold of $3.5 billion of derivative liabilities. In accordance with Accounting Standards Codification 815, derivative liabilities equals the fair value of any derivatives contracts in a negative position after taking into account the effects of master netting agreements and cash collateral held with the same counterparty on a net basis, if elected.

- Loans and Bonds Outstanding. The Council intends to apply a threshold of $20 billion of outstanding loans borrowed and bonds issued.

- Leverage Ratio. The Council intends to apply a threshold leverage ratio of total consolidated assets (excluding separate accounts) to total equity of 15 to 1. The Council intends to exclude separate accounts from this calculation because separate accounts are not available to claims by general creditors of a nonbank financial company.

- Short-Term Debt Ratio. The Council intends to apply a threshold ratio of debt with a maturity of less than 12 months to total consolidated assets (excluding separate accounts) of 10 percent.

Notwithstanding the thresholds listed above, the Council stated that "the Council does not believe that a determination decision can be reduced to a formula. Each determination will be made on a firm-specific basis, taking into account qualitative, as well as quantitative, information that the Council deems relevant to a particular nonbank financial company." Applying a three-stage process of review, the Council also stated that "[i]n all instances, the Council reserves the right, in its discretion, to subject any nonbank financial company, irrespective of whether such company was identified in Stage 1, to further review if the Council believes that further analysis of the company is warranted to determine if the company could pose a threat to U.S. financial stability." Stages 2 and 3 will involve additional analysis of companies selected. Companies selected have notice and hearing rights to contest selection, and the Council has emergency rights to select companies under certain circumstances. The Dodd-Frank Act requires an annual evaluation of companies selected to determine whether a selection should be rescinded.

For more information, click here.

Federal Reserve Proposes Changes in Reserve Requirements Of Depository Institutions and Related Programs

Section 19 of the Federal Reserve Act (the Act) authorizes the Board of Governors of the Federal Reserve System (the Board) to impose reserve requirements on certain deposits and other liabilities of depository institutions for the purpose of implementing monetary policy. The Board's Regulation D (Reserve Requirements of Depository Institutions, 12 CFR part 204) implements section 19 of the Act. Transaction account balances maintained at each depository institution are subject to reserve requirement ratios of zero, three, or ten percent, depending on the level of transaction accounts at that institution.

On October 11, the Board requested public comment on its proposed amendments to Regulation D to simplify the administration of reserve requirements. The proposed amendments would create a common two-week maintenance period for all depository institutions (eliminating the one-week maintenance period generally used by smaller institutions), create a penalty free band around reserve balance requirements in place of carryover and routine penalty waivers, discontinue as-of adjustments related to deposit revisions, replace all other as-of adjustments with direct compensation, and, somewhat more significantly, eliminate the contractual clearing balance program. Although the contractual clearing program would be eliminated, the Board does not anticipate that small depository institutions (those institutions with assets of $175 million or less) would be negatively affected because small depository institutions would receive explicit interest on excess balances instead of earnings credits on clearing balances. Small depository institutions could then use this explicit interest to pay for Reserve Bank priced services or for other purposes.

The proposed amendments are designed to reduce the administrative burdens and operational costs associated with reserve requirements for both depository institutions and the Federal Reserve. The Board is requesting comment on all aspects of the proposal. In connection with the proposed elimination of the contractual clearing balance program, the Board is requesting comment on several issues related to the methodology used for the Private Sector Adjustment Factor that is part of the pricing of Federal Reserve Bank services.

The Board proposes to eliminate the contractual clearing balance program and the use of as-of adjustments no earlier than the first quarter of 2012 and to implement a common reserves maintenance period and the penalty-free band around reserve balance requirements no earlier than the third quarter of 2012. The Board requests comment on whether the proposed effective dates are appropriate. The Board specifically seeks comment on the time that depository institutions will need to effect the changes in their systems to adapt to these changes and whether the cost of adapting to these changes will be material.

Proposed amendments to Regulation J (Collection of Checks and Other Items by Federal Reserve Banks and Funds Transfers through Fedwire) would eliminate references in Regulation J to "as-of adjustments," consistent with the proposed amendments to Regulation D, and make clarifications about the handling of checks and funds transfers sent to the Federal Reserve Banks.

To view the press release, click here.

For those seeking a broader understanding of the manner in which the Board currently administers Regulation D, it is recommended that they link to the Board's Background and Overview sections of the proposal, which begin on page 2 and end on page 15. They may be found here.

For further information on the proposed changes to Regulation J, click here.

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