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CORPORATE & FINANCIAL
WEEKLY DIGEST

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SEC/CORPORATE

PCAOB Adopts New Auditing Standard relating to Communications Between Auditors and Audit Committees, Subject to SEC Approval

On September 10, the Securities and Exchange Commission posted for comment Auditing Standard No. 16, "Communications with Audit Committees," adopted by the Public Company Accounting Oversight Board (PCAOB) on August 15. The new standard sets out a list of specific requirements designed to improve communication between auditing firms and public company audit committees. Many of these requirements supersede interim standards or otherwise reflect, expand or modify current practices.

Among the issues that the auditor is required to discuss with the audit committee prior to the issuance of an auditor's report (or, to the extent these standards are relevant to interim financials, prior to Form 10-Q filings), are the following:

- Significant issues that the auditor discussed with management in connection with the appointment or retention of the auditor;
- The objectives of the audit, overall audit strategy, including the timing of the audit and significant risks identified during the auditors risk assessment procedures;
- If applicable, the nature and extent of specialized skill or knowledge needed to perform the audit procedure and the extent to which the auditor plans to use the work of the company's internal auditors;
- Management's initial selection of or changes in significant accounting policies in the current period and their effect on the financial statements or disclosures;
- A description of the process management used to develop critical accounting estimates, including management's significant assumptions in connection therewith and any significant changes management made in the processes used to develop critical accounting estimates or significant assumptions;
- An assessment of critical accounting policies and practices along with significant modifications to these policies and practices proposed by the auditor that management did not make;
- The auditor's evaluation of the quality of the company's financial report including with respect to situations in which the auditor identified bias in management's judgment about the amount and disclosures in the financial statements;
- Significant unusual transactions as well as matters that are difficult or contentious for which the auditor consulted outside the engagement team;
- Any disagreements with management about matters, whether or not satisfactorily resolved, that individually or in the aggregate could be significant to the company's financial statements;

- Any significant difficulty encountered during the audit, including delays, an unreasonably brief time within which to complete the audit or unreasonable management restrictions in the conduct of the audit;

- When the auditor is aware that management consulted with other accountants about significant auditing or accounting matters and the auditor has identified a concern regarding such matters, the views of the auditor about such matters; and

- Whether the audit committee is aware of violations of regulations or law that may be relevant to the audit.

In addition, the auditor is required to provide the audit committee with a schedule of uncorrected misstatements related to accounts and disclosures and, if the auditor believes there is a substantial doubt about the company's ability to continue as a going concern for a reasonable period of time, matters related to that concern.

Comments are to be submitted to the SEC on or before 21 days from publication in the Federal Register. The PCAOB expects the new standards to be effective for quarterly reviews and audits for fiscal years beginning on or after December 15, 2012.

For more information, click here.

BROKER DEALER

FINRA Rule Change Relating to Private Placements of Securities

The Financial Industry Regulatory Authority (FINRA) has issued Regulatory Notice 12-40 regarding the Securities and Exchange Commission's approval of FINRA Rule 5123 relating to private placements of securities.

Currently, FINRA Rule 5122 generally requires, subject to certain exemptions, that a member firm or associated person engaging in a private placement of unregistered securities in which it (or a control entity of such member) is the issuer: (1) disclose in the offering documents the intended use of offering proceeds, offering expenses and the amount of selling compensation to be paid to the broker-dealer and its associated persons; (2) submit the offering documents to the FINRA Corporate Financing Department prior to or at the time such documents are provided to a prospective investor; and (3) comply with the requirement that at least 85% of the offering proceeds raised not be used to pay for offering costs, discounts, commissions or any other cash or non-cash sales incentives, and that such proceeds be used for the business purposes disclosed in the offering documents.

New FINRA Rule 5123 will require member firms to provide FINRA with information about the member firms' activities with respect to private placements of securities by issuers that are non-FINRA members. Specifically, a member firm that sells a security in a private placement, subject to certain exemptions described below, must file a copy of the offering document, or any materially amended versions of the offering document, with FINRA within 15 calendar days of the date of first sale or indicate that it did not use any such offering document. The rule contains a list of private placements that are exempt from the above requirements, including an exemption for private placements sold solely to qualified purchasers under the Investment Company Act, qualified institutional buyers under the Securities Act of 1933 and other sophisticated investors. FINRA Rule 5123 includes all of the exemptions provided in FINRA Rule 5122 and also includes exemptions for certain sophisticated investors, such as employees and affiliates of the issuer, that are not included in FINRA Rule 5122.

Regulatory Notice 12-40 provides that FINRA Rule 5123 applies prospectively to private placements that begin selling efforts on or after December 3, 2012. In addition, effective December 3, 2012, members firms that file offering documents pursuant to FINRA Rule 5122 and FINRA Rule 5123 must use FINRA's new private placement filing system on FINRA's Firm Gateway system.

Click here to read Regulatory Notice 12-40.

CFTC

CFTC Staff Issues Guidance on Timing of Swap Dealer Registration Rules

On September 10, Commodity Futures Trading Commission staff issued a set of responses to frequently asked questions (FAQs) related to the timing of the swap dealer registration requirements. The staff guidance also clarifies certain aspects of the *de minimis* exemption from swap dealer registration.

Pursuant to CFTC Regulation 1.33(ggg)(4)(i), a market participant must register as a swap dealer within two months after the end of the month in which the participant has entered into swap positions that exceed certain *de minimis* thresholds. The *de minimis* thresholds are applied based on the aggregate gross notional amount of the swaps a market participant has entered into over the prior 12 months. During a preliminary phase-in period, which will last a maximum of five years, the *de minimis* threshold applicable will be $8 billion. Following the phase-in period, the threshold will be reduced to $3 billion. In addition, a person relying on the *de minimis* exemption may not enter into swaps with “special entities” whose gross notional value over the prior 12 months exceeds $25 million.

The CFTC staff clarified that only swaps entered into after the effective date of the swap definition (i.e., October 12) count toward the *de minimis* threshold threshold. For example, a market participant that is not registered as a swap dealer that enters $8 billion worth of swaps on October 13 may apply for registration as a swap dealer as early as October 13, but would not be required to register until December 31.

The FAQs are available here.

CFTC Seeks Comments on ICE Clear Europe Petition

On September 11, the CFTC requested public comment on a petition submitted by ICE Clear Europe Limited (ICE Clear Europe). ICE Clear Europe, which is registered with the CFTC as a derivatives clearing organization and with the UK Financial Services Authority as a recognized clearing house, will clear energy futures contracts that are traded on ICE Futures US and ICE Futures Europe. The petition requests a CFTC order that would allow ICE Clear Europe and futures commission merchants that are clearing members of ICE Clear Europe to commingle in a US customer segregated funds account futures and options traded on ICE Futures US and ICE Futures Europe and related customer funds, as well as to permit portfolio margining between such positions.

Comments must be filed on or before September 25.

More information is available here.

LITIGATION

District Court Rejects SEC Argument that General Partnership Interests in Joint Ventures Are Securities

The Securities and Exchange Commission brought an enforcement action against defendant Geodymanics, Inc. and others alleging fraud in connection with four oil and gas exploration and drilling ventures, each of which was governed by a separate but comparable joint venture agreement. The U.S. District Court for the District of Colorado granted Geodynamics’ motion to dismiss on the ground that the general partnership interests purchased by investors were not “investment contracts” – and thus not “securities” – within the meaning of the federal securities laws.

Under the Securities Act of 1933 and the Securities Exchange Act of 1934, a “security” includes an “investment contract,” which in turn is defined as “a contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.”

A general partnership interest is presumed not to be an investment contract because a general partner typically takes an active part in managing the business. That presumption can be overcome by evidence showing that the general partner was somehow precluded from exercising his or her control and supervision powers.

The SEC argued that defendants' alleged fraud precluded the general partners from exercising their control rights. In particular, the SEC argued that defendants controlled the information necessary for informed voting, concealed their misappropriation of funds, and misrepresented the status of projects.

The court rejected the SEC's argument on the ground that the parties' joint venture agreement on its face gave the general partners sufficient control over the business such that the joint venture agreement could not be considered an "investment contract." The alleged fraud by defendants could not retroactively convert an ordinary general partnership interest into a security.

SEC v. Shields, No. 11-02121 (D.Colo. Sept. 6, 2012).

District Court Rejects Claim of Presumptive Lead Plaintiff's Inadequacy in Securities Class Action

Stockholder plaintiffs brought a purported class action against defendant China-Biotics, Inc. and certain of its officers and directors on behalf of all purchasers of China-Biotic shares during the period from February 9, 2011 and July 1, 2011.

In deciding two competing "lead plaintiff" motions submitted pursuant to the Private Securities Litigation Reform Act of 1995 (the PSLRA), the U.S. District Court for the Southern District of New York held that: (a) the size of the loss was the most significant factor in determining which plaintiff had the "largest financial interest", and (b) a competing plaintiff could not overcome the presumption in favor of the plaintiff with the "largest financial interest" simply by speculating as to chosen counsel's alleged lack of experience and resources.

Under the PLSRA, stockholder plaintiffs may, within 60 days of the first published notice of a securities class action, move to be appointed "lead plaintiff" and to have their counsel designated as "lead plaintiff's counsel." In the case of competing motions, the PLSRA provides that courts must presume that the stockholder with the "largest financial interest" (and who otherwise satisfies the class certification requirements of Rule 23) is the most appropriate lead plaintiff. The presumption can be overcome if another stockholder proves that the presumptive appointee would not fairly and adequately represent the interests of the class or would be subject to unique defenses.

Here, the court held that the question of which plaintiff had "the largest financial interest" was controlled by a four-factor test: (1) the total number of shares purchased; (2) the net number of shares purchased; (3) the net funds expended; and (4) the stockholder's approximate loss. The last factor – the size of the loss – carries the greatest weight. Applying this test, the court found that the Blanck Investor Group, with the largest out of pocket loss, was the presumptive lead plaintiff, notwithstanding that another proposed plaintiff, Crist, purchased more total shares during the class period.

Proposed plaintiff Crist attempted to overcome the presumption by arguing that the Blanck Investor Group's chosen counsel was inexperienced and lacked sufficient resources to pursue this case. The court rejected this argument on the grounds that (a) the PSLRA requires "proof" of inadequacy (not mere speculation), and (b) the proposed counsel had been approved by other courts in complex class action cases.

Casper v. Song Jinan, No. 12 Civ. 4202 (S.D.N.Y. Sept. 6, 2012).

BANKING

FDIC Releases Participation Guidance

On September 12, the Federal Deposit Insurance Corporation (FDIC) released a financial institution advisory letter related to effective credit risk management practices for purchased loan participations (Advisory). The Advisory applies to all FDIC-supervised banks and savings associations, including community institutions.

The Advisory, which notes the benefits to financial institutions that purchase loan participations, reminds purchasing institutions that losses on purchased loan participations can result from an over-reliance on originating institutions, particularly with respect to out-of-territory and unfamiliar markets.

The Advisory suggests that institutions implement an appropriate credit risk management framework that includes effective loan policy guidelines, written loan participation agreements and an independent credit analysis before purchasing a participation loan.

For more information, click here.

UK DEVELOPMENTS

FSA Consults on Rules Changes Linked to Handover to PRA and FCA

On September 12, the UK Financial Services Authority (FSA) published a consultation paper (CP12/24-Regulatory Reform) regarding changes to the existing FSA Handbook on aspects of the regulatory regime which will apply after the date in 2013 (currently expected to be about April 2013) when the FSA will be replaced by the two successor regulators – the Prudential Regulatory Authority (PRA) (which will be a subsidiary of the Bank of England) and the Financial Conduct Authority (FCA).

CP12/24, prepared by the FSA in consultation with the Bank of England addresses aspects of the authorization and supervision regimes including changes to:

- The prescribed wording that different types of regulated firms must use to identify who regulates them and whether the use by regulated firms of future PRA or FCA logos in their communications should be permitted.
- The way in which a firm must apply to vary or cancel its authorization or permission, or to vary or cancel requirements imposed on it by the regulator.
- Applications by firms for waivers or modifications of rules.
- The appointment of skilled persons and the FSA's relationship with them.
- Notification of changes in control of regulated firms.

Consultation responses should be submitted by December 12.

For more information, click here.

EU DEVELOPMENTS

European Commission Proposes Single Supervisor for Eurozone Banks

On September 12, the European Commission published its legislative proposals for the creation of a single supervisory mechanism (SSM) under which the European Central Bank (ECB) will supervise eurozone banks.

The Commission proposes to have the SSM in place by January 1, 2013, with a phasing-in period to facilitate a smooth transition. The current proposal envisages that from January 1, 2013, the ECB will be permitted to assume full supervisory responsibility over any bank. From July 1, 2013, all eurozone banks of major systemic importance will be ECB supervised. By January 1, 2014, all banks in the eurozone would be supervised by the ECB under the SSM.

The Commission has issued:

- A draft regulation conferring powers on the ECB for the supervision of all banks in the eurozone, with a mechanism for non-eurozone countries to opt in.
- A draft regulation aligning the existing regulation by the European Banking Authority (EBA) with the ECB's proposed powers.
- A communication outlining the Commission's overall vision for banking union, including an EBA single European rulebook for banks as well as the SSM.

For more information, click here.

ESMA Publishes Short Selling Regulation Q&A

The European Securities and Markets Authority (ESMA) has published *Questions and Answers: Implementation of the Regulation on Short Selling* (Q&A) which addresses questions arising with respect to the implementation of the EU Regulation on short selling and certain aspects of credit default swaps (the Short Selling Regulation).

ESMA stated that the purpose of publishing the Q&A is the promotion of common supervisory approaches and practices amongst the EU's national regulators on the requirements of the Short Selling Regulation when it enters into force on November 1, 2012. ESMA expects to revise and update the Q&A before November 1 as ESMA responds to further questions.

ESMA indicated that the Q&A is intended to provide clarity on the requirements of the new regime by providing responses to questions asked by market participants, national regulators, and others in relation to the application of the Short Selling Regulation. Specifically it addresses issues related to:

- territorial scope;
- transparency requirements;
- calculation of net short positions;
- uncovered short sales; and
- the applicable enforcement regime.

For more information, click here.

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