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CORPORATE & FINANCIAL
WEEKLY DIGEST

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SEC/CORPORATE

Delaware Legislature Adopts Amendments to Delaware General Corporation Law

Effective as of August 1, 2013, the Delaware legislature adopted several significant amendments to the Delaware General Corporation Law (DGCL).

No Stockholder Vote Required in Certain Second-Step Mergers

Prior to the adoption of the amendment to Section 251 of the DGCL, following the consummation of a tender or exchange offer, an acquirer was required to obtain approval of a second-step merger from the target corporation's stockholders unless the acquirer owned at least 90% of each class of the target corporation's voting stock. That was the case whether such ownership was acquired directly in the first-step tender or exchange offer or through the use of a "top-up option" following the offer. That meant that, if the target corporation was a public company and the acquirer failed to achieve the 90% threshold, the target corporation would need to prepare and file with the Securities and Exchange Commission a proxy or information statement with respect to the stockholder vote (which proxy or information statement would have been subject to potential SEC review). As a result, there could have been a meaningful delay between the closing of the tender or exchange offer and the completion of the second-step merger, which could adversely impact debt financing for the transaction.

Under new subsection (h) of Section 251, unless the target corporation's certificate of incorporation expressly requires otherwise, a vote of the target corporation's stockholders would not be required to authorize a second-step merger following a tender or exchange offer if: (1) the merger agreement expressly provides that the merger will be governed by Section 251(h) and that the second-step merger will be consummated as soon as practicable following the offer; (2) the acquirer consummates the offer for any and all of the outstanding stock of the target corporation that would otherwise be entitled to vote on the adoption of the merger agreement; (3) following the consummation of the offer, the acquirer owns at least the percentage of the stock of the target corporation that otherwise would be required to adopt the merger agreement; (4) at the time the target corporation's board of directors approves the merger agreement, no other party to the merger agreement is an "interested stockholder" (as defined in Section 203(c) of the DGCL) of the target corporation; (5) the acquirer merges with the target corporation pursuant to the merger agreement; and (6) the outstanding shares of the target corporation not canceled in the merger are converted into the right to receive the same amount and kind of consideration paid for shares in the offer.

Section 251(h) applies only to target corporations with shares listed on a national securities exchange or held of record by more than 2,000 holders immediately prior to the execution of the merger agreement.

Pursuant to a parallel amendment to Section 262 of the DGCL, appraisal rights are available to the target corporation's stockholders in connection with a second-step merger effected pursuant to Section 251(h), unless all of the stock of the target corporation is owned by the acquirer immediately prior to the merger.

Ratification of Defective Corporate Acts

Under new Section 204 of the DGCL, no corporate act or purported stock issuance would be void or voidable solely on the basis of a failure of authorization, so long as the act is ratified in accordance with the procedures outlined in new Section 204 or validated by the Delaware Court of Chancery in a proceeding under new Section 205.

In order to ratify a defective corporate act, the board of directors of the corporation is required to adopt a resolution stating (1) the defective corporate act to be ratified, (2) the time of the defective corporate act, (3) if such defective corporate act involved the issuance of shares of stock, the number and type of shares of stock issued and the date or dates upon which such shares were purported to have been issued, (4) the nature of the failure of authorization in respect of the defective corporate act to be ratified and (5) that the board of directors approves the ratification of the defective corporate act. The corporation's stockholders are also required to adopt the resolutions adopted by the board of directors, unless (1) stockholder approval was not required at the time of the board's adoption of such resolutions or would not have been required at the time of the defective act and (2) the defective act did not result from a failure to comply with Section 203 of the DGCL (the business combinations statute).

New Section 205 grants the Delaware Court of Chancery exclusive jurisdiction to determine the validity of any defective corporate acts ratified pursuant to Section 204. Under Section 205, the Delaware Court of Chancery has broad powers to determine the validity of any defective corporate act, including the power to modify or waive any provision of Section 204.

Formula for Stock Issuance Consideration

Section 152 of the DGCL was amended to clarify that a board of directors may determine the price at which the corporation's stock is issued by approving a formula by which such price is determined.

Public Benefit Corporations

New Sections 361 through 368 of the DGCL authorize the formation of for-profit corporations, known as "public benefit corporations," that are formed for the purpose of promoting public benefits. A "public benefit" is broadly defined as a "positive effect (or reduction of negative effects) on one or more categories of persons, entities, communities or interests." The board of directors of a public benefit corporation is required to balance the pecuniary interests of the stockholders, the best interests of those materially affected by the corporation's conduct, and the specific public benefit or public benefits identified in the public benefit corporation's certificate of incorporation when it manages the corporation's business and affairs. The stockholders of a public benefit corporation owning a specified threshold of the corporation's outstanding shares are permitted to bring a derivative suit asserting that the board of directors is not fulfilling the public benefit mandate.

Shelf Corporations

Amendments to Sections 312(b) and 502(a) of the DGCL are designed to discourage the establishment of "shelf" corporations having no activities, directors or stockholders. As amended, Section 312(b) provides that only directors or stockholders may authorize a renewal or revival of a corporation that has ceased to be in good standing. As amended, Section 502(a) prohibits an incorporator from signing any annual franchise tax reports (other than the corporation's initial report) and requires a corporation to list at least one director on its franchise tax reports.

BROKER DEALER

Amendments to SEC Rules Regarding Broker Dealer Financial Responsibility and Reporting Requirements

The Securities and Exchange Commission adopted amendments to the financial responsibility requirements for broker dealers under the Securities Exchange Act of 1934 (Exchange Act) designed to safeguard customer securities and funds held by broker dealers. Such requirements include Exchange Act Rule 15c3-1 (Net Capital Rule), Rule 15c3-3 (Customer Protection Rule), Rules 17a-3 and 17a-4 (together, Books and Records Rules) and

Rule 17a-11 (Notification Rule, and together with the Net Capital Rule, the Customer Protection Rule and the Books and Records Rules, the Financial Responsibility Rules).

The SEC amended the Customer Protection Rule to: (1) require "carrying broker dealers" that maintain customer securities and funds to maintain new segregated reserve accounts for account holders that are broker dealers; (2) place certain restrictions on cash bank deposits for purposes of the requirement to maintain a reserve to protect customer cash, by excluding cash deposits held at affiliated banks and limiting cash held at non-affiliated banks to an amount no greater than 15 percent of the bank's equity capital, as reported by the bank in its most recent call report; and (3) establish customer disclosure, notice and affirmative consent requirements (for new accounts) for programs where customer cash in a securities account is "swept" to a money market or bank deposit product.

The SEC amended the Net Capital Rule to: (1) require a broker dealer when calculating net capital to include any liabilities that are assumed by a third party if the broker dealer cannot demonstrate that the third party has the resources to pay the liabilities; (2) require a broker dealer to treat as a liability any capital that is contributed under an agreement giving the investor the option to withdraw it; (3) require a broker dealer to treat as a liability any capital contribution that is withdrawn within a year of its contribution unless the broker dealer receives permission for the withdrawal in writing from its designated examining authority; (4) require a broker dealer to deduct from net capital (with regard to fidelity bonding requirements prescribed by a broker dealer's self-regulatory organization (SRO)) the excess of any deductible amount over the amount permitted by the SRO's rules; and (5) clarify that any broker dealer that becomes "insolvent" is required to cease conducting a securities business.

The SEC amended the Books and Records Rules to require large broker dealers (*i.e.*, at least $1,000,000 in aggregate credits or $20,000,000 in capital) to document their market, credit and liquidity risk management controls. Under the amended Notification Rule there are new notification requirements for when a broker dealer's repurchase and securities lending activities exceed 2,500 percent of tentative net capital (or, alternatively, a broker dealer may report monthly its stock loan and repurchase activity to its designated examining authority, in a form acceptable to such authority). In addition, the amended Notification Rule requires insolvent broker dealers to provide notice to regulatory authorities.

In a separate release, the SEC also amended Exchange Act Rule 17a-5 (Reporting Rule). Under the amended Reporting Rule, a broker dealer that has custody of the customers' assets must file a "compliance report" with the SEC to verify that it is adhering to broker dealer capital requirements, protecting customer assets it holds and periodically sending account statements to customers. The broker dealer also must engage a Public Company Accounting Oversight Board (PCAOB)-registered independent public accountant to prepare a report based on an examination of certain statements in the broker dealer's compliance report. A broker dealer that does not have custody of its customers' assets must file an "exemption report" with the SEC citing its exemption from requirements applicable to carrying broker dealers. The broker dealer also must engage a PCAOB-registered independent public accountant to prepare a report based on a review of certain statements in the broker dealer's exemption report. A broker dealer that is a member of the Securities Investor Protection Corporation (SIPC) also must file its annual reports with SIPC.

The rule amendments also require a broker dealer to file a new quarterly report, called Form Custody, that contains information about whether and how it maintains custody of its customers' securities and cash. The SEC intends that examiners will use Form Custody as a starting point to focus their custody examinations. In addition, a broker dealer, regardless of whether it has custody of its clients' assets, must agree to allow SEC or SRO staff to review the work papers of the independent public accountant if it is requested in writing for purposes of an examination of the broker dealer and must allow the accountant to discuss its findings with the examiners.

The effective date for the amendments to the Financial Responsibility Rules is 60 days after publication in the *Federal Register*. The effective date for the requirement to file Form Custody and the requirement to file annual reports with SIPC is Dec. 31, 2013. The effective date for the requirements relating to broker dealer annual reports is June 1, 2014.

Click here to read SEC Release No. 34-70072 (Financial Responsibility Rules for Broker Dealers).

Click here to read SEC Release No. 34-70073 (Broker Dealer Reports).

FINRA Issues FAQs Regarding TRACE Reporting

The Financial Industry Regulatory Authority has issued a trade reporting notice that addresses several issues in connection with reporting transactions to the Trade Reporting and Compliance Engine (TRACE) system involving TRACE-eligible securities. The notice contains questions and answers covering the following topics: (1) split-volume reporting; (2) reporting investment adviser-directed transactions; (3) reporting Securities Act of 1933 Regulation S transactions; (4) transfers establishing the underwriting syndicate; (5) firm commitments prior to final pricing; (6) transfers facilitating settlement; and (7) reporting transactions in collateralized mortgage obligations. The questions and answers in the notice will be incorporated in FINRA's Reporting of Corporate and Agencies Debt FAQ and the Reporting of Mortgage and Asset Backed Securities (Securitized Products) FAQ.

The notice is available here.

CFTC

CFTC Releases Rule Enforcement Review of the Chicago Mercantile Exchange and Chicago Board of Trade

The Commodity Futures Trading Commission's Division of Market Oversight (DMO) has issued the results of a rule enforcement review of the Chicago Mercantile Exchange and Chicago Board of Trade for the period beginning November 1, 2010 and ending October 31, 2011. The rule enforcement review recommended certain changes to the exchanges' hedge exemption procedures and exchange for related position (EFRP) surveillance program. DMO recommended that the exchanges (1) refrain from granting retroactive hedge exemptions if a participant does not file a timely application; (2) consider untimely hedge exemption applications to be speculative limit violations; (3) refer egregious conduct, such as continuing to increase positions after notification of a speculative limit violation, to enforcement; (4) ensure that hedge exemption applications are complete, accurate and have designated the appropriate hedging categories; and (5) refrain from granting hedge exemptions at levels above those requested by applicants.

DMO also recommended that the exchanges review the factors they use to select potentially problematic EFRPs and identified the following as factors that the exchanges currently consider in determining whether an EFRP warrants further review: (1) transactions where a participant rolls a position; (2) transactions involving participants that do not ordinarily engage in EFRPs; (3) transactions in which the price of the futures leg is not within the daily range for the relevant contract; (4) EFRPs tied to a spread transaction; and (5) EFRPs in unusual products or for unusual volumes. DMO also recommended that the exchanges establish an adequate and robust program to ensure that market participants and clearing firms maintain documents related to EFRP transactions and to review a sufficiently large, strategically selected sample of EFRPs to ensure that they are bona fide EFRP transactions.

The Rule Enforcement Review of the Chicago Mercantile Exchange and Chicago Board of Trade is available here.

LITIGATION

Ninth Circuit Remands "Say-on-Pay" Cases Back to State Court for Lack of Jurisdiction

The US Court of Appeals for the Ninth Circuit affirmed the lower court's decision to remand to state court two "say-on-pay" cases, finding no questions of federal law had been raised. In the shareholder derivative actions, which were initially filed in California state court, plaintiffs asserted a host of state law claims, including breach of fiduciary duty and gross mismanagement, alleging that defendants, PICO Holdings and its board of directors, acted wrongly when they increased executive compensation despite poor financial results and the disapproval of 61 percent of shareholders. The Dodd-Frank Wall Street Reform and Consumer Protection Act requires a public company to hold a shareholder vote on executive compensation at least once every three years. These votes, however, are not binding and the provision of Dodd-Frank explicitly provides that the votes do not "create or imply" additional fiduciary duties.

The Ninth Circuit affirmed the district court's determination that there was no federal jurisdiction over plaintiffs' claims, rejecting each of defendants' theories. First, the court found Section 27 of the Securities Exchange Act of 1934 (Exchange Act) insufficient to provide federal jurisdiction because plaintiffs' claims are rooted in state law and not based on violations of the Exchange Act. As the court observed, the defendants held the "say-on-pay"

vote, as required. Second, the court concluded that federal question jurisdiction was lacking because only defendants' potential *defense*—that Dodd-Frank does not require companies to act consistently with a say-on-pay vote—relates to federal law, but not plaintiffs' *claims* themselves. Third, the court determined that the "say-on-pay" provision of Dodd-Frank did not "completely preempt" state law on fiduciary duties. In fact, the court noted that it "created no new fiduciary duties and explicitly preserved existing state laws." Accordingly, plaintiffs' claims were remanded to state court, where they are entitled to pursue their claims against the board.

Dennis v. Hart, No. 12-55241 (9th Cir. July 31, 2013).

Southern District of New York Dismisses Complaint Against Madoff-Invested Fund

The US District Court for the Southern District of New York dismissed a complaint against J. Ezra Merkin and Gabriel Capital Corporation (together, Defendants), which together managed Ascot Fund Limited (Ascot), an offshore hedge fund. Plaintiff, a nonprofit, had invested in Ascot in 2002 and again in 2004. Ascot in turn invested substantially all of its assets with Bernard Madoff. Plaintiff asserted various claims, alleging that Defendants made material misrepresentations and omissions about Ascot's investment strategies. In particular, Plaintiff alleged that Defendants breached their obligations by, among other things, ceding management of Ascot's assets to Madoff without conducting adequate due diligence on Madoff and by ignoring red flags of Madoff's fraud.

Plaintiff's fraud claim relied on a "holder" theory of liability, alleging that Ascot's misrepresentations and omissions caused Plaintiff to retain, as opposed to buy or sell, securities. The District Court noted that it is unsettled whether New York law recognizes a "holder" claim to recover lost profits or out-of-pocket losses (*i.e.*, the investment itself). Regardless, the court found that Plaintiff failed to plead its claim with sufficient particularity and dismissed the claim without prejudice, thereby allowing Plaintiff to replead.

The timeliness of the action was at issue because Plaintiff had not asserted its claim until more than four years after the exposure of Madoff's fraud and Ascot's investment with Madoff. As a result, the District Court dismissed many of Plaintiff's claims as untimely, including certain of Plaintiff's fraud claims as well as Plaintiff's breach of fiduciary duty and gross negligence claims. In reaching this conclusion, the court rejected Plaintiff's theory that its claims were tolled by a pending private class action or, alternatively, a settled 2009 enforcement action by the New York State Attorney General (NYAG). The principal of tolling embodied in the Supreme Court decision *American Pipe and Construction Co. v. Utah*, involving the interplay between putative class actions and individual claims, was inapplicable because Plaintiff was not a member of the putative class in the related class-action lawsuits. The NYAG action also did not serve to toll Plaintiff's claim as it does not purport to aggregate individual claims but to vindicate public policy by enforcement of the law.

Matana v. Merkin, No. 13 Civ. 1534 (PAE) (S.D.N.Y. July 30, 2013).

EU DEVELOPMENTS

ESMA Publishes Updated Q&A

EU national competent authorities and the European Securities and Markets Authority have published an amended set of European Market Infrastructure Regulation (EMIR) Q&As. The purpose of the document is to promote common supervisory approaches and practices in the application of EMIR.

The Q&As cover questions in regard to over-the-counter (OTC) Derivatives, central counterparties (CCPs) and trade repositories. There are new questions in regard to:

- Funds and counterparties;
- Principal-to-principal model;
- Definition of OTC derivatives;
- Calculation of the clearing threshold;
- Timely confirmation;
- Intragroup transactions;
- Hedging definition;
- Risk mitigation techniques for OTC derivative contracts not cleared by a CCP;
- Status of entities not established in the European Union;

- Portfolio reconciliation;
- Dispute resolution;
- Deposit of financial instruments;
- Segregation and portability;
- Default fund;
- Organizational requirements;
- Allocation of additional resources;
- Classification of financial instruments; and
- Reporting of collateral and valuation.

Read more.

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