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SEC/CORPORATE

SEC Adopts Final Rules for Regulation A+ Offerings

On March 25, the Securities and Exchange Commission adopted final rules that will expand the exemption from registration under the Securities Act of 1933 provided by Regulation A to include an exemption for up to $50 million of securities sold during a 12-month period in accordance with the new rules. This new exemption, which is often referred to as Regulation A+, implements Section 401 of The Jumpstart Our Business Startups Act (JOBS Act) (adding Section 3(b)(2) of the Securities Act), which required the SEC to adopt rules that would have the effect of updating and expanding Regulation A. The final rules address a number of comments received by the SEC in response to its December 2013 proposal, which was discussed in a prior edition of *Corporate and Financial Weekly Digest*.

The SEC's final rules create two "tiers" of Regulation A offerings: (1) offerings of up to $20 million of securities, including no more than $6 million of securities offered by selling security holders, in any 12-month period (Tier 1); and (2) offerings of up to $50 million of securities, including no more than $15 million of securities offered by selling security holders, in any 12-month period (Tier 2). Sales by selling stockholders will be subject to additional limitations in an issuer's initial Regulation A offering and any subsequently qualified Regulation A offering within the first 12-month period following the date of qualification of the initial Regulation A offering. Securities sold in either a Tier 1 or a Tier 2 offering would not be "restricted securities" for purposes of the Securities Act.
The final rules include various conditions and requirements that must be satisfied in order to rely on Regulation A (including more stringent requirements for Tier 2 offerings), as well as provisions intended to modernize the Regulation A offering process.

The final rules also provide for preemption of state securities laws in the case of Tier 2 offerings, although state securities regulators will retain, among other things, their authority to require the filing with them of any documents filed with the SEC. Tier 1 offerings, however, will remain subject to review by both state regulators and the SEC. We intend to discuss the final rules in more detail in an upcoming publication.

To view the complete text of the final rules, click here.

BROKER-DEALER

FINRA Issues Notice on New Rules and Amendments Relating to Transaction-Based Compensation, Membership and Sanctions

The Financial Industry Regulatory Authority released Regulatory Notice 15-07 to alert member firms of the new consolidated rules regarding payments to unregistered persons and membership. The notice also alerts member firms of amendments to a FINRA rule regarding sanctions related to improper payments by member firms to persons subject to suspension, revocation, cancellation, bar or other disqualification.

The Securities and Exchange Commission approved FINRA Rule 2040, which governs the payment of transaction-based compensation by member firms to unregistered persons. The new rule expressly aligns with

Section 15(a) of the Securities Exchange Act of 1934, as amended, in terms of providing guidance to determine if registration as a broker-dealer is required for persons to receive transaction-related compensation. FINRA Rule 2040 also addresses and codifies FINRA's "continuing commission" policy relating to the payment of ongoing commissions to retiring registered representatives and provides guidance regarding the payment of transaction-related compensation to non-registered foreign finders and the conditions that apply to such payments.

The SEC also approved FINRA Rule 0190, which provides that a member firm will be considered a non-member of FINRA from the effective date of any SEC or FINRA order or notice issuing a revocation or cancellation of its membership or expulsion from FINRA. In addition, the SEC approved amendments to FINRA Rule 8311, which clarify that if an associated person becomes subject to a sanction or disqualification, the member firm may not allow such person to be associated with it in any capacity that is inconsistent with the sanction.

The effective date for FINRA Rules 2040 and 0190, as well as the amendments to Rule 8311, is August 24.

FINRA Regulatory Notice 15-07 is available here.

FINRA Issues Guidance on Effective Supervision for Firms Engaging in Algorithmic Trading Strategies

The Financial Industry Regulatory Authority released Regulatory Notice 15-09 to provide guidance to member firms and market participants on effective supervision and control practices with respect to algorithmic trading strategies. This notice is one of seven FINRA initiatives related to equity market structure and automated trading activities. These initiatives are designed to increase the amount of information that FINRA receives and to provide more transparency to investors.

Algorithmic strategies account for a substantial portion of activity on US securities markets, and the potential for such strategies to have an adverse impact on the market and firm stability is considerable. As a result of the large impact that algorithmic strategies have on the market, member firms that engage in such strategies are already subject to many Securities and Exchange Commission and FINRA rules.

The suggested effective practices for firms engaging in algorithmic strategies include general risk assessment and response, software/code development and implementation, software testing and system validation, trading systems, and compliance.

FINRA Regulatory Notice 15-09 is available here.

SEC Proposes to Amend Rule 15b9-1

The Securities and Exchange Commission is proposing to amend Rule 15b9-1 under the Securities Exchange Act of 1934, as amended, to require broker-dealers that engage in off-exchange proprietary trading to become members of a registered national securities association such as the Financial Industry Regulatory Authority. Under the proposed amendment, an affected broker-dealer will have 360 days after the publication of the final rule in the *Federal Register* to become a member of FINRA. The proposed amendment would narrow the exemption from membership in a national securities association for certain broker-dealers. The SEC's proposal would narrow the exemption so that firms that are not focused on trading on an exchange and are responsible for a substantial percentage of trading volume in the off-exchange market may no longer be exempt.

The proposed amendment, if adopted, would also create a new limited exemption for hedging. This proposed exemption recognizes that dealers trading mainly on one exchange may have a need to hedge their exposure. Dealers must prove that their hedging transactions are legitimate hedges to qualify for this exemption. The 60-day comment period will commence upon publication of the rule proposal in the *Federal Register*.

A more detailed analysis of this proposed amendment will be provided in a separate client advisory to be posted on Katten's website.

The SEC's proposed amendment to Rule 15b9-1 is available here.

SEC Staff Clarifies Regulation SHO FAQ 2.5(B) on Order Marking

As reported in the March 20 edition of the *Corporate & Financial Weekly Digest*, the staff of the Securities and Exchange Commission's Division of Trading and Markets (Staff) issued new frequently asked questions (FAQs) relating to Regulation SHO. As discussed below, during recent discussions with Katten, the Staff clarified that the scope of new FAQ 2.5(B) is limited to the specific scenario set forth in the Staff's guidance.

In new FAQ 2.5(B), the Staff stated that sale orders may only be marked "long" to the extent of a seller's net long position. If a seller is net long 1,000 shares and simultaneously enters multiple orders to sell 1,000 shares owned, only one such order would constitute a long sale. Any additional orders to sell the same shares must be marked "short." According to the guidance in new FAQ 2.5(B), an unexecuted order to sell a security is presumed to decrease a seller's net long position, unless there is no realistic possibility that such sale order will be executed. The Staff offered one example to illustrate when an unexecuted order is unlikely to be executed and thus would not be presumed to decrease a seller's net long position. Specifically, a seller may calculate its net position without decrementing for a market maker peg offer if such offer is set at the maximum allowable price away from the inside market, which is significantly higher than the inside offer and as a result will never or rarely be executed. A seller that does not decrement a market maker peg offer would be required to demonstrate, upon request, that such sale order is never or rarely executed.

During recent discussions with Katten, the Staff stated that the market maker peg offer scenario in new FAQ 2.5(B) may be the *only* scenario in which a sale order would not be presumed to decrease a seller's net long position. The Staff indicated that firms should not rely on the FAQ for other scenarios without more guidance from the Staff. Anyone intending to make use of the guidance in new FAQ 2.5(B) under circumstances other than those in the above scenario should contact Katten for further clarification.

New FAQ 2.5(B) is available here.

CFTC

CFTC Issues Advisory on Ownership and Control Reporting

The Division of Market Oversight (DMO) and Division of Swap Dealer and Intermediary Oversight (DSIO) of the Commodity Futures Trading Commission have issued an advisory on ownership and control reporting (OCR) for futures commission merchants, clearing members, foreign brokers, swap dealers and certain reporting markets. In 2013, the CFTC adopted changes to its OCR requirements, including changes to OCR forms that identify market participants that own or control reportable positions in certain futures or swaps and provide detailed market participant data to the CFTC. CFTC staff have subsequently issued temporary no-action relief to extend the dates by which reporting parties must begin using the new OCR forms.

DMO and DSIO have issued the advisory to remind reporting parties to obtain from their customers or counterparties information necessary to submit new Forms 102A, 102B and 102S once the temporary no-action relief has expired. DMO and DSIO recommend that reporting parties manage their customer relationships appropriately to help ensure that the reporting parties can submit complete and accurate forms by the reporting deadlines. Reporting parties should contact customers and counterparties as appropriate to request that they provide complete OCR information as soon as possible.

The staff advisory is available here.

LITIGATION

Fourth Circuit Sustains Securities Fraud Claim Against Drug Manufacturer

On March 6, the US Court of Appeals for the Fourth Circuit found that the United States District Court for the Western District of North Carolina had erred in dismissing a class action lawsuit filed under Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) because the lower court had inappropriately relied on regulatory filings provided to the Securities and Exchange Commission and had incorrectly applied case law precedent. The plaintiff class contended that the defendants, Chelsea International, Ltd. and several of its corporate officers, materially misled investors over the risk associated with securing Food and Drug Administration (FDA) approval for a blood pressure medication that Chelsea was developing. Notably, the plaintiffs alleged that defendants had misled investors to believe that the FDA would approve the drug at issue based on the results of only one successful efficacy study, even though the FDA repeatedly had warned Chelsea that two successful studies and evidence of "duration of effect" would be necessary for approval of the new drug. The Fourth Circuit first held that the District Court erred in finding that the plaintiffs had failed to demonstrate the scienter necessary to sustain a securities fraud claim under the Exchange Act. The Fourth Circuit found that the District Court erred in its scienter analysis by considering SEC documents submitted by the defendants that were not integral to the complaint. The documents purportedly showed that the defendants did not sell any Chelsea stock during the class period. However, stock sales were never a part of the plaintiffs' complaint and thus, the Fourth Circuit reasoned that the lower court should not have considered these SEC documents as evidence of the defendants' intentions. Further, the Fourth Circuit held that material, non-public information known to the defendants about the status of the drug application conflicted with the defendants' public statements on those subjects, which was an inconsistency the Fourth Circuit deemed sufficient to establish the severe reckless conduct necessary to establish an inference of scienter in securities fraud cases.

Zak v. Chelsea Therapeutics No. 13-2370 (4th Cir. Mar. 16, 2015)

Software Company to Face Suit Over Contract Restructuring

The United States District Court for the Northern District of California sustained a securities fraud complaint alleging that the defendants, a software company and its executives, had defrauded investors by failing to disclose that the company had systematically restructured contracts with its customers for the purpose of accelerating revenue recognition. The defendant company, Epocrates, Inc., developed applications that, in part, allowed pharmaceutical companies to advertise to doctors. The plaintiffs, seeking to represent a class of investors who had purchased Epocrates stock after an initial public offering, alleged that Epocrates had used fraudulent measures to appear more profitable. Specifically, Epocrates would charge pharmaceutical companies for the right to communicate with Epocrates' subscribers through, *inter alia*, "DocAlerts," short messages that Epocrates would disseminate to its subscribing health professionals. It was alleged that Epocrates, relying on "use-it-or-lose-it" provisions in the contracts, would prematurely cancel these contracts with the pharmaceutical companies in an effort to recognize revenue in time for its quarterly financial report, and then restructure the contracts with the pharmaceutical companies post-cancellation. The District Court held that these actions sufficiently established a cognizable basis for a federal securities fraud cause of action, and that at the pleading stage, it was immaterial whether contract restructuring itself was illegal or constituted fraud. Additionally, the District Court determined that the complaint sufficiently alleged that the defendants possessed the requisite knowledge and intent to mislead investors when they reworked the contracts. In reaching this conclusion, the District Court cited the complaint's allegations of the detailed involvement of Epocrates' chief executive officer and chief financial officer and the urgency with which they dealt with the restructuring by reviewing every contract to establish which could be restructured and accelerated.

Police and Fire Retirement System of Detroit v. Rosemary Crane, No. 13-CV-009450-VC (N.D. Cal. Mar. 13, 2015)

EU DEVELOPMENTS

ESMA Updates Q&A on the AIFMD

On March 26, the European Securities and Markets Authority (ESMA) published an updated questions and answers (Updated Q&A) of the application on the Alternative Investment Fund Managers Directive (AIFMD). The Updated Q&A includes updated and new questions and answers on reporting, notification, additional own funds and scope as discussed below.

Regarding reporting, the Updated Q&A clarifies that Alternative Investment Fund Managers (AIFMs) should take into account all the EU Alternative Investment Funds (AIFs) they both manage and market in the European Union to calculate their reporting frequency and apply the same reporting frequency to all member states where they market AIFs.

The Updated Q&A states that an AIFM that is already managing AIFs in a host member state under Article 33 of the AIFMD is not required to undertake a new notification under Article 33(2) if it wishes to manage a new AIF in that host member state. The AIFM should, however, send an update in accordance with Article 33(6) to identify each new AIF to be managed under the original Article 33(2) notification and note whether such new AIF(s) are of a different type.

On the issue of additional own funds, the Updated Q&A notes that AIFMs should exclude investment by AIFs in other AIFs they manage in the general calculation of additional own funds under Article 9(3) of the AIFMD, but should include them for the calculation of additional own funds to cover potential liability risks arising from professional negligence under Article 9(7) of the AIMFD. Investment in other AIFs managed by the same AIFM is viewed as increasing operational risk.

The Updated Q&A also clarifies the scope of the AIFMD as it applies to an EU AIFM marketing to professional investors in a particular member state the shares of EU feeder AIFs that have a non-EU master AIF managed by a non-EU AIFM if the EU AIFM complies with the conditions set out in Article 36(1) (a) to (c) of the AIFMD. Whether or not such non-EU AIFM managing the non-EU master also has to be authorized under the AIFMD is a matter of national law of the member state transposing Article 36 of the AIFMD, as the AIFMD permits member states to impose stricter rules on the AIFM regarding the application of Article 36.

A copy of the Updated Q&A on the application of the AIFMD can be found here.

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