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# CORPORATE & FINANCIAL

WEEKLY DIGEST

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## SEC/CORPORATE

### SEC Division of Corporation Finance Issues 14 New C&DIs Relating to "Bad Actor" Rules

On December 4, the Securities and Exchange Commission's Division of Corporation Finance issued 14 new Compliance and Disclosure Interpretations (C&DIs) with respect to Rule 506 under the Securities Act of 1933. These C&DIs relate to the rules recently adopted by the SEC (the Bad Actor Rule) that disqualify issuers from relying on Rule 506 for securities offerings involving certain felons and other so-called "bad actors" (the persons subject to the Bad Actor Rule being referred to as covered persons). The new C&DIs provide, among other things, that:

- An issuer must determine if it is subject to bad actor disqualification *any time* it is offering or selling securities in reliance on Rule 506. For example, in an offering that is continuous, delayed or long-lived, the issuer is required to update its factual "bad actor" inquiry periodically (including through bring-down of representations, questionnaires and certifications, etc.). If a placement agent or one of its covered control persons becomes subject to a "disqualifying event" under the Bad Actor Rule during an ongoing offering, an issuer may continue to rely on Rule 506 for future sales in that offering only if: (1) the engagement with the placement agent was terminated and the placement agent did not receive compensation for future sales; or (2) if the "disqualifying event" affected only such covered control persons, such persons were terminated or no longer performing roles for the placement agent that would cause them to be covered persons for purposes of the Bad Actor Rule.

- "Covered persons" subject to the Bad Actor Rule include any person that has been or will be paid (directly or indirectly) for solicitation of purchasers in the offering as well as any director, executive officer, or other officer *participating* in the offering of such a solicitor. The "participation" in an offering is not limited to the solicitation of investors, but rather includes such activities as involvement in due diligence, providing structuring or other advice to the issuer and communicating with prospective investors, so long as any such activity is "more than transitory or incidental." Those performing administrative functions will generally not be presumed to be participating in the offering.

- The Bad Actor Rule includes an exception to its disqualification provisions if the issuer establishes that it did not, and in the exercise of reasonable care could not, know about a disqualifying event. This reasonable care exception applies when, despite the exercise of reasonable care, the issuer was unable to determine the existence of a disqualifying event, was unable to determine that a particular person was a covered person, or initially determined that the person was not a covered person but subsequently learned that determination was incorrect.

The new C&DIs are available here.

### NASDAQ Proposes Change to Listing Rules Regarding Compensation Committee Independence

On November 26, the NASDAQ Stock Market (NASDAQ) proposed an amendment to its recently amended listing rules covering the independence of compensation committee members. Earlier this year, NASDAQ adopted amendments to its listing rules regarding compensation committee composition, responsibilities and authority, which, among other things, prohibit the receipt of any consulting, advisory or other compensatory fees (excluding any fees for board or committee service) by compensation committee members. NASDAQ's current rule proposal would remove the bright-line prohibition on compensatory fees and instead require that a company's board, in affirmatively determining the independence of any compensation committee member, consider the source of compensation of the director (including any consulting, advisory or other compensatory fees paid by the company, without excluding fees paid for board or committee service). This proposal would harmonize NASDAQ's requirement with that of the New York Stock Exchange.

To view the full text of NASDAQ's proposed rule change, click here.

## BROKER DEALER

### FINRA Issues New Rules on Securities Borrowing, Customer Protection and Callable Securities

On December 4, the Securities and Exchange Commission approved rules proposed by the Financial Industry Regulatory Authority regarding securities loans and borrowings, permissible use of customers' securities, and callable securities. For securities loans and borrowings, Financial Industry Regulatory Authority proposed new Rule 4314, which requires a member firm acting as an agent in a securities lending or borrowing transaction to disclose its capacity as agent. The rule aims to clarify whether parties are acting as principals or agents when entering into security lending or borrowing agreements. When member firms loan securities to or borrow securities from a counterparty acting in an agency capacity, the rule requires the member firm to maintain books and records to reflect the details of the transaction with the agent and each principal on whose behalf the agent is acting as well as the details of the transaction. The rule allows a member firm that is a party to a loan or borrowing agreement with another member firm to liquidate the transaction whenever the other party becomes subject to one of the specified liquidation conditions. Additionally, no member firm can lend or borrow any security to or from any person that is not a member of FINRA, including any customer, except pursuant to a written agreement. Each member firm subject to Securities Exchange Act Rule 15c3-3 that borrows fully paid or excess margin securities from a customer must comply with the Securities Exchange Act Rule 15c3-3 requirements for a written agreement between the borrowing member firm and lending customer.

FINRA also adopted new Rule 4330 regarding the permissible use of customers' securities. The rule prohibits a member firm from lending securities held on margin for a customer that are eligible to be pledged or loaned unless the member firm first obtains written authorization from the customer permitting the lending arrangement. The rule also requires a member firm that borrows fully paid or excess margin securities carried for a customer account to comply with Securities Exchange Act Rule 15c3-3, provide notices to customers in compliance with Securities Exchange Act Section 15(e), and notify FINRA at least 30 days prior to the borrowing. Before any member firm engages in a securities borrowing transaction with a customer, the rule requires the member firm to have reasonable grounds for believing that the customer's loan of securities is appropriate for its financial situation and needs and that the member firm provide certain disclosures to the customer in writing. A FINRA member firm is also required to keep books and records evidencing compliance with these rules.

Finally, FINRA adopted new Rule 4340 to clarify requirements applicable to callable securities. The rule requires each member firm with possession or control of a callable security, in the event of a partial redemption or call, to identify such securities and establish an impartial lottery system to allocate the securities among its customers. The member firm must also provide written notice, which may be electronic, to new customers opening an account and to all customers once a year that describes how customers may access the allocation procedures on the member firm's website or obtain hard copies upon request. The rule prohibits a member firm from allocating securities to its own or an associated person's account during a redemption until all other customers' positions have been satisfied. This prohibition applies only when the redemption is offered on terms favorable to the called parties. When on unfavorable terms, a member firm cannot exclude its positions or those of its associated persons from the redemption.

The proposed rules with links to amendments, comments, and the approval order may be accessed here.

# CFTC

### Trade Associations File Lawsuit Over CFTC's Cross-Border Guidance

The Securities Industry and Financial Markets Association, the International Swaps and Derivatives Association, Inc. and the Institute of International Bankers (collectively, Trade Associations) filed a complaint challenging the legality of the Commodity Futures Trading Commission's Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations (Cross-Border Guidance) that was issued earlier this year.

The crux of the complaint is that the Cross-Border Guidance operates as a rule (even though it is not labeled as such) because it imposes mandatory requirements on swap market participants. Accordingly, the Trade Associations claim that the CFTC acted illegally when it issued the Cross-Border Guidance without adhering to the requirements of the Administrative Procedure Act (APA) and the Commodity Exchange Act (CEA) that apply to all formal CFTC rulemakings. The complaint further alleges that a number of CFTC rules that were adopted to give effect to Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Title VII Rules), including rules relating to the registration of swap dealers and swap execution facilities, mandatory clearing, and the process by which swaps will be deemed "made available to trade" were adopted in violation of the APA and CEA because the CFTC improperly failed to address the extraterritorial scope of those rulemakings.

Specifically, the complaint makes the following assertions:

- The Cross-Border Guidance and the Title VII Rules are invalid because the CFTC violated the CEA by failing to evaluate costs and benefits in enacting such guidance and rules.
- The Cross-Border Guidance and the Title VII Rules are invalid because the CFTC violated the APA by failing to provide interested persons sufficient opportunity to participate in the rulemaking.
- The CFTC violated the APA by failing to respond adequately to comments it received about the Cross Border Guidance and the Title VII Rules.
- The Cross-Border Guidance violates the APA because the CFTC acted arbitrarily and capriciously in determining the entities and transactions covered by the Guidance.
- The Cross-Border Guidance violates Section 2(i) of the CEA by improperly regulating activities outside the United States.
- The Title VII Rules violate the APA because the CFTC acted arbitrarily and capriciously in determining the entities and transactions covered by such regulations.

The Trade Associations have requested that the court vacate and set aside the Cross-Border Guidance and enjoin the CFTC from giving extraterritorial effect to the Title VII Rules.

A copy of the complaint is available here.

### CFTC Delays Transaction-Level Requirements for Certain Non-US SD Transactions

The Commodity Futures Trading Commission's Division of Swap Dealer and Intermediary Oversight (DSIO) has delayed until January 14, 2014 the effectiveness its Advisory 13-69 issued on November 14 in which it took the position that a non-US swap dealer (SD) using personnel or agents located in the U.S. to arrange, negotiate, or execute a swap with a non-US person generally would be required to comply with transaction-level requirements for that swap. More information about Advisory 13-69 is available here.

This relief was provided in no-action letter 13-71 issued jointly on November 26 by DSIO, the Division of Clearing and Risk and the Division of Market Oversight. Pursuant to the no-action letter, non-US SDs using personnel or agents located in the United States to arrange, negotiate, or execute a swap with non-US persons that are not guaranteed affiliates or conduit affiliates of a US person are exempt, until January 14, 2014, from transaction-level requirements for such swap. However, if the counterparty for such swap is also a non-US SD, then the non-US SDs must still comply with the multilateral portfolio compression requirements and the swap trading relationship requirements under CFTC Regulations 23.503 and 23.504.

No-action letter 13-71 is available here.

### CFTC Open Meeting on Proprietary Trading and Block Trading

The Commodity Futures Trading Commission will hold a public meeting on December 10 to discuss: (1) proprietary trading and certain interests in and relationships with covered funds; and (2) block trading for futures and options on futures on designated contract markets. Interested parties may view a webcast of the meeting at the CFTC's website or listen to an audio feed by calling a toll-free number.

More information is available here.

### NFA Issues Guidance on Affirmation Process for CPO and CTA Exemptions and Exclusions

The National Futures Association (NFA) issued guidance on the annual affirmation requirement for persons operating under an exemption or exclusion from commodity pool operator (CPO) or commodity trading advisor (CTA) registration. Any person claiming such exemption or exclusion must annually affirm the applicable exemption or exclusion within 60 days of the end of each calendar year. Any person that does not affirm its applicable CPO or CTA exemption will be deemed to have requested to withdraw the exemption or exclusion. The affirmation process can be completed through NFA's online exemption system. NFA will publish on its website a list of all entities that have affirmed their continued eligibility for exemption.

More information is available here.

## LITIGATION

### Delaware Supreme Court Defines Unexhausted Insurance Policies as Property of Dissolved Corporations

The Supreme Court of the State of Delaware recently reversed a Court of Chancery decision declining to appoint a receiver for a dissolved Delaware corporation, Krafft-Murphy Company, Inc. (Krafft). The Chancery Court determined that a receiver was inappropriate because Krafft had no property for the receiver to distribute to potential tort victims. The Supreme Court disagreed, holding that an unexhausted insurance policy is property of the dissolved company even after its three-year wind-up period under Delaware law.

Krafft, a plastering business that supplied and installed an asbestos-containing product, dissolved in 1999. Petitioners were tort plaintiffs seeking recovery from Krafft. Krafft's only remaining assets were unexhausted insurance policies, which paid for the continuing litigation costs. Delaware law provides that corporations dissolved for more than the three-year wind-up period can no longer be sued; in order for tort victims to recover, a receiver must be assigned to handle the dissolved corporation's assets. The plaintiffs sought to appoint a receiver for Krafft's assets so that their cases could continue. The Chancery Court held that because Krafft had no property for the receiver to manage, appointing one would be inappropriate.

The Supreme Court reversed, finding that in Delaware a contingent contractual right is property under 8 Del. C. § 279, the statute for appointing receivers, to the extent the contingent right could still vest. The court held that unexhausted insurance policies could still vest, and that they should be considered property of the dissolved company. Because the court found that the insurance contracts were assets of Krafft, it held that a receiver must be appointed to manage those assets in tort litigation.

*In the Matter of Krafft-Murphy Co., Inc.*, No. 85, 2013 (Del. Nov. 26, 2013).

### District Court Denies Class Certification For Text Message Recipients Where Issue of Consent Predominate

The United States District Court for the Northern District of California recently denied class certification for plaintiffs alleging a claim under the Telephone Consumer Protection Act (TCPA). Plaintiffs alleged that Wise Media, LLC (Wise), illegally signed up cell phone users for subscription plans to receive texts offering trivial information such as horoscope updates and celebrity gossip. Wise then charged the plaintiffs a $9.99 monthly fee. Because the action against Wise Media was stayed, plaintiffs pursued their claim against "aggregators," which plaintiffs alleged facilitated Wise's purported scam by processing billings and monitoring customer complaints. Plaintiffs also accused Mobile Messengers of enrolling them in subscription plans without their consent by means of a software platform owned by Wise.

The court held that for plaintiffs to certify a class asserting a TCPA claim, they must show the lack of consent is common within the class. The TCPA requires that the defendant called or texted a cellular telephone, using an automatic telephone dialing system, without the recipient's prior consent. The court held that the issue of consent could not be proven on a class-wide basis because individual questions would abound. In addition, the court found that plaintiffs' speculation that Wise engaged in mass fraud to sign up users was insufficient to demonstrate that consent would be common to the entire class. Accordingly, the court denied class certification.

*Fields v. Mobile Messengers Am., Inc.*, No. C 12-05160 WHA (N.D. Cal. Nov. 18, 2013).

### ***Gruss v. Zwirn*: SDNY Strikes a Blow Against Selective Waiver**

On November 20, US District Judge Paul G. Gardephe of the US District Court for the Southern District of New York issued a decision with potentially significant consequences for attorneys conducting internal investigations and parties seeking to obtain (or shield) disclosure of witness interview notes memorializing such investigations. *Gruss v. Zwirn*, 09-CV-6441 (S.D.N.Y., November 20, 2013). Judge Gardephe's ruling, issued in a defamation action brought against a hedge fund by a former employee, followed a request for clarification after an earlier ruling in July. Through the two rulings, Judge Gardephe ordered production, for *in camera* inspection by the court, of interview notes prepared by outside counsel for the fund pertaining to 21 witnesses whose statements were obtained in the course of an internal investigation. The witness statements were voluntarily disclosed to the Securities and Exchange Commission, in summary form, through PowerPoint presentations. Judge Gardephe found that the fund's voluntary production of the PowerPoint presentations to the SEC containing summaries of what the 21 witnesses told outside counsel during the internal investigation constituted a subject-matter waiver warranting the production of the underlying witness interview notes, subject to redaction of opinion work product material (which plaintiff in the defamation action did not seek).

Judge Gardephe's rulings offer a broad application of the Second Circuit's decision in *In re Steinhardt Partners*, L.P., 9 F.3d 230 (2d Cir. 1993), and further limit the utility of the "selective waiver" doctrine, under which a party may, under narrowly circumscribed conditions, voluntarily produce privileged material to an adversary on a selective basis, while maintaining the privilege as to others. Indeed, Judge Gardephe's rulings arguably expand on *Steinhardt*'s repudiation of selective waiver in three important ways: (1) the court ignored a confidentiality agreement between the fund and the SEC that sought to insulate the voluntary SEC production from a waiver claim, finding that a carve-out in the confidentiality agreement permitting disclosure "in furtherance of [the SEC's] discharge of its duties and responsibilities" rendered the agreement illusory; (2) the court extended the waiver to witness interview notes prepared by outside counsel that were not themselves produced to the SEC; and (3) the court expanded on doctrinal opposition to selective waiver, highlighting purported "strategic and manipulative" abuses of selective productions while minimizing the indisputable salutary purposes of the doctrine (e.g., promotion of cooperation with governmental investigations).

Continue reading

## BANKING

### **Three Financial Regulators Set Volcker Rule Meeting Date**

On December 3, three of the five regulators charged with writing the Volcker Rule released notices that they will hold votes on the rule. The U.S. Commodity Futures Trading Commission, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation issued "Sunshine Act" notices saying they would hold open meetings on December 10 to discuss and vote upon the rule. It has also been reported that Comptroller of the Currency Thomas Curry will also take action on December 10. The Securities and Exchange Commission at this writing has not given notice of its meeting date, although it is expected that the SEC will act soon after the other agencies issue their version of the rule. While the agencies are under legal compulsion to consult with each other about the rule, which must take effect in July, there is fear in the markets that some agencies will issue stricter versions of the rule than others. While it has been reported by *The Wall Street Journal* that "people familiar with the discussions" say the agencies have reached broad agreement on how to define hedging, even small differences in how terms are defined, much less interpreted, could result in differences in how entities conduct their operations. There is also fear that financial entities in other countries could have a competitive advantage over those institutions subject to the rule, which is expected to be enforced starting in 2015.

**FinCEN Issues Advisory on Jurisdictions with AML/CFT Deficiencies**

The Financial Crimes Enforcement Network (FinCEN) on December 4 issued an advisory to financial institutions based on the Financial Action Task Force's updated lists of jurisdictions with strategic anti-money laundering and counter-terrorist financing deficiencies. These changes affect US financial institutions' obligations and risk-based approaches with respect to relevant jurisdictions.

The advisory can be viewed here.

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