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SEC/CORPORATE

US Court of Appeals for the District of Columbia Circuit Partially Invalidates Conflict Minerals Rule

On April 14, the US Court of Appeals for the District of Columbia Circuit issued an opinion in the lawsuit challenging the Securities and Exchange Commission's conflict minerals rule which reversed, in part, the prior decision of the US District Court for the District of Columbia upholding the conflict minerals rule and remanded the case back to the district court for further proceedings. In the opinion, the court found that, to the extent that the conflict minerals rule requires an issuer to disclose that any of its products "have not been found to be 'DRC conflict free,'" such portion of the rule violates the First Amendment's prohibition against compelled speech. However, the remainder of the conflict minerals rule, including the provisions requiring issuers to conduct country-of-origin inquiries and due diligence and the lack of any *de minimis* exception for reporting under the rule, was upheld by the court, as opponents of the conflict minerals rule were unable to convince the court that it should be invalidated as arbitrary, capricious, an abuse of discretion or in excess of the SEC's statutory jurisdiction. As the decision remanded the lawsuit back to the lower court for further proceedings, a final decision with respect to the invalidated portion of the rule may be delayed for some time. A copy of the court's full opinion is available here.

The partial invalidation raises significant questions about how issuers should comply with the conflict minerals rule, and it is possible that the SEC will voluntarily stay the application of the rule until the courts reach a final decision. However, in the absence of a stay from the SEC, issuers should continue their efforts to comply with the conflict minerals rule for the calendar year beginning January 1, 2013 (regardless of the issuer's fiscal year), as the first filings on Form SD pursuant to the conflict minerals rule will be required to be filed with the SEC no later than May 31, 2014.

For additional information, please see the *Corporate and Financial Weekly Digest* edition of August 24, 2012, regarding the release of the conflict minerals rule, the edition of July 26, 2013, addressing the initial ruling in the case challenging the rule and the edition of January 10, 2014, discussing the oral arguments in the above appellate court case.

BROKER DEALER

FINRA Proposes Rule 2081 to Prohibit "Bargained-For" Expungements

The Financial Industry Regulatory Authority, Inc. (FINRA) filed a proposed rule change with the Securities and Exchange Commission to adopt FINRA Rule 2081 that would prohibit broker dealers and associated persons from conditioning the settlement of a customer dispute on the customer agreeing to expunge the information regarding the dispute from the Central Registration Depository (CRD). On February 13, the FINRA Board of Governors approved the filing of the proposed rule with the SEC. FINRA did not solicit public comment for the proposed rule. The CRD system contains a variety of licensing and registration information, including administrative and disciplinary information about registered personnel. Information accessible by the public through FINRA's BrokerCheck comes from the CRD system. FINRA acknowledged that it had taken steps to prevent bargained-for expungement as part of a settlement agreement, but it continued to have concerns with respect to such conduct, which would be expressly prohibited by the proposed rule. The effective date of the proposed rule will be 90 days following SEC approval.

The proposed rule can be found here.

SEC Issues FAQs on Rule 15c3-5 for Broker Dealers with Market Access

On April 15, the Securities and Exchange Commission's Division of Trading and Markets issued guidance in the form of 19 frequently asked questions (FAQs) on Rule 15c3-5 of the Securities Exchange Act of 1934 (Exchange Act), which requires risk management controls and supervisory procedures for broker dealers with market access.

Among the issues addressed by the FAQs, the SEC staff stated that a broker dealer providing market access may contractually grant control over specific regulatory risk management controls and supervisory procedures to a broker dealer client only if the broker dealer client is better situated to implement the controls and procedures and is not trading for its own account. Broker dealers are also permitted to use independent third-party risk management tools or technology, provided that they retain exclusive control over and perform due diligence (beyond merely relying on the mere representations of the third party) on such tools or technology. The third party providing the tools or technology is permitted to be the exchange or alternative trading system. With respect to credit or capital thresholds, the broker dealer should be prepared to explain how a threshold was chosen and how it limits financial exposure. Such thresholds can be adjusted under appropriate circumstances, such as when they are met and orders exceeding such thresholds are blocked. Any reasons for modifying thresholds should be documented and retained in the books and records of the broker dealer.

Click here to read the full text of the FAQs, which includes additional topics.

CFTC

CME Group Issues Notice Prohibiting Transitory EFRPs

CME Group has issued an advisory notice prohibiting transitory exchange for related positions (EFRPs) on each of the Chicago Mercantile Exchange (CME), the Chicago Board of Trade (CBOT), the New York Mercantile Exchange (NYMEX) and the Commodity Exchange (COMEX). Pursuant to the advisory notice, transitory EFRPs, which had previously been permitted in CME foreign currency products, NYMEX energy products and COMEX and NYMEX metals products, will no longer be permitted as of June 2, 2014.

As provided in the advisory notice, a transitory EFRP is one whose execution is contingent upon the execution of another EFRP or related position transaction where the transactions result in the offset of the related positions without incurring market risk that is material in the context of the related position transactions. Under the newly articulated policy, each transaction must have integrity as an independent transaction exposed to market risk. The time period between transactions is also a factor in determining whether a transaction is a transitory EFRP. However, an exchange of futures for physicals in foreign currency futures in which the foreign currency position is immediately offset is permitted under revised CME Group Exchanges' Rule 538.K.

The advisory notice also provides further information relating to EFRP recordkeeping obligations, including the requirement to maintain all relevant records for the related position transaction. The advisory notice and related rule revisions will become effective on June 2, 2014.

The advisory notice, which was deemed approved by the Commodity Futures Trading Commission pursuant to CFTC Regulation 40.5, is available here.

LITIGATION

SEC Brings Lawsuit Against Hedge Fund Manager for Defrauding Investors

On April 4, the Securities and Exchange Commission filed a complaint against Matthew D. Sample, founder of hedge fund Lobo Volatility Fund, LLC, for fraudulently raising approximately $1 million from five investors. According to the complaint, Sample raised the funds between October 2009 and June 2012 by selling Lobo limited liability units to investors and misrepresented that he would use investors' money to trade options by employing a propriety trading strategy.

The SEC alleged that Sample diverted approximately one-third of the funds for personal use and payments to other investors. The complaint further alleged that Sample's trading strategy failed, causing the loss of the remaining funds, and that Sample falsely informed investors that he was trading profitably and that the funds were being held in capital accounts. According to the SEC, after one investor made repeated requests to withdraw $500,000, Sample provided the investors with false excuses as to why he could not make a distribution.

The SEC asserts that the alleged acts violate Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and Sections 206(1), (2) and (4) of the Investment Advisers Act. Sample consented to a permanent injunction against further violations, without admitting or denying the allegations. The SEC seeks disgorgement of the illicitly obtained funds and civil penalties.

Securities and Exchange Commission v. Sample, C.A. No. 3:14-cv-1218 (N.D. Tex. Apr. 4, 2014).

SEC Alleges Insider Trading by Two Friends in Advance of the Acquisition of The Shaw Group Inc.

On April 3, the Securities and Exchange Commission brought a lawsuit against Walter Wagner and Alexander Osborn, alleging that the two friends realized almost $1 million in profits by illegally trading securities of The Shaw Group Inc. in advance of its acquisition by Chicago Bridge & Iron Company, N.V.

According to the SEC, Wagner received material, non-public information about the acquisition from his former classmate John Femenia, an associate at a large investment bank, who learned of the transaction in the course of his employment. The SEC alleged that Wagner traded on the tip and purchased Shaw equity and short-term call options, and that Wagner tipped his friend Osborn, who then did the same.

On July 30, 2012, after Chicago Bridge announced its agreement to acquire Shaw, Shaw's stock price increased 55 percent over the prior day's closing price. The complaint asserts that Wagner and Osborn then sold their Shaw equities and call options and reaped profits of $517,784 and $439,830, respectively.

The SEC alleged that the acts violate Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Wagner agreed to settle by disgorging his illicit profit plus interest, paying a civil penalty to be determined at a later date, and consenting to an injunction against further violations. The SEC litigation against Osborn is ongoing.

Securities and Exchange Commission v. Wagner, C.A. No. 8:14-cv-01036 (D. Md. Apr. 3, 2014).

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