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BROKER DEALER

FINRA Issues New Investor Alert on Closed-End Funds

The Financial Industry Regulatory Authority issued an investor alert regarding closed-end funds to explain what investors should know before investing. Like other mutual funds, closed-end funds are professionally managed portfolios of stocks, bonds and other investments. They can charge annual fees, utilize leverage to enhance returns, and invest in a diverse pool of assets to minimize exposure to unsystematic risk. Unlike open-end mutual funds, which issue new and redeem outstanding shares on a continuous basis, closed-end funds offer a fixed number of shares in an initial public offering (IPO) that are then traded on an exchange. Buyers and sellers can trade these shares like stocks or bonds. The market price of a closed-end fund is therefore determined not only by its net asset value (NAV), but also the market price investors are willing to pay for fund shares.

The price of shares of a closed-end fund is based largely on distributions. Distributions derive from interest income, dividends, capital gains and occasionally a return of principal. Distribution amounts are calculated differently than open-end mutual fund yields. A yield shows income as a percentage of the fund's current share price; closed-end fund distribution can vary with share price or a fund's NAV, or be fixed by fund management prior to the IPO. Funds that return principal—especially those that do so because of previously fixed distribution rates—carry higher levels of risk because the fund must sometimes erode its asset base to generate income for distributions. Investors are encouraged to consider this and other factors before investing in closed-end funds, including personal investment objectives, the fund's investment strategy, the percentage of IPO price actually invested, tax implications, how the distribution rate is set and whether shares are trading at a premium or discount to NAV.

The FINRA alert may be accessed here.

CFTC

CFTC Adopts Enhanced Customer Protection Rules

On October 30, the Commodity Futures Trading Commission adopted final rules designed to enhance customer protection. The rules expand the information provided to customers regarding the risks of trading generally and the potential risks of trading through a particular futures commission merchant (FCM). The rules require each FCM to post on its website, or otherwise make available to customers, a disclosure document, to be updated at least annually, describing the FCM's business activities, product lines, risk profile and recent financial information. The final rule also requires FCMs to post certain financial information, including the daily segregation calculation, on their websites. In addition, FCMs must adopt written risk management policies and procedures that address the risks of their business. The final rule also expands the early warning notice requirements under CFTC Rule 1.12 and provides that such notices must be filed electronically with the CFTC and applicable self-regulatory organizations.

Perhaps the most controversial rule is the so-called "residual interest" rule. Beginning one year after publication in the *Federal Register*, FCMs will be required to use their own funds to cover any individual customer margin deficits outstanding as of 6:00 p.m. Eastern Time on the business day following the trade date. The final rule calls for the CFTC to complete within 30 months a study assessing the feasibility of reducing the time for residual interest calculations. Unless the CFTC takes further action no later than five years thereafter, FCMs will be required to calculate and fund their residual interest requirement prior to the time of daily settlement with each applicable derivatives clearing organization.

The customer protection rules will become effective 60 days after publication; however, certain provisions have alternative compliance dates as set forth in the final rules.

The final rules are available here.

CFTC Adopts Rules Regarding the Protection of Collateral and Treatment of Securities in a Portfolio Margining Account in a Bankruptcy

On October 30, the Commodity Futures Trading Commission adopted final rules regarding (i) the protection of collateral and (ii) the treatment of securities in a portfolio margining account in a commodity broker bankruptcy. The protection of collateral rules were adopted to codify Section 746(c) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which requires swaps dealers and major swap participants in connection with uncleared swaps to inform their counterparties that they have the right to require their initial margins to be held by an independent custodian. Under the final rule, if a counterparty elects segregation for its initial margin, the account must be held by an independent custodian pursuant to a written custody agreement that fulfills certain minimum criteria.

The final rule related to portfolio margining clarifies that securities held in a futures or cleared swaps customer account that is subject to portfolio margining are customer property under the Bankruptcy Code.

The final rules will be effective 60 days after publication in the *Federal Register*. Swap dealers and major swap participants must comply with the notification requirements set forth in the final rules no later 180 days after publication for uncleared swap transactions with new counterparties and no later than 360 days after publication for uncleared swap transactions with existing counterparties.

The final rules are available here.

CFTC Adopts Final Rules for Ownership and Control Reports

On October 30, the Commodity Futures Trading Commission approved final rules that implement position and trading activity based reporting requirements for market participants that trade futures and swaps. The final rules modify the existing Form 102 and 102S (Identification of "Special Accounts") and Form 40 (Statement of Reporting Trader) and implement two new forms that will be used to identify and collect information related to accounts that exceed a specified daily trading volume. Under the final rules, these reports will be submitted to the CFTC electronically.

Form 102A (revised Form 102) requires clearing members to identify special accounts (as defined in Part 15 of the CFTC Regulations) as well as the underlying trading accounts. Form 102S has been updated and will continue to be used to collect information related to certain categories of swaps. Form 102B is a new form that will be used by clearing members and certain reporting markets to identify accounts with daily trading volumes that exceed a specified level regardless of whether the accounts maintain positions at the end of the day. Form 71 is a new form that will be sent pursuant to a special call to identify the ultimate owners and controllers of omnibus accounts that exceed specified trading volumes.

Revised Form 40 must be submitted to the CFTC upon receipt of a special call; however, each reporting trader that is required to complete a Form 40 will be under a continuing obligation to update and maintain the accuracy of the information it provides. The compliance date for the final rule will be 270 days after publication in the *Federal Register*.

The final rules are available here.

CFTC Announces Mutual Acceptance of Approved Legal Entity Identifiers

On October 30, the Commodity Futures Trading Commission's chief information officer announced that registered entities and swap counterparties subject to CFTC swap data recordkeeping and reporting requirements concerning legal entity identifiers (LEIs) may now comply with those regulations by using any LEI issued by a provider that has been endorsed by the Regulatory Oversight Committee (ROC) of the global LEI system. Following this announcement, market participants may use CFTC Interim Compliant Identifiers (CICIs) issued by the CICI utility operated by DTCC-SWIFT or any other LEI codes endorsed by the ROC.

A complete listing of LEIs that have been endorsed by the ROC is available here.

The CFTC notice is available here.

CFTC Seeks Comments on TW SEF Available-to-Trade Certification

On October 29, the Commodity Futures Trading Commission requested public comment on a made-available-to-trade certification submitted by TW SEF, LLC, a temporarily registered swap execution facility (SEF). By submitting this certification, TW SEF seeks to implement available-to-trade determinations for certain interest rate and credit default swaps. If certified by the CFTC, these swaps would be subject to the mandatory trade execution requirement set forth in Section 2(h)(8) of the Commodity Exchange Act, which would generally require these swaps to be executed on or pursuant to the rules of a designated contract market or SEF. Comments are due by November 29.

The CFTC's request for public comment is available here.

LITIGATION

Second Circuit Affirms Dismissal of *Qui Tam* Case Based on Attorney's Use of Confidential Information

The US Court of Appeals for the Second Circuit recently affirmed the decision of the District Court for the Southern District of New York to disqualify Fair Laboratory Practices Associates (FLPA) from its *qui tam* suit against Quest Diagnostics (Quest) and Unilab Corporation (Unilab) because the FLPA used confidential information provided by Unilab's former general counsel, Mark Bibi.

FLPA sued under the False Claims Act (FCA), alleging that from at least 1996 to 2005 Unilab illegally priced its medical testing services by providing sharp discounts to medical care providers to induce them to refer Medicare and Medicaid business. Unilab then billed the incoming federal business at significantly higher rates. The US Department of Health and Human Services Office expressly prohibited this "pull-through" scheme in a 1999 advisory opinion. Less than five months after instructing Unilab's chief executive officer on the advisory opinion, Bibi was replaced as general counsel.

Bibi, along with two colleagues from Unilab, formed FLPA in 2005. Although Bibi knew he had confidential information, he concluded exceptions to the ethical rules applied in this FCA case brought against Unilab and Quest. The District Court disagreed that the attorney-client confidentiality rules did not apply and disqualified FLPA as a potential plaintiff.

The Second Circuit affirmed, noting that the FCA did not preempt state ethical rules, and that Bibi's disclosures exceeded what was reasonably necessary to prevent a crime as permitted by the ethical rules. The court also upheld the District Court's decision to dismiss FLPA's complaint due to Bibi's ethical violation because allowing the case to proceed would permit FLPA to use unethical disclosures against Quest and Unilab.

United States v. Fair Laboratory Practices Assoc.s, No. 11-1565-cv (2d Cir. Oct. 25, 2013).

District Court Dismisses a Shareholder Suit for Failing to Plead Scienter

The US District Court for New Jersey recently granted a motion to dismiss by defendants, Columbia Laboratories, Inc. (Columbia) and Watson Pharmaceuticals, Inc. (Watson). The plaintiff group brought an action under Section 10(b) of the Securities and Exchange Act of 1934 and under Securities and Exchange Commission Rule 10b-5 for

fraudulent misrepresentation. The District Court held that the plaintiff group's second amended complaint failed the scienter pleading requirement of the Private Securities Litigation Reform Act because it failed to allege Columbia knew about a heightened statistical significance standard for a study to approve a new drug.

In 2004, Columbia started a clinical study to evaluate a new drug called Prochieve. The US Food and Drug Administration (FDA) advised that one study might be enough if it showed a more robust statistical significance (99% confidence) than usually required (95% confidence). Although the 2004 study did not produce significant results, Prochieve was later tested from 2008 to 2010 for a new use. Columbia and Watson announced on June 27, 2011, that the FDA had accepted the filing for Prochieve based on test results meeting the 95% confidence standard. On June 28, 2011, the FDA issued a letter that there was a problem with discrepancies in the data between tests in the United States and abroad that would be a potential review issue.

The District Court found that plaintiffs failed adequately to allege facts creating a strong inference that Columbia or Watson knew the FDA would not approve Prochieve. In their second amended complaint, the plaintiff group focused on the original conversations between Columbia and the FDA regarding the more robust 99% confidence standard for the test trials, alleging that Columbia knew this standard was meant for the 2008 to 2010 trial as well. The District Court concluded that even if that were true, the plaintiffs did not plead that the FDA ever communicated this fact to Columbia, and thus could not plead that Columbia knew the statements were false when made.

In re Columbia Lab.s, Inc. Sec. Litig., No. 12-614 (FSH) (D.N.J. Oct. 21, 2013).

BANKING

OCC Issues Risk Management Guidance

On October 30, the Office of the Comptroller of the Currency (OCC) issued guidance (Bulletin 2013-29) to national banks and federal savings associations (collectively, banks) for assessing and managing risks associated with third-party relationships. A third-party relationship is “any business arrangement between a bank and another entity, by contract or otherwise.” The bulletin rescinds OCC Bulletin 2001-47, “Third-Party Relationships: Risk Management Principles” and OCC Advisory Letter 2000-9, “Third-Party Risk.”

The OCC “expects a bank to practice effective risk management regardless of whether the bank performs the activity internally or through a third party. A bank’s use of third parties does not diminish the responsibility of its board of directors and senior management to ensure that the activity is performed in a safe and sound manner and in compliance with applicable laws.” The OCC “is concerned that the quality of risk management over third-party relationships may not be keeping pace with the level of risk and complexity of these relationships.” The OCC stated that it has identified instances in which bank management has

- Failed to properly assess and understand the risks and direct and indirect costs involved in third-party relationships.
- Failed to perform adequate due diligence and ongoing monitoring of third-party relationships.
- Entered into contracts without assessing the adequacy of a third party’s risk management practices.
- Entered into contracts that incentivize a third party to take risks that are detrimental to the bank or its customers, in order to maximize the third party’s revenues.
- Engaged in informal third-party relationships without contracts in place.

According to the OCC, an effective third-party risk management process follows a continuous life cycle for all relationships and incorporates the following phases:

- **Planning**: Developing a plan to manage the relationship is often the first step in the third-party risk management process. This step is helpful for many situations but is necessary when a bank is considering contracts with third parties that involve critical activities.
- **Due diligence and third-party selection**: Conducting a review of a potential third party before signing a contract helps ensure that the bank selects an appropriate third party and understands and controls the risks posed by the relationship, consistent with the bank’s risk appetite.

- **Contract negotiation**: Developing a contract that clearly defines the expectations and responsibilities of the third party helps to ensure the contract's enforceability, limit the bank's liability and mitigate disputes about performance.
- **Ongoing monitoring**: Performing ongoing monitoring of the third-party relationship once the contract is in place is essential to the bank's ability to manage risk of the third-party relationship.
- **Termination**: Developing a contingency plan to ensure that the bank can transition the activities to another third party, bring the activities in-house, or discontinue the activities when a contract expires, the terms of the contract have been satisfied in response to contract default, or in response to changes to the bank's or third party's business strategy.

In addition, a bank should perform the following throughout the life cycle of the relationship as part of its risk management process:

- **Oversight and accountability**: Assigning clear roles and responsibilities for managing third-party relationships and integrating the bank's third-party risk management process with its enterprise risk management framework to enable continuous oversight and accountability.
- **Documentation and reporting**: Proper documentation and reporting to facilitate oversight, accountability, monitoring and risk management associated with third-party relationships.
- **Independent reviews**: Conducting periodic independent reviews of the risk management process to enable management to assess whether the process aligns with the bank's strategy and effectively manage risk posed by third-party relationships.

The entire Bulletin is available here.

OCC and FDIC Propose Rule to Strengthen Liquidity Risk Management

On October 30, as expected, the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) each proposed a rule to strengthen the liquidity risk management of large banks and savings associations. The OCC's and FDIC's proposed liquidity rules are substantively the same as the proposal approved by the Board of Governors of the Federal Reserve System on October 24. That proposal, as reported in the *Corporate and Financial Weekly Digest* edition of October 25, 2013,

> was developed collaboratively by the three agencies, is applicable to banking organizations with $250 billion or more in total consolidated assets; banking organizations with $10 billion or more in on-balance sheet foreign exposure; systemically important, non-bank financial institutions that do not have substantial insurance subsidiaries or substantial insurance operations; and bank and savings association subsidiaries thereof that have total consolidated assets of $10 billion or more (covered institutions). The proposed rule does not apply to community banks.

Read more.

For more information, contact:

FINANCIAL SERVICES

Janet M. Angstadt	+1.312.902.5494	janet.angstadt@kattenlaw.com
Henry Bregstein	+1.212.940.6615	henry.bregstein@kattenlaw.com
Wendy E. Cohen	+1.212.940.3846	wendy.cohen@kattenlaw.com
Guy C. Dempsey Jr.	+1.212.940.8593	guy.dempsey@kattenlaw.com
Kevin M. Foley	+1.312.902.5372	kevin.foley@kattenlaw.com
Jack P. Governale	+1.212.940.8525	jack.governale@kattenlaw.com
Arthur W. Hahn	+1.312.902.5241	arthur.hahn@kattenlaw.com
Carolyn H. Jackson	+44.20.7776.7625	carolyn.jackson@kattenlaw.co.uk
Kathleen H. Moriarty	+1.212.940.6304	kathleen.moriarty@jkattenlaw.com
Ross Pazzol	+1.312.902.5554	ross.pazzol@kattenlaw.com
Kenneth M. Rosenzweig	+1.312.902.5381	kenneth.rosenzweig@kattenlaw.com
Fred M. Santo	+1.212.940.8720	fred.santo@kattenlaw.com
Christopher T. Shannon	+1.312.902.5322	chris.shannon@kattenlaw.com
Peter J. Shea	+1.212.940.6447	peter.shea@kattenlaw.com
James Van De Graaff	+1.312.902.5227	james.vandegraaff@kattenlaw.com
Robert Weiss	+1.212.940.8584	robert.weiss@kattenlaw.com
Gregory E. Xethalis	+1.212.940.8587	gregory.xethalis@kattenlaw.com
Lance A. Zinman	+1.312.902.5212	lance.zinman@kattenlaw.com
Krassimira Zourkova	+1.312.902.5334	krassimira.zourkova@kattenlaw.com

LITIGATION

Bruce M. Sabados	+1.212.940.6369	bruce.sabados@kattenlaw.com

BANKING

Jeff Werthan	+1.202.625.3569	jeff.werthan@kattenlaw.com

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London: Katten Muchin Rosenman UK LLP.