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SEC/CORPORATE

Recent Developments Relating to Rights to Exclude Shareholder Proposals from Proxy Statements

A recent court decision and no-action letter have brought to light new issues surrounding issuer requests for Securities and Exchange Commission no-action relief with respect to the ability to exclude shareholder proposals from the issuer's proxy statement.

On November 26, the US District Court for the District of Delaware ruled that Wal-Mart Stores, Inc. improperly excluded a shareholder proposal from its 2014 proxy statement even though Wal-Mart had previously been granted no-action relief by the Office of Chief Counsel of the SEC's Division of Corporation Finance (Office of Chief Counsel).

Prior to Wal-Mart's 2014 annual meeting, a shareholder requested the inclusion in Wal-Mart's proxy statement of a proposal that would require Wal-Mart's Compensation, Nominating and Governance Committee to evaluate whether Wal-Mart should sell a product that endangers public safety, has the substantial potential to impair Wal-Mart's reputation or would be considered offensive to the values that are integral to Wal-Mart's brand. Wal-Mart applied to the SEC for no-action relief with respect to the exclusion of such proposal from its proxy statement on the grounds that it related to ordinary business operations, a position that is consistent with prior views of the SEC staff. Such SEC no-action relief was granted, and Wal-Mart accordingly excluded the proposal.

The District Court ruled, however, that the shareholder's proposal was not related to ordinary business matters because it intended to cause Wal-Mart's board of directors to oversee the development and implementation of a policy. The District Court distinguished between the policy that, if implemented, may have an impact on the products that Wal-Mart sold in its business and the proposal itself, which the District Court ruled would not have such an impact. The District Court noted that while in the past it had given substantial deference to the SEC's staff no-action process, the determination of whether the ordinary business exemption applied was ultimately in the purview of the District Court. The District Court's relief provides that Wal-Mart may not exclude the shareholder's proposal from Wal-Mart's 2015 proxy materials.

On December 4, the Office of Chief Counsel granted no-action relief with respect to Whole Foods Market, Inc.'s determination to exclude a shareholder "proxy access" proposal from Whole Foods' proxy materials because of the intention of the board of directors of Whole Foods to seek shareholder approval for a competing proposal.

The shareholder's proposal would have asked Whole Foods' shareholders to vote to allow any shareholder or group of shareholders that collectively own at least three percent of the company's outstanding shares continuously for a period of three years to nominate director candidates for inclusion in Whole Foods' proxy materials. Whole Foods' proposal, on the other hand, would require a shareholder or group of shareholders to collectively own at least nine percent of the company's outstanding shares continuously for a period of five years before they could nominate director candidates for inclusion in Whole Foods' proxy materials. The SEC staff, in its first decision regarding exclusion of a shareholder proxy access proposal, granted Whole Foods' no-action relief request on the basis of Whole Foods' contention that its plan to include a more restrictive proposal regarding proxy access conflicted with the shareholder's proposal and that the inclusion of both proposals would present alternative and conflicting decisions for Whole Foods' shareholders.

Read more here and here.

BROKER-DEALER

SEC Approves MSRB Best Execution Rule

On December 5, the Securities and Exchange Commission approved Municipal Securities Rulemaking Board (MSRB) Rule G-18 (Best Execution Rule) that will require municipal securities dealers to seek the most favorable terms reasonably available for their retail customers' transactions. The Best Execution Rule, which will become effective December 7, 2015, establishes explicit standards for how dealers handle and execute customer orders for municipal securities.

The Best Execution Rule will require municipal securities dealers to use "reasonable diligence" to identify the best potential trading venue for a particular security and then execute transactions in that venue to provide the customer with a price as favorable as possible under prevailing market conditions. The Best Execution Rule provides a non-exhaustive list of factors that a dealer must consider when exercising this diligence: the character of the market for the security, the size and type of transaction, the number of markets checked, the information reviewed to determine the current market for the subject security or similar securities, the accessibility of quotations and the terms and conditions of the customer's inquiry or order.

The Best Execution Rule is generally harmonized with the Financial Industry Regulatory Authority's corresponding rule for best execution in the equity and corporate debt markets, but is tailored to the characteristics of the municipal securities market. Accordingly, transactions with sophisticated municipal market professionals (SMMPs) are exempt from the Best Execution Rule and its adoption is accompanied by amendments to related MSRB rules to help ensure that only appropriate investors are treated as SMMPs. SMMPs are institutional investors or individual investors with assets of at least $50 million.

Prior to effectiveness of the Best Execution Rule, the MSRB and FINRA plan to provide practical guidance on complying with the best-execution standard in both the municipal securities and corporate debt markets.

Click here for MSRB Regulatory Notice 2014-22.

DIGITAL ASSETS AND VIRTUAL CURRENCIES

SEC Sanctions Operator of Unregistered Virtual Currency Exchanges

On December 8, the Securities and Exchange Commission sanctioned a computer programmer for operating two online exchanges that traded securities using virtual currencies without registering them as broker-dealers or stock exchanges. The programmer, Ethan Burnside, operated the two exchanges through his company, BTC Trading Corp., from August 2012 to October 2013. Account holders were able to purchase securities in virtual currency businesses using bitcoins on BTC Virtual Stock Exchange and using litecoins on LTC-Global Virtual Stock Exchange. The exchanges were not registered as broker-dealers but solicited the public to open accounts and trade securities. The exchanges also were not registered as stock exchanges but enlisted issuers to offer securities to the public for purchase and sale. Burnside also offered shares in LTC-Global Virtual Stock Exchange itself, as well as interests in a separate Litecoin mining venture, LTC-Mining, in exchange for virtual currencies. The SEC charged Burnside with willful violations of Sections 5(a) and 5(c) of the Securities Act of 1933 and Burnside and BTC Trading Corp. with willful violations of Sections 5 and 15(a) of the Securities Exchange Act of 1934. Burnside cooperated with the SEC's investigation and settled, paying more than $68,000 in profits plus interest and a penalty. The SEC also barred Burnside from the securities industry.

The action may indicate that the SEC is taking a closer look at decentralized platforms for trading virtual currency using cryptocurrency technology, but the SEC has neither confirmed nor denied such speculation. In recent months, the SEC has reportedly sent voluntary information requests to companies and online "crypto-equity exchanges" offering equity and related interests denominated in virtual currency and websites offering digital tokens for programming platforms. A discussion of the SEC's voluntary information sweep is available here.

Click here to read the SEC Press Release and here to read the SEC order.

NYS Department of Taxation and Finance Issues Tax Guidance on Virtual Currency Transactions

On December 5, the New York State Department of Taxation and Finance (DTF) issued the memorandum "Tax Department Policy on Transactions Using Convertible Virtual Currency." The memorandum clarified that under New York law, convertible virtual currency (such as bitcoin) is considered "intangible property," which is not subject to sales tax. Therefore, the purchase or sale of convertible virtual currency for fiat cash (such as US dollars) is not subject to sales tax. Because convertible virtual currency is property, an exchange of convertible virtual currency for goods and services is treated as a barter transaction. The transfer of the convertible virtual currency in the barter transaction is not subject to sales tax; however, the transfer of tangible goods or certain services in the barter transaction is subject to sales tax. Accordingly, a seller that accepts convertible virtual currency for goods and services must (a) register for sales tax purposes, (b) record the value of the convertible virtual currency in US dollars, (c) record any sales tax in US dollars and (d) report such sales and remit such sales tax when filing its sales tax returns. For income tax purposes, the DTF clarified that New York state tax law adheres to IRS guidance defining virtual currency as property.

Click here to read the tax memorandum.

LITIGATION

Second Circuit Clarifies a Heightened Standard for Insider Trading Convictions

The US Court of Appeals for the Second Circuit recently held that, in order to convict a tippee for insider trading under Section 10(b) of the Securities Act of 1934 and Rule 10b-5, the government must prove beyond a reasonable doubt that the tippee had knowledge of the benefit received by the tipper who breached his or her duty of confidentiality.

Todd Newman and Anthony Chiasson were convicted in May 2013 of insider trading in the US District Court for the Southern District of New York. Newman and Chiasson both received tips from other financial analysts, as well as each other. In 2008, Newman and Chiasson learned of Dell's and NVIDIA's upcoming earnings announcements but were far removed from the original insiders. Newman and Chiasson executed trades earning approximately $72 million from trading based on the tips. At trial, the jury was instructed that, in order to convict, it must find that the tippees (Newman and Chiasson) knew that the information was originally disclosed by an insider in breach of a duty of confidentiality, but the jury instruction was silent in regard to whether the defendants must have had knowledge of the original tipper's personal benefit.

The Second Circuit held that knowledge of the tipper's personal benefit is an essential element of insider trading. The government argued that it need only show that the tippee had knowledge of the breach of the duty of confidentiality, not of the personal benefit received in return. The court rejected this argument, criticizing the government for "overreliance on our prior dicta," and concluding that, for the purpose of insider trading, the insider must have breached a duty of confidentiality in return for a personal benefit, and therefore the tippee's knowledge of the breach must also include knowledge of the benefit.

Based on its holding, the court overturned the convictions of Newman and Chiasson. First, the court determined that the omission of knowledge of the tipper's personal benefit from the jury instruction was not harmless error, as Newman and Chiasson both contested that they had any such knowledge. Second, the court determined that there was insufficient evidence of any personal benefit to the original tippers from Dell and NVIDIA. Third, the court emphasized that it cannot be inferred that Newman and Chiasson knew that the data must have been obtained through breach of the duty of confidentiality for personal benefit, as the record demonstrated the industry custom of leaking earnings results and assisting analysts with their methodology.

In overturning the convictions, the Second Circuit noted: "Although the Government might like the law to be different, nothing in the law requires a symmetry of information in the nation's securities markets."

United States v. Newman, Nos. 13-1837-cr (L), 13-1917-cr (con) (2d Cir. December 10, 2014).

Deputy Treasury Secretary Discusses Cybersecurity Checklist for Banks

Deputy Treasury Secretary Sarah Raskin, who recently spoke at the Texas Bankers' Association Executive Leadership Cybersecurity Conference, provided bank executives and boards some guidance on preventing, preparing for and responding to cyberattacks.

Citing recent attacks against Target, Home Depot and JP Morgan Chase as evidence of the growing cybersecurity threat, Raskin offered a checklist of 10 questions to guide bank CEOs and their boards. The questions encompass three broad areas—baseline protection, information sharing and response and recovery—and aim to provide a roadmap for banks before an attack occurs.

The questions covered areas such as: whether the bank follows the National Institute of Standards and Technology's Cybersecurity Framework; what cyber risks do the bank's vendors and other third parties expose it to; whether the bank has cyber risk insurance; when and how the bank engages with law enforcement after a cyber incident; and when the bank informs customers, investors and the general public about cyber incidents.

One point Raskin emphasized is exercising "basic cyber hygiene," meaning knowing all the systems on your network, knowing who has what administrative privileges and routinely patching software and assessing security weaknesses. According to her estimate, such activities could prevent 80 percent of all known attacks. Another important point of emphasis was the preparedness of a bank's leadership for an attack, including having a cyber-incident "playbook," which details who is responsible for coordinating the bank's response and what their first course of action should be. Additionally, Raskin recommends that banks engage in cyber exercises that simulate a cyber intrusion in order for the leadership to be prepared for the organizational challenges such an attack would pose. The Department of the Treasury is currently in the process of developing such an exercise regime, with input from both the financial sector and other federal departments and agencies.

Remarks are available here.

UK DEVELOPMENTS

FCA Announces Major Restructuring

On December 8, the UK Financial Conduct Authority (FCA) announced a new strategic approach that is intended to provide a "sharper focus" for the agency as it grapples with its new responsibilities and the implementation of new European financial services regulations. Principally, the changes are justified on the basis of making the FCA's organizational structure more flexible, to reflect the heterogeneity of market participants, as well as to ensure collaboration across formerly separated functions where appropriate. For example, the Authorisation and Supervision Divisions will be brought together with the financial crime and client assets teams to focus resources appropriately in the regulation of large versus small investment firms.

The UK Listing Authority and Market Monitoring functions will now be combined into a single Market Oversight Division, whereas a separate Markets Policy and International Division will focus on promoting the FCA's vision for market structure reforms at the European and international levels. The FCA also has an obligation to promote effective competition in the interests of consumers in the markets it regulates. The FCA's new Strategy and Competition Division will bring together the agency's competition resources and capabilities under one roof to ensure better prioritization and focus.

These changes are the result of an internal review of the FCA's strategies and priorities in the 18 months since the FCA took over certain of the functions of its predecessor agency, the Financial Services Authority. The FCA's announcement can be found here.

EU DEVELOPMENTS

Basel Publishes Assessment Reports for the European Union and United States

On December 5, the Basel Committee on Banking Supervision (Committee) published separate reports assessing the implementation of the Basel III capital framework in the United States and the European Union. The Committee conducts a Regulatory Consistency Assessment Programme (RCAP) to determine a jurisdiction's implementation of the Basel III capital framework and to identify any significant deviations from compliance.

The RCAP assessment evaluates a jurisdiction's regulations across the various components of the risk-based capital standards. The assessments are made on a four-grade scale: 1) compliant; 2) largely compliant; 3) materially non-compliant; and 4) non-compliant. The RCAP evaluations do not consider a jurisdiction's bank supervision practices, the adequacy of regulatory capital for individual banks or the banking system as a whole.

For the United States, the RCAP assessment concluded that seven of the 13 evaluated components were compliant and four were largely compliant; however, two—the securitization framework and the standardized approach for market risk—were materially non-complaint. For the European Union, the RCAP assessment concluded that eight of the 14 evaluated components were compliant and four were largely compliant; one—the Internal Ratings-based approach for credit risk—was materially non-compliant and one—the counterparty credit risk framework—was found to be non-compliant.

The RCAP assessment reported that both the United States and the European Union were not applying credit valuation adjustments (CVA) in line with the Basel III requirements. The European Union's counterparty credit risk framework provides an exemption from the Basel III framework's CVA capital charge for certain derivatives exposures. In the United States, the CVA capital charge has not been incorporated in the new standardized approach, with the result that a number of core banks have not been subject to a separate capital charge for CVA risk for a protracted amount of time.

The Committee's report on the United States can be found here; the report on the European Union can be found here.

ESMA Reviews Supervisory Practices on MiFID Investor Information

On December 11, the European Securities and Markets Authority (ESMA) published a press release stating that it had conducted a review of how EU national regulators supervise conduct of business rules under the Markets in Financial Instruments Directive (MiFID) on providing fair, clear and not misleading information to clients.

The review focused on the rules in a sample selection of EU countries (Cyprus, the Czech Republic, Germany, Italy, Portugal and the United Kingdom) and found that a variety of approaches were being followed with a differing intensity of supervision. A number of areas for improvement were identified. They include:

- enhanced use of on-site inspections and thematic reviews;
- a specific focus on conduct of business issues in firms' risk assessments; and
- greater efforts to detect failings by firms in a timely manner.

The review's key findings covered the following areas:

1. *Ex-ante and ex-post supervision* – supervisory systems are divided between ex-ante and ex-post reviews of marketing material. Within the ex-post approach there is also divergence in terms of the timeliness with which regulators review the material following its dissemination and consider complaints made by clients of firms;
2. *Direct and indirect supervision* – while some regulators directly supervise firms' compliance with their obligations relating to the provision of information and marketing material to clients, others rely on annual checks performed by external auditors. The latter approach may make it difficult to detect failings by firms in a timely manner due to the successive sampling process employed by auditors and then the regulators concerned;

3. *Complaints and sanctions* – a low level of complaints and equally low level of sanctions are reported by regulators in the area of information and marketing to clients; and
4. *Definition of information and marketing communication* – there is no precise definition of the term “marketing communication” in EU law; this would need to be further defined in order to build effective convergence of supervisory practices.

In connection with key finding 4 referenced above, a definition of “marketing” already exists under the Alternative Investment Fund Managers Directive and the ESMA release only refers to “marketing communications under MiFID,” so it is unlikely that the changes would be significant for the funds industry and it would be most likely to impact MiFID firms promoting/marketing shares and other securities that are not interests in alternative investment funds.

ESMA’s findings are currently at a high level and the findings and recommendations made by ESMA are merely preliminary; more work will need to be undertaken by ESMA and the European Commission to develop these findings. Revisions to MiFID (in the form of a new EU directive and a new maximum-harmonization regulation) have already been approved by the European Parliament and Council and are due to come into force in January 2017. It appears that ESMA’s latest round of findings will be developed into a further amending directive and/ or regulation—likely a MiFID III.

The ESMA press release is available here.

For more information, contact:

SEC/CORPORATE

David S. Kravitz	+1.212.940.6354	david.kravitz@kattenlaw.com
Mark J. Reyes	+1.312.902.5612	mark.reyes@kattenlaw.com
Mark D. Wood	+1.312.902.5493	mark.wood@kattenlaw.com

FINANCIAL SERVICES

Janet M. Angstadt	+1.312.902.5494	janet.angstadt@kattenlaw.com
Henry Bregstein	+1.212.940.6615	henry.bregstein@kattenlaw.com
Kimberly L. Broder	+1.212.940.6342	kimberly.broder@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@kattenlaw.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
Lance A. Zinman	+1.312.902.5212	lance.zinman@kattenlaw.com
Krassimira Zourkova	+1.312.902.5334	krassimira.zourkova@kattenlaw.com

DIGITAL ASSETS AND VIRTUAL CURRENCIES

Evan L. Greebel	+1.212.940.6383	evan.greebel@kattenlaw.com
Kathleen H. Moriarty	+1.212.940.6304	kathleen.moriarty@kattenlaw.com
Claudia Callaway	+1.202.625.3590	claudia.callaway@kattenlaw.com
Michael M. Rosensaft	+1.212.940.6634	michael.rosensaft@kattenlaw.com
Diana S. Kim	+1.212.940.6427	diana.kim@kattenlaw.com
Robert Loewy	+1.212.940.6303	robert.loewy@kattenlaw.com
Gregory E. Xethalis	+1.212.940.8587	gregory.xethalis@kattenlaw.com

LITIGATION

Michael M. Rosensaft	+1.212.940.6631	michael.rosensaft@kattenlaw.com
Tenley Mochizuki	+1.212.940.8568	tenley.mochizuki@kattenlaw.com

UK/EU DEVELOPMENTS

Carolyn H. Jackson	+44.20.7776.7625	carolyn.jackson@kattenlaw.co.uk
Nathaniel Lalone	+44.20.7776.7629	nathaniel.lalone@kattenlaw.co.uk
Neil Robson	+44.20.7776.7666	neil.robson@kattenlaw.co.uk

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London: Katten Muchin Rosenman UK LLP.