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CORPORATE & FINANCIAL
WEEKLY DIGEST

September 25, 2015 Volume X, Issue 37

SEC/CORPORATE

SEC Advisory Committee on Small and Emerging Companies Makes Recommendations

On September 23, the Securities and Exchange Commission Advisory Committee on Small and Emerging Companies (Advisory Committee) met to discuss, and submit to the SEC, recommendations regarding (1) public company disclosure effectiveness, focusing on the definition of "smaller reporting company" and disclosures by smaller reporting companies; (2) modernizing Rule 147 under the Securities Act of 1933 (a "safe harbor" for intrastate securities offerings) to facilitate recently enacted and future state-based crowdfunding initiatives; and (3) the regulation of finders and other intermediaries in small business capital formation transactions. Additionally, the SEC announced its renewal of the Advisory Committee (the term of which was originally scheduled to expire in September 2015) for an additional two years.

Smaller Reporting Companies. The Advisory Committee's written recommendations note that (1) "emerging growth companies" are provided with a number of less-burdensome disclosure requirements as a result of the Jumpstart Our Business Startups Act, relative to smaller reporting companies; and (2) the accommodations granted to emerging growth companies with respect to these disclosure requirements also would be beneficial for smaller reporting companies.

The Advisory Committee recommended that the SEC revise the definition of "smaller reporting company" under SEC rules to include companies with a public float of up to $250 million (an increase from the current $75 million threshold). The Advisory Committee noted that this revision would exempt a smaller reporting company from the SEC's pay ratio rule, the auditor attestation requirement with respect to internal control over financial reporting and the requirement to provide a Compensation Discussion & Analysis. Additionally, the Advisory Committee recommended that SEC rules be revised to extend to smaller reporting companies the same disclosure exemption accommodations that are available to emerging growth companies (e.g., providing an exemption from say-on-pay and say-on-frequency votes).

Modernizing Rule 147. The Advisory Committee also expressed its concern that, while Rule 147 provides a safe harbor for companies seeking exemption from federal registration for intrastate offers and sales of securities, the rule makes it difficult for issuers to take advantage of the new state-based crowdfunding provisions (recognizing that, in the near future, a majority of states will have adopted some form of crowdfunding legislation). Specifically, the Advisory Committee noted that the rule (1) does not allow offers to be viewed by out-of-state residents (limiting, for example, offerings placed on publicly available websites); (2) requires that 80 percent of the proceeds be generated in-state, 80 percent of the issuer's assets are held in-state, and at least 80 percent of gross proceeds raised be deployed in-state, and (3) requires that the issuer be incorporated or organized in the state where the intrastate offering would be conducted.

The Advisory Committee recommended that the SEC allow offers made in reliance on Rule 147 to be viewed by out-of-state residents, while still requiring that all sales be made only to residents of the state in which the issuer has its main offices. The Advisory Committee also recommended removing all of the percentage thresholds referenced above, and that the SEC evaluate whether alternative criteria should be used to determine whether an issuer has sufficient nexus with the state where all sales occur. The Advisory Committee also called for eliminating the requirement that the issuer be incorporated or organized in the same state where all sales occur.

Regulating Finders and Other Intermediaries. The Advisory Committee noted that less than 15 percent of Regulation D private offerings use financial intermediaries, such as broker-dealers or finders, in part due to the financial intermediaries' legal costs and risks involved in undertaking small transactions and ambiguities in the definition of "broker." The Advisory Committee also noted that a number of smaller market participants use unregistered parties to identify and solicit investors.

The Advisory Committee recommended that the SEC clarify the ambiguity in broker-dealer regulation by determining that persons who receive transaction-based compensation solely for making introductions to prospective investors are not subject to broker registration under the Securities Exchange Act of 1934. The Advisory Committee also recommended that the SEC exempt from federal broker registration any intermediary registered as a broker under state law that is actively and regularly involved in private financings and the solicitation of investors. The Advisory Committee asked the SEC to incrementally address these issues rather than waiting to develop a comprehensive solution, and recommended that the SEC coordinate with the North American Securities Administrators Association and the Financial Industry Regulatory Authority to ensure coordinated and measured regulation.

The text of the recommendations from the September 23 meeting may be found here.

BROKER-DEALER

See the third subhead, "Regulating Finders and Other Intermediaries" in the "SEC Advisory Committee on Small and Emerging Companies Makes Recommendations" story in the SEC/Corporate section.

DERIVATIVES

See "CFTC Issues Guidance on 'Firm or Forced Trades' Process" in the CFTC section.

See "CFTC Issues Guidance on CFTC Requirements for DCOs and the Principles for Financial Market Infrastructures" in the CFTC section.

See "CFTC Seeks Comment on Japan Securities Clearing Corporation's Petition for Exemption from DCO Registration" in the CFTC section.

See "CFTC Grants DCO Registration to Nodal Clear, LLC" in the CFTC section.

CFTC

CFTC Modifies Position Limit Aggregation Proposal

The Commodity Futures Trading Commission has modified its position aggregation proposal, which initially was proposed on November 15, 2013. Under the 2013 proposal, an entity owning 50 percent or more of another entity would be required to aggregate the owned entity's positions for purposes of complying with speculative position limits unless it filed an application with the CFTC and obtained the CFTC's prior approval to disaggregate. In contrast, an entity owning between 10 and 50 percent of another entity would be required to aggregate the owned entity's positions unless the entity files a notice with the CFTC. This notice filing, which must demonstrate compliance with certain conditions set forth in the proposed rule, would be effective upon submission.

Under the CFTC's proposed modifications, entities owning 50 percent or more of another entity would be permitted to disaggregate the owned entity's positions by following the notice filing procedures that would apply to entities owning between 10 and 50 percent of another entity.

The CFTC's proposing release is available here.

CFTC Issues Guidance on "Firm or Forced Trades" Process

The Commodity Futures Trading Commission's Division of Clearing and Risk and Division of Market Oversight have issued guidance to derivatives clearing organizations (DCOs) that use a "firm or forced trades" process to determine the price of swaps for which public market prices are not available. Specifically, the guidance confirms that a DCO is not required to register as a swap execution facility solely by virtue of using a "firm or forced trades" process.

The guidance also confirms that swaps executed during the "firm or forced trades" process are not subject to the clearing and trade execution requirements of the Commodity Exchange Act. However, DCOs must report such swaps as the reporting counterparty under Part 45 of CFTC Regulations.

The divisions' interpretation is available here.

CFTC Issues Guidance on CFTC Requirements for DCOs and the Principles for Financial Market Infrastructures

The Commodity Futures Trading Commission's Division of Clearing and Risk (DCR) has issued an interpretation on the consistency between Part 39 of CFTC Regulations and the Principles for Financial Market Infrastructures. The CFTC previously has adopted additional regulatory requirements for systemically important derivatives clearing organizations (SIDCOs) and other derivatives clearing organizations (DCOs) that opt in to the additional requirements for SIDCOs. These additional requirements are intended to be consistent with the Principles for Financial Market Infrastructures.

DCR's interpretation is intended to remove any apparent ambiguity between the CFTC's Regulations and the Principles for Financial Market Infrastructures, including regulatory requirements related to the following: (1) managing risks associated with exchange-of-value settlement services; (2) managing risks associated with DCO link arrangements; (3) accessing central bank accounts, payment services or custodial services; and (4) conducting due diligence on custodian banks.

DCR's interpretation is available here.

CFTC Seeks Comment on Japan Securities Clearing Corporation's Petition for Exemption from DCO Registration

The Commodity Futures Trading Commission is seeking public comment on a petition by the Japan Securities Clearing Corporation (JSCC) for an order of exemption from registration as a derivatives clearing organization (DCO). Pursuant to temporary no-action relief, JSCC currently allows US clearing members to clear certain swaps, provided that certain conditions are met. In particular, a US clearing member may clear swaps only on behalf of the clearing member's proprietary accounts, and may not otherwise clear swaps for US persons. Unless the CFTC takes further action, this temporary relief will expire on December 31.

The CFTC is considering granting JSCC a permanent order of exemption. Comments on JSCC's petition must be submitted by October 2.

To submit an online comment to the CFTC, click here. JSCC's petition and related documents are available here.

CFTC Grants DCO Registration to Nodal Clear, LLC

The Commodity Futures Trading Commission has granted registration to Nodal Clear, LLC as a derivatives clearing organization (DCO). Pursuant to the registration order, Nodal Clear may clear contracts executed on or through its affiliated designated contract market, Nodal Exchange, LLC.

Nodal Clear's registration order is available here.

INVESTMENT COMPANIES AND INVESTMENT ADVISERS

SEC Proposes Liquidity Management Rules for Mutual Funds and ETFs

On September 22, the Securities and Exchange Commission proposed a comprehensive package of rule reforms designed to enhance effective liquidity risk management by open-end funds, including mutual funds and exchange-traded funds (ETFs). Under the proposal, mutual funds and ETFs would be required to implement liquidity risk management programs and enhance disclosure regarding fund liquidity and redemption practices. The proposal is designed to better ensure investors can redeem their shares and receive their assets in a timely manner.

Liquidity Risk Management Programs. Proposed new Rule 22e-4 would require mutual funds and other open-end management investment companies, including ETFs but excluding money-market funds, to have a liquidity risk management program. A fund's liquidity risk management program would be required to contain multiple elements, including: (1) classification of fund portfolio assets based on the amount of time an asset would be able to be converted to cash without a market impact; (2) assessment, periodic review and management of a fund's liquidity risk; (3) establishment of a fund's three-day liquid asset minimum; and (4) board approval and review.

Asset Classification. Funds would be required to classify each asset position into one of six liquidity categories that would be convertible to cash within a certain number of days: one business day; two to three business days; four to seven calendar days; eight to15 calendar days; 16 to 30 calendar days; and more than 30 calendar days. The proposed rule includes factors that would have to be addressed when classifying fund assets. In addition, Rule 22e-4 would codify the 15 percent limit on illiquid assets included in current SEC guidelines.

Ongoing Assessment. Funds would be required to assess and periodically review their liquidity risk, based on specified factors. Liquidity risk would be defined as the risk that a fund could not meet redemption requests that are expected under normal conditions or under stressed conditions, without materially affecting the fund's net asset value (NAV) per share.

Three-Day Liquid Asset Minimum. A fund would be required to determine a minimum percentage of its net assets that must be invested in cash and assets that are convertible to cash within three business days at a price that does not materially affect the value of the assets immediately prior to sale.

The Board's Role. A fund's board, including a majority of the fund's independent directors, would be required to approve the fund's liquidity risk management program, including the three-day liquid asset minimum. The board also would annually review a written report concerning the program's adequacy prepared by the fund's investment adviser or officer administering the program.

Mutual Fund Swing Pricing. Proposed changes to Rule 22c-1 would provide a framework under which mutual funds, but not ETFs, could elect to use "swing pricing" to effectively pass on the costs stemming from shareholder purchase or redemption activity to the shareholders associated with that activity. Subject to board approval and oversight, a fund that chooses to use swing pricing would reflect in its NAV a specified amount, the "swing factor," once the level of net purchases into or net redemptions from the fund exceeds a specified percentage of the fund's NAV known as the "swing threshold."

Proposed Disclosure Changes. The SEC also is proposing amendments to the Form N-1A registration statement and two reporting forms proposed in May 2015—N-PORT and N-CEN. The proposed Form N-1A amendments would require disclosure of fund policies concerning the redemption of fund shares and the use of swing pricing. Amendments to proposed Form N-PORT would require disclosure of each fund asset's Rule 22e-4 classification and the fund's three-day liquid asset minimum. Amendments to N-CEN would require disclosure of committed lines of credit, interfund borrowing and lending, and swing pricing. ETFs also would be required to report on Form N-CEN whether they required an authorized participant to post collateral in purchase or redemption transactions. In connection with these proposed form amendments, the SEC is re-opening the comment period for its prior proposed reform entitled "Investment Company Reporting Modernization," Investment Company Act Release No. 31610 (May 20, 2015).

White Paper and Comment Period. The proposed liquidity rules are supported by a white paper prepared by the SEC's Division of Economic and Risk Analysis staff entitled, "Liquidity and Flows of U.S. Mutual Funds," which will be available on the SEC's website. The comment period for the proposed liquidity rules will be 90 days after publication in the *Federal Register*. The proposing release may be found here.

IRS Addresses RIC Asset Diversification Requirements

On September 14, the Internal Revenue Service (IRS) issued final regulations under Internal Revenue Code Section 851 clarifying that control groups under the regulated investment company (RIC) rules may consist of two entities (i.e., the RIC and one subsidiary), rather than two levels of entities, settling a decades-long debate. The IRS also issued Rev. Proc. 2015-45, 2015-39 IRB 1, which provides a safe harbor for fund of funds structures.

RIC Control Groups. Changes have been made to examples 1 and 4 in Reg. Section 1.851-5 to clarify that a wholly owned subsidiary of a RIC is a member of the RIC's control group whether or not the subsidiary controls another entity. New example 7 was also added to illustrate the application of the requirement under Section 851(b)(3)(B)(iii) that no more than 25 percent of a RIC's assets may be in qualified publicly traded partnerships (QPTPs). The new example clarifies that RICs must look through a corporation to the corporation's assets if the RIC owns more than 20 percent of the voting stock of the corporation in assessing compliance with the 25 percent limit on QPTP investment.

Fund of Fund Safe Harbor. The new safe harbor for a RIC of RICs is in the form of a *per se* determination, subject to anti-abuse rules, that a RIC will be treated as satisfying its asset diversification requirement if each subsidiary RIC that is within its control group meets the 25 percent asset diversification test (including by applying certain exceptions and cure periods at the subsidiary RIC level). Thus, the IRS has clarified that a fund of funds may look through its underlying funds to determine compliance with the requirements. Prior uncertainty under the RIC control group rules as to whether the fund of funds could satisfy its diversification requirements on a look-through basis, and whether it could determine some of the exceptions and cure periods based on the subsidiary RIC, would have led to unanticipated compliance burdens for a fund of funds.

BANKING

Federal Reserve To Require Same-Day ACH Service

On September 23, the Federal Reserve Board announced the approval of "enhancements" to the Federal Reserve Banks' same-day automated clearing house (ACH) service. According to the Fed, "[t]he enhancements are intended to align the Reserve Banks' same-day ACH service with recent amendments to NACHA's (formerly known as the National Automated Clearing House Association) ACH operating rules and will facilitate the use of the ACH network for certain time-critical payments, accelerate final settlement, and improve funds availability to payment recipients." The changes become effective September 23, 2016, and require receiving depository financial institutions (RDFIs) to participate in the service, and originating depository financial institutions (ODFIs) to pay a fee to RDFIs for each same-day ACH forward transaction. The enhancements will be adopted by incorporating of NACHA's amended operating rules into Operating Circular 4, which governs the Reserve Banks' ACH services.

A copy of the joint NACHA and Regional Payment Association comment letter to the Federal Reserve may be found here.

UK DEVELOPMENTS

FCA Publishes New Supervisory Approach for Regulated Firms in UK

On September 18, the UK Financial Conduct Authority (FCA) published two papers with new guidance (the "Guides") regarding how it will supervise different types of UK regulated financial services firms in the future.

The FCA previously used four categories (denoted as C1 to C4) for the conduct classification of UK-regulated firms. However, the FCA has now simplified this approach and will now differentiate firms as either a "fixed

portfolio firm" or as a "flexible portfolio firm." Based on these two broad categories, the FCA will determine the nature and intensity of supervision needed of such firms.

Fixed portfolio firms are a small population of firms (out of the total number regulated by the FCA), which, based on factors such as size, market presence and customer footprint, the FCA considers will require the highest level of supervisory attention. These firms will be allocated to a named, individual supervisor, and will be proactively supervised by the FCA using a continuous assessment approach rather than on a reactionary basis.

Flexible portfolio firms comprise the balance (and the majority) of firms regulated by the FCA. Such firms are supervised on a reactionary basis, i.e., as and when the FCA receives a report or has concerns about the relevant firm's activities or, otherwise. The FCA's supervision is conducted on a proactive basis through market-based thematic work and programs of communication, engagement and education activity aligned with the key risks identified for the sector in which the relevant firm operates. Flexible portfolio firms will not be allocated a dedicated, named supervisor and, instead, will use the FCA's Customer Contact Centre as their first point of contact with the FCA.

The focus of the guidance in the Guides is how the FCA approaches conduct supervision for each type of firm. In the Guides, the FCA reconfirms its prior guidance to the effect that it intends to examine each of the following areas to see how firms put the integrity of the market and the fair treatment of consumers at the heart of how they conduct their business: (1) business model and strategy; (2) culture; (3) front-line business processes; (4) systems and controls; and (5) governance. However, the Guides also focus on the FCA's three-pillar model for supervising firms, with each of the three pillars of activity contributing to the FCA's understanding of a firm, its sector and the risks arising from both.

The first pillar is firm or group supervision, and the FCA engages with firms to assess whether they have the interests of their customers and the integrity of the market at the heart of their business.

The second pillar is event-driven, reactive supervision; when the FCA becomes aware of significant risks to consumers or markets, or when damage has already been done, the FCA asserts that it will respond swiftly and robustly.

The third pillar is focused on issues and products supervision—whereby the FCA looks at each sector as a whole to analyze current events and investigates potential drivers of poor outcomes for consumers and markets.

The Guides make clear that the FCA will continue to interact with the UK Prudential Regulation Authority whenever necessary or appropriate.

The Guide for Fixed Portfolio Firms is available here.

The Guide for Flexible Portfolio Firms is available here.

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