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CORPORATE & FINANCIAL
WEEKLY DIGEST

July 29, 2011

SEC/CORPORATE

SEC Adopts Rules Removing Credit Ratings as Short-Form Eligibility Criteria

On July 26, the Securities and Exchange Commission adopted final rules removing credit ratings as one of the several alternative "transaction" eligibility criteria for companies seeking to use short-form registration statements when registering primary offerings of non-convertible securities. The new rules were adopted pursuant to Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which required U.S. Federal agencies to remove references to, or requirement of reliance on, credit ratings from their regulations and replace such ratings with a standard of credit-worthiness that the agency deemed appropriate.

Previously, issuers that met the "registrant" eligibility criteria were eligible to register primary offerings of non-convertible securities (such as debt securities) on Forms S-3 or F-3 if they had received an investment grade rating from at least one nationally recognized statistical rating organization (NRSRO). The new rules remove references to NRSROs and revise General Instruction I.B.2. of Forms S-3 and F-3 to provide that offerings of non-convertible securities other than common equity are eligible to be registered on Forms S-3 and F-3 if:

- The issuer has issued (as of a date within 60 days prior to the filing of the registration statement) at least $1 billion in non-convertible securities, other than common equity, in primary offerings for cash, not exchange, registered under the Securities Act of 1933, over the past three years; or
- The issuer has outstanding (as of a date within 60 days prior to the filing of the registration statement) at least $750 million of non-convertible securities, other than common equity, issued in primary offerings for cash, not exchange, registered under the Securities Act; or
- The issuer is a wholly-owned subsidiary of a well-known seasoned issuer (WKSI); or
- The issuer is a majority-owned operating partnership of a real estate investment trust that qualifies as a WKSI.

The SEC also adopted a grandfather provision that allows an issuer to use Forms S-3 and F-3 for a period of three years from the effective date of the new rules if the issuer would have been eligible to register non-convertible securities under the old rules that relied on ratings from NRSROs.

It should be noted that if an issuer meets the "registrant" eligibility requirements for Forms S-3 and F-3 then, notwithstanding new General Instruction 1.B.2, it may also be eligible for the use of Forms S-3 and F-3 if it meets one of the other alternative "transaction" eligibility criteria, including having a non-affiliate market capitalization (voting and non-voting common equity) of $75 million or more.

The new rules also revise Form S-4, Form F-4, Schedule 14A and Securities Act Rules 138, 139 and 168 to refer to the new eligibility criteria in Forms S-3 and F-3. Finally, the new rules amend Securities Act Rule 134(a)(17) to remove a safe harbor permitting the disclosure of security ratings issued or expect to be issued by NRSROs in certain communications deemed not to be a prospectus.

Click here to read the final rules.

BROKER DEALER

SEC Adopts Large Trader Reporting Regime

On July 26, the Securities and Exchange Commission adopted Rule 13h-1 under Section 13(h) of the Securities Exchange Act of 1934. The rule is intended to help the SEC identify market participants engaged in substantial trading, obtain information needed to monitor the impact of those trades, and analyze such market participants' trading activity. The rule contains the following requirements:

- *Form 13H*: Large traders will be required to file Form 13H. A "large trader" is defined as a person whose transactions in exchange-listed securities equal or exceed two million shares or $20 million during any calendar day, or 20 million shares or $200 million during any calendar month. The rule provides guidance on certain types of transactions that can be excluded for purposes of calculating trading levels.

- *Identification Number*: After it files Form 13H, the SEC will then assign each large trader a unique large trader identification number (LTID), which a large trader will be required to disclose to its broker-dealers.

- *Recordkeeping, Reporting, and Monitoring*: Broker-dealers will be required to maintain and report data that is largely identical to the information covered by the SEC's Electronic Blue Sheets (EBS) system, which the SEC currently uses to collect transaction data from broker-dealers. The only additional items that broker-dealers will be required to maintain and report are the LTID and the time a transaction occurs. In addition, the rule requires broker-dealers to monitor whether their customers meet the threshold levels that define a "large trader."

- *Ready Access to Data*: Transaction data will be required to be available for reporting on the morning after the day the transactions were effected. When the SEC requests data from broker-dealers, it would not under normal circumstances require responses earlier than the opening of business on the day after it makes its request.

Rule 13h-1 will become effective 60 days after the date of publication of the rule in the Federal Register. Large traders will have two months after the effective date to comply with the identification requirements of the rule. Broker-dealers will have seven months after the effective date to comply with the requirements to maintain records, report transaction data when requested, and monitor large trader activity.

For the fact sheet and press release announcing the new rule, see here.

For the text of Chairman Shapiro's speech introducing the rule, see here.

PRIVATE INVESTMENT FUNDS

Please see "SEC Adopts Large Trader Reporting Regime" in **Broker Dealer** above.

CFTC

Joint CFTC-SEC Study on International Swap Regulation

The Commodity Futures Trading Commission and Securities and Exchange Commission have published a request for comment in connection with a joint study and report to Congress on international swap and clearinghouse regulation. The study and report, required under section 719(c) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, must identify major swap contracts, dealers, exchanges, clearinghouses and regulators in the United States, Asia and Europe; describe the methods for clearing swaps and systems used for setting margin; and indicate similar areas of regulation for harmonization. Comments must be received within 60 days of the publication of the request for comment in the Federal Register.

The joint release is available here.

Public Meeting of the Technology Advisory Subcommittee on Data Standardization

The Commodity Futures Trading Commission's Technology Advisory Subcommittee on Data Standardization will hold its first public meeting on August 5. The Subcommittee will review public and private solutions for creating well-accepted standards for describing, communicating and storing complex financial products data. Two additional Subcommittee meetings are tentatively scheduled for September 30 and November 4.

Information regarding the meeting can be found here and the agenda is available here.

LITIGATION

Court Vacates SEC Shareholder Nomination Rule

The U.S. Court of Appeals for the District of Columbia Circuit sharply criticized the Securities and Exchange Commission and vacated Exchange Act Rule 14a-11, which permitted certain shareholders of public companies to nominate candidates for the board of directors outside a company's normal nomination process. As noted in last week's edition of the *Corporate and Financial Weekly Digest*, the court held that the SEC was "arbitrary and capricious" in promulgating Rule 14a-11 and thus violated the Administrative Procedure Act in failing to adequately consider the Rule's effect upon efficiency, competition and capital formation.

Typically, incumbent directors nominate candidates for board positions by including information about such nominees in a company's proxy materials. A shareholder who wishes to nominate a potential board member not chosen by the board must file his own proxy statement and solicit votes from shareholders, thereby initiating a proxy contest. Rule 14a-11 would have permitted shareholder nominees to be included in a company's proxy statement under certain conditions.

In rejecting Rule 14a-11, the court held that the SEC "inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters."

In particular, the court noted that while the SEC acknowledged that companies may incur costs in opposing shareholder nominees, it did nothing to estimate those costs nor did it claim that the costs were inestimable. Additionally, the SEC employed insufficient empirical data in concluding that Rule 14a-11 would improve board performance and increase shareholder value. Commenters pointed out that investors with special interests such as employee benefit funds could gain leverage by threatening to impose additional costs on companies through the use of Rule 14a-11. The court found the SEC's failure to seriously evaluate these potential costs problematic and concluded that the SEC acted arbitrarily in this regard. The court also determined that the SEC also acted arbitrarily in predicting frequent use Rule 14a-11 when estimating its benefits, but infrequent use when estimating its costs.

Finally, the court held that the SEC failed to adequately address the effects Rule 14a-11 would have on investment companies, characterizing the SEC's rationale as "unutterably mindless." Note that this decision does not address the adopted amendments to Rule 14a-8, which allow shareholders to propose amendments to a company's bylaws to provide a procedure for including shareholder nominees in a company's proxy statement.

Business Roundtable and Chamber of Commerce of the United States of America v. Securities and Exchange Commission, No. 10-1305 (D.C. Cir. 2011).

BANKING

FFIEC Issues Supplement to Authentication in an Internet Banking Environment to Prevent Fraud

The Federal Financial Institutions Examination Council recently issued a supplement to the Authentication in an Internet Banking Environment guidance, which was first issued in October 2005. The purpose of the supplement is to reinforce the risk-management framework described in the original guidance and update the FFIEC member agencies' supervisory expectations regarding customer authentication, layered security, and other controls in the increasingly hostile online environment.

The continued growth of electronic banking and greater sophistication of the associated threats have increased risks for financial institutions and their customers. Customers and financial institutions have experienced substantial losses from online account takeovers. Fraudsters have continued to develop and deploy more sophisticated, effective, and malicious methods to compromise authentication mechanisms and gain unauthorized access to customers' online accounts. Rapidly growing organized criminal groups have become more specialized in financial fraud and have been successful in compromising an increasing array of controls. Various complicated types of attack tools have been developed and automated into downloadable kits, increasing availability and permitting their use by less experienced fraudsters. Rootkit-based malware surreptitiously installed on a personal computer can monitor a customer's activities and facilitate the theft and misuse of their login credentials. Fraudsters are responsible for losses of hundreds of millions of dollars resulting from online account takeovers and unauthorized funds transfers.

The supplement stresses the need for performing risk assessments, implementing effective strategies for mitigating identified risks, and raising customer awareness of potential risks, but does not endorse any specific technology for doing so. The FFIEC member agencies will continue to work closely with financial institutions to promote security in electronic banking and have directed examiners to formally assess financial institutions under the enhanced expectations outlined in the supplement beginning in January 2012.

Click here to read the FFIEC Supplement.

Federal Reserve Issues Proposed Rule on Retail Foreign Exchange Trading

The Federal Reserve Board on July 28 issued a proposed rule that sets standards for banking organizations regulated by the Federal Reserve that engage in certain types of foreign exchange transactions with retail customers. The proposal, issued pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, outlines requirements for disclosure, recordkeeping, business conduct, and documentation for retail foreign exchange transactions. Institutions engaging in such transactions will be required to identify themselves to their regulator and to be well capitalized. They will also be required to collect margin for retail foreign exchange transactions.

The types of transactions covered by the rule include off-exchange futures and options on futures, over-the-counter options on foreign currency, and so-called rolling spot transactions. The proposal does not include regular spot transactions, listed options on foreign currency, and foreign currency forwards and swaps. The proposal would cover entities regulated by the Federal Reserve including state member banks, bank and financial holding companies, Edge Act and agreement corporations, and uninsured state-licensed branches and agencies of foreign banks.

Comments on this notice of proposed rulemaking must be received by October 11, 2011.

Click here to read the proposed rule.

UK DEVELOPMENTS

Latest FSA Hedge Fund Surveys Published

On July 27, the Financial Services Authority produced its latest biannual report *Assessing Possible Sources of Systemic Risk from Hedge Funds*. This report sets out the results of the FSA's two regular hedge fund surveys – the Hedge Funds As Counterparties Survey (HFACS) and the Hedge Funds Survey (HFS). These were conducted in March and April 2011. The FSA conducts these surveys every six months to assist it in understanding potential sources of systemic risk in the hedge fund sector. (See *Corporate and Financial Weekly Digests* of March 4, 2011, and August 13, 2010, for articles on previous HFS and HFACS.)

The July 2011 report's findings include the following:

- The "footprint" of surveyed hedge funds remains largely unchanged – modest within most markets. The FSA considers that risks to financial stability through the hedge fund market channel remained limited at the time of the latest surveys.
- Counterparties have increased margin requirements and tightened other conditions on their exposures to hedge funds thereby increasing their resilience to hedge fund defaults.

- Counterparty credit exposures to hedge funds remain concentrated among a small number of counterparty banks.
- Leverage, measured in aggregate, has not changed significantly relative to previous surveys.

The FSA stated that it intends to repeat the HFS and HFACS in September/October 2011. It also intends to work closely with the International Organization of Securities Commissions and other national regulators with a view to achieving a consistent and proportionate global approach to systemic risk data collection from hedge funds.

Click here to read the latest biannual FSA report.

EU DEVELOPMENTS

ESMA Issues Discussion Paper on UCITS ETFs and Structured UCITS

On July 22, the European Securities and Markets Authority published a discussion paper *Policy Orientations on Guidelines for UCITS Exchange-Traded Funds and Structured UCITS* on aspects of the regulatory regime governing Undertakings for Investments in Transferable Securities (UCITS).

ESMA stated that it had reviewed the current regulatory regime applicable to UCITS Exchange-Traded Funds (ETFs) and Structured UCITS and, in light of its review, considered that existing regulatory requirements were not sufficient to take account of the specific features and risks associated with these types of funds. In particular, the discussion paper suggests possible measures that could mitigate the risks following from complex products being made available to retail investors described as UCITS.

ESMA seeks feedback on the various "policy orientations."

For ETFs points raised include:

- **Identifier.** Whether ETFs should be required to identify themselves as such in their name, instrument of incorporation, prospectus and marketing material.
- **Index-tracking issues.** The manner in which the prospectus of index-tracking ETFs should contain a description of the index to be tracked and the mechanism used to gain exposure to it.
- **Actively managed ETFs.** Where an ETF is actively managed, investors should be clearly informed of that fact and of the risks arising from its investment strategy.
- **Leveraged ETFs.** The leverage policy and the risks associated with it should be clearly disclosed to investors.
- **Redemption rights**. ETFs should be required to give all investors, including those who acquire units on the secondary market, the right to redeem their units directly from the fund.

For structured UCITS points raised include:

- ESMA considers guidelines are needed to cover the use of total return swaps and strategy indexes.
- Where a structured UCITS gains exposure to complex investment strategies, ESMA considers the structure of the UCITS fund's investment portfolio that is swapped and the instruments underlying the swap to which the UCITS gains exposure should comply with relevant diversification rules of the EU directives and regulations.
- For strategy indexes, ESMA is concerned about frequency of rebalancing the index and the manner in which the index must fulfill the criterion of being an adequate bench mark for the market to which it relates.

The comment period closes on September 22. Responses to the discussion paper will be used by ESMA to formulate proposed guidelines for UCITS ETFs and Structured UCITS.

Click here for ESMA's discussion paper.

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