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CORPORATE & FINANCIAL
WEEKLY DIGEST

August 16, 2013

BROKER-DEALER

SEC Issues Risk Alert on Options Trading Used to Evade Short-Sale Requirements

The Securities and Exchange Commission's Office of Compliance Inspections and Examinations (OCIE) has issued a Risk Alert regarding options trading that may circumvent Regulation SHO. Regulation SHO tightened requirements for short sales, which involve sales of borrowed securities. Regulation SHO aims to ensure that trades settle promptly, thereby reducing settlement failures. Under Regulation SHO, short sellers who fail to deliver securities after the settlement date are required to close out their position immediately, unless they qualify as bona fide market makers, which are entitled to a limited amount of extra time to close out. OCIE examiners have observed certain trading strategies that, while seeming to comply with such close-out requirement, effectively evade the requirement. In addition, the Risk Alert includes a list of indicators that may alert market participants to attempts to circumvent Regulation SHO, including: (i) trading exclusively or excessively in hard-to-borrow securities or threshold list securities, or in near-term listed options on such securities; (ii) large short positions in hard-to-borrow securities or threshold list securities; (iii) large failure to deliver positions in an account, often in multiple securities; (iv) continuous failure to deliver positions; (v) using buy-writes, married puts or both, particularly deep in-the-money buy-writes or married puts, to satisfy the close-out requirement; (vi) using buy-writes with little to no open interest aside from that trader's activity, resulting in all or nearly all of the call options being assigned; (vii) trading in customizable FLexible EXchange (FLEX) Options in hard-to-borrow securities or threshold list securities, particularly very short-term FLEX Options; (viii) purported market makers trading in hard-to-borrow or threshold list securities claiming the exception from the locate requirement of Regulation SHO (often these traders do not make markets in these securities, but instead effect trades only to take advantage of the option mispricing); and (ix) multiple large trades with the same trader acting as a contra party in several hard-to-borrow or threshold list securities (often traders assist each other to avoid having to deliver shares).

Click here to read the Risk Alert.

SEC Order Temporarily Exempting Certain Broker-Dealers and Certain Transactions from the Recordkeeping and Reporting Requirements of Rule 13H-1

Rule 13h-1 (the "Large Trader Rule") under the Securities Exchange Act of 1934 requires that market participants that conduct a substantial amount of trading activity, as measured by volume or market value, in US securities register with the Securities and Exchange Commission by electronically filing and periodically updating Form 13H. The Large Trader Rule also requires that every registered broker-dealer maintain records of certain data ("Transaction Data"), including the applicable large trader identification number and execution time on each component trade, for all transactions effected directly or indirectly by or through: (i) an account such broker-dealer carries for a large trader; or (ii) if the broker-dealer is itself a large trader, any proprietary or other account over which such broker-dealer exercises investment discretion. Additionally, where a non-broker-dealer carries an account for a large trader under the Large Trader Rule, the broker-dealer effecting transactions directly or indirectly for such large trader must maintain records of all Transaction Data. The Large Trader Rule further requires that, upon SEC request, every registered broker-dealer that is itself a large trader or that carries an account for a large trader must electronically report Transaction Data to the SEC through the Electronic Blue

Sheet system for all transactions equal to or greater than the reporting activity level that are effected directly or indirectly by or through accounts carried by such broker-dealer for large traders. Additionally, where a non-broker-dealer carries an account for a large trader, the broker-dealer effecting such transactions directly or indirectly for a large trader must electronically report Transaction Data to the SEC through the Electronic Blue Sheet system.

Initially, the compliance date for the broker-dealer requirements was April 30, 2012. In response to industry requests, the SEC extended the compliance date for the broker-dealer recordkeeping, reporting and monitoring requirements and took a two-phased approach to implementation of the broker-dealer requirements under the Large Trader Rule. On August 8, 2013, the SEC issued an order temporarily exempting certain broker-dealers and certain transactions from the recordkeeping and reporting requirements of the Large Trader Rule. Specifically, broker-dealers that are large traders but do not self-clear, and broker-dealers effecting transactions directly or indirectly for a large trader where a non-broker-dealer carries the account for the large trader, are temporarily exempted from recording and reporting Transaction Data through the Electronic Blue Sheet system for the duration of “phase two,” which ends November 1, 2013. The SEC has established a new “phase three” for which the compliance date will be November 1, 2015. Such broker-dealers will be subject to these requirements by that date.

Click here to read SEC Release No. 34-70150.

CFTC

CFTC Issues Final Rules for SIDCOs

The Commodity Futures Trading Commission issued new risk management standards for systemically important derivatives clearing organizations (SIDCOs). Pursuant to CFTC Regulation 39.11, a derivatives clearing organization (DCO) is required to maintain sufficient financial resources to meet its financial obligations notwithstanding a default by the clearing member creating the largest financial exposure for the DCO in extreme but plausible market conditions. The newly issued rules heighten this requirement for certain SIDCOs by requiring each SIDCO that is systemically important in multiple jurisdictions or that is involved in activities with a more complex risk profile to maintain sufficient financial resources to meet its financial obligations notwithstanding a default by the two clearing members creating the largest combined financial exposure for the SIDCO in extreme but plausible market conditions. The final rules also prohibit such SIDCOs from using assessments for additional guaranty fund contributions in calculating their available default resources.

SIDCOs must also have a business continuity and disaster recovery plan with a recovery time objective of no later than two hours following a disruption, as compared to a recovery time objective of no later than the next business day for all other DCOs. The final rules also implement the CFTC’s special enforcement authority over SIDCOs, which applies in the same manner and to the same extent a federal banking agency may assert enforcement authority over an insured depository institution pursuant to Section 8 of the Federal Deposit Insurance Act.

The CFTC’s adopting release is available here.

CFTC Proposes Rules for SIDCOs to Conform to International Standards

The Commodity Futures Trading Commission has proposed additional standards for systemically important derivatives clearing organizations (SIDCOs) that are consistent with the Principles for Financial Market Infrastructures published by the Committee on Payment and Settlement Systems of the Bank for International Settlements (BIS) and the Board of the International Organization of Securities Commissions. The proposed rules include new or revised standards for governance, financial resources, system safeguards, default rules and procedures for uncovered losses or shortfalls, risk management, disclosure, efficiency, and recovery and wind-down procedures.

The proposed rules are designed to assure that SIDCOs will be deemed to be qualifying central counterparties (QCCPs) for purposes of international bank capital standards set by the BIS’ Basel Committee for Banking Supervision. The proposed rules would also allow a derivatives clearing organization (DCO) that is not a SIDCO to elect to opt in to the SIDCO regulatory requirements, thereby allowing the DCO to be deemed a QCCP.

The CFTC’s proposing release is available here.

CFTC Adopts Final Harmonization Rules for Registered Investment Company Advisers Required to Register as CPOs Under Regulation 4.5; Also Adopts Changes Applicable to All CPOs

Please see "CFTC Adopts Final Harmonization Rules for Registered Investment Company Advisers Required to Register as CPOs Under Regulation 4.5; Also Adopts Changes Applicable to All CPOs" in **Investment Companies and Investment Advisers** below.

CME Amends Electronic Audit Trail Requirements

The Chicago Mercantile Exchange (CME) issued a market regulation advisory relating to electronic audit trail requirements for orders entered into the Globex platform through the CME iLink® gateway. Pursuant to the advisory and revised CME Rule 536.B, each entity certified to connect an order routing/front-end system to the Globex platform through the CME iLink gateway is required to create an audit trail for each message entered into Globex. Clearing members guaranteeing connections to Globex are responsible for maintaining electronic audit trails for such systems.

Revised CME Rule 536.B also provides that each electronic audit trail must be complete and accurate and account for every electronic communication received or generated by such system, including any electronic communication received from Globex. The minimum requirement for timing data has also been revised from a hundredth of a second to a thousandth of a second.

CME's advisory notice is available here.

NFA Reminds SDs and MSPs of Portfolio Reconciliation Requirements

Pursuant to Commodity Futures Trading Commission No-Action Letter No. 13-40, swap dealers (SDs) and major swap participants (MSPs) are required to comply with the portfolio reconciliation requirements in CFTC Regulation 23.502 as of August 23, 2013. The National Futures Association (NFA) issued a notice to remind SDs and MSPs to submit policies and procedures relating to such requirements no later than August 23. SDs and MSPs should make the required submissions through the NFA's Registration Documentation Submission System, which can be accessed here.

SDs and MSPs relying on the CFTC's Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations are not required to submit policies and procedures relating to such portfolio reconciliation requirements for trades with non-US counterparties.

The NFA's Notice I-13-21 is available here.

INVESTMENT COMPANIES AND INVESTMENT ADVISERS

CFTC Adopts Final Harmonization Rules for Registered Investment Company Advisers Required to Register as CPOs Under Regulation 4.5; Also Adopts Changes Applicable to All CPOs

On August 13, 2013, the Commodity Futures Trading Commission issued its final rules ("Final Rules") applicable to registered investment companies now required to dually register as commodity pool operators ("Dually-Registered CPOs") as a result of changes made to CFTC Regulation 4.5 finalized in February 2012 (as described in a Katten Client Advisory of February 22, 2012). The CFTC adopted the Final Rule to harmonize CFTC and Securities and Exchange Commission regulatory requirements applicable to Dually-Registered CPOs by permitting them to comply with the SEC requirements relating to disclosure, reporting and recordkeeping applicable to registered investment companies and their advisers ("SEC Regulatory Regime") in lieu of compliance with substantially all of the CFTC's relevant Part 4 regulations ("Part 4 Regulations"). The Final Rules reflect the CFTC's conclusion that compliance with the regulatory objectives in its Part 4 Regulations largely can be accomplished by compliance with the SEC Regulatory Regime.

The Final Rules also amend certain provisions of Part 4 Regulations that will be applicable to all commodity pool operators and commodity trading advisers, including those relating to (i) signed acknowledgements to evidence receipt of disclosure documents, (ii) disclosure document updating time periods and (iii) third-party service providers for books and records.

The use of the SEC Regulatory Regime in substituted compliance with Part 4 Regulations is not automatic, but elective. Therefore, a Dually-Registered CPO electing to comply with the SEC Regulatory Regime must file a notice with the NFA. Certain of the Final Rules' requirements will become effective immediately upon their publication in the *Federal Register*, while others will become effective 30 days after such publication.

The details will be the subject of a forthcoming Katten Client Advisory.

LITIGATION

Matria Healthcare Insider Traders Will Go to Trial

The US District Court for the Northern District of Georgia denied a motion for partial summary judgment in the Security and Exchange Commission's insider trading case against Earl Arrowood and Parker Petit. The SEC alleges that Arrowood purchased shares of Matria Healthcare after receiving non-public information from Petit—Matria's then-CEO—regarding a potential merger. Petit moved for partial summary judgment on two grounds: that the SEC lacked circumstantial evidence of communications between Arrowood and Petit, and that the timing of Arrowood's trade predated serious merger discussions between Matria and Inverness Medical Innovations, Inc. by two months. The district court rejected both arguments and denied the motion, finding that the SEC's allegations of (i) a close personal relationship between the defendants, (ii) frequent communications between them around the time of the trade, (iii) possible inconsistencies in the deposition testimony of Arrowood and his wife and (iv) Petit's involvement in Arrowood's trading management cumulatively were sufficient to survive summary judgment. Moreover, the court found that non-public information regarding the possibility of a merger, even if not concrete about when and with whom such a merger would occur, could be material.

SEC v. Arrowood, No. 1:12-CV-82-RWS (N.D. Ga. Aug. 7, 2013).

Securities Fraud Claims Against CommScope Dismissed

The US District Court for the Western District of North Carolina dismissed a shareholder securities fraud claim against CommScope, Inc. and its officers, holding that the company's alleged misrepresentations constituted either forward-looking statements or were not misleading. Plaintiffs alleged that CommScope—a communications infrastructure corporation—misled shareholders by forecasting unreasonable sales growth in 2008, based on internal sales budgets that were "impossible" to achieve. The court first considered whether trades made by individual defendants during the class period could be used to prove *scienter*, when those trades were made pursuant to a pre-established stock-trading plan. To rebut *scienter* under SEC Rule 10b5-1, the defendant must demonstrate good faith. However, because a good-faith inquiry involves issues of fact requiring additional evidence from defendants, the court deemed such inquiry premature and instead focused on class-period stock sales by the defendants. The court further held that CommScope's statements about revenue guidance and anticipated earnings were "forward-looking" and accompanied by meaningful cautionary language, and thus entitled to the Private Securities Litigation Reform Act's safe-harbor protections. Finally, the court found no connection between CommScope's ambitious internal budgets and those forecasts presented to investors, noting that "[a] company may presumably set internally unattainable sales goals for any number of other reasons, including motivating its sales representatives to strive for those numbers."

Electrical Workers Pension Trust Fund of IBEW Local Union No. 58 v. CommScope, Inc., No. 5:10-CV-00062-RLV-DSC (W.D.N.C. Aug. 6, 2013).

EXECUTIVE COMPENSATION AND ERISA

Court Finds Private Equity Portfolio Company May Have Liability for Withdrawal by Another Portfolio Company

The US Court of Appeals for the First Circuit recently delivered a potentially far-reaching decision for the private equity industry. In a case which involved a typical private equity structure, *Sun Capital Partners III, LP, et al. v. New England Teamsters & Trucking Industry Pension Fund, et al.*, the First Circuit adopted a broad view of what constitutes a "trade or business" for purposes of determining whether a private equity fund (and its portfolio companies) is a "controlled group" that can be held jointly liable for withdrawal liability from a multiemployer pension fund where one of the fund's portfolio companies withdraws from the fund.

In this case, Sun Capital Funds III and IV (the "Funds") together acquired 100 percent of a portfolio company, with neither of the Funds owning 80 percent or more of the portfolio company on its own. The Funds had no offices or employees, did not make or sell goods and did not report any income other than investment income. The Funds' general partner entered into an agreement with the Funds to provide management services to the portfolio company for a fee through a subsidiary of the general partner. When the portfolio company paid the management fee to the subsidiary, the Funds would receive an offset to the other fees it paid to the general partner.

After the Funds acquired the portfolio company, the portfolio company filed for bankruptcy and incurred withdrawal liability to the multiemployer plan. ERISA imposes joint and several liability for multiemployer plan withdrawals on all entities that are trades or businesses under common control. The issue before the court in this case was whether the Funds are trades or businesses.

The court applied an investment plus activity test to determine whether the Funds were a trade or business. Because of the substantial management services and control that the Funds had over the operations of the portfolio company in question, the court held that the Funds were engaged in a trade or business for a substantial fee. In reaching its holding, the First Circuit rejected the case law rationale used by many private equity funds for the conclusion that they are not trades or businesses, even where they are acting through subsidiaries and affiliates.

The court did not determine whether the Funds are to be aggregated for purposes of the 80 percent ownership test that would expose the Funds, and possibly other portfolio companies, to joint and several withdrawal liability. That issue will be determined by the district court on remand.

Thus, while this case may have far-reaching consequences, it is too early to tell what those consequences will be. It is important to remember that other Circuits have not yet adopted the same or similar position as the First Circuit, and they may not do so. It is also important to wait to see whether on remand the Funds are aggregated for purposes of the 80 percent ownership test for common control. It additionally remains to be seen whether there are other consequences for the Funds and their portfolio companies beyond ERISA withdrawal liability.

A copy of the case is available here.

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