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SEC/CORPORATE

SEC Issues New FAQs on Conflict Minerals

On April 7, the Division of Corporation Finance of the Securities and Exchange Commission issued nine new responses to frequently asked questions regarding the disclosure of conflict mineral usage that is required by rules adopted pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, as discussed in the *Corporate and Financial Weekly Digest* edition of August 24, 2012. The Division of Corporation Finance released an initial set of FAQs regarding conflict mineral usage on May 30, 2013, which were previously discussed in the *Corporate and Financial Weekly Digest* edition of June 7, 2013.

With respect to the requirement to obtain an independent private sector audit (IPSA) of a Conflict Minerals Report, the Division of Corporation Finance provided the following guidance:

- An auditor that is not a certified public accountant may perform the IPSA of an issuer's Conflict Minerals Report as long as the auditor meets the requirements in the US Government Accountability Office's Government Auditing Standards (Yellow Book).
- An IPSA is not required to cover any matter beyond the IPSA objective provided in the rule, including completeness or reasonableness of the due diligence measures performed by an issuer.
- An IPSA need not include a reasonable country of origin inquiry because such an inquiry is a distinct step separate from the due diligence process.
- Though an issuer's due diligence measures covered by an IPSA apply to the conflicts minerals in products manufactured during the calendar year, the requirement does not imply that such measures need to be carried out consistently throughout the year.
- An issuer is not required to include a full description of the design of its due diligence in its Conflict Minerals Report. However, the Conflict Minerals Report must include a description of the due diligence measures taken that are the subject of the IPSA.

With respect to disclosure of the use of conflict minerals, the Division of Corporation Finance provided the following guidance:

- During the temporary transition period, an issuer will not be required to obtain an IPSA of its Conflicts Minerals Report if any of its products are "DRC conflict undeterminable."
- In order to describe any of its products as "DRC conflict free" in its Conflict Minerals Report, an issuer must obtain an IPSA.
- During the temporary transition period, if an issuer has a product that contains a conflict mineral that the issuer is unable to determine did not originate in the Democratic Republic of the Congo (DRC) or an adjoining country, or finance or benefit armed groups in such countries, the issuer may not describe the product as "DRC conflict free." In addition, if an issuer determines that a product contains a conflict mineral that did finance or benefit armed groups in the DRC or an adjoining country, it must describe the product as "having not been found to be 'DRC conflict free.'"

With respect to disclosure requirements on Form SD, the Division of Corporation Finance provided that if an issuer has a product that contains conflict minerals from recycled or scrap sources, it must disclose information about those conflict minerals in a specialized disclosure report on Form SD. If the product also contains conflict minerals not from recycled or scrap sources, the issuer must include a Conflict Minerals Report covering those conflict minerals. The Conflict Minerals Report and IPSA only need to cover the conflict minerals that are not from recycled or scrap sources.

Click here to read the full text of the FAQs.

BROKER DEALER

SEC Issues Frequently Asked Questions Regarding the Amendments to the Broker-Dealer Reporting Rule

The Securities and Exchange Commission’s Division of Trading and Markets has issued frequently asked questions (FAQ) concerning the amendments adopted on July 30, 2013, to Rule 17a-5 (Broker-Dealer Reporting Rule) of the Securities Exchange Act of 1934 (Exchange Act).

Among other things, under the amendments to the Broker-Dealer Reporting Rule:

- A broker-dealer that did not claim an exemption from Rule 15c3-3 of the Exchange Act throughout the broker-dealer’s fiscal year must file with the SEC annually a compliance report and an exemption report.
- A broker-dealer must also file together with the compliance or exemption reports, as applicable, a report prepared by the broker-dealer’s independent public accountant based on an examination of the compliance or exemption report. The examination and review, as well as the audit of the financial statements, must be conducted in accordance with standards of the Public Company Accounting Oversight Board.
- A broker-dealer that clears transactions or carries customer accounts must allow the SEC, or the broker-dealer’s examining authority, to review the documentation associated with certain reports of its independent public accountant and allow the accountant to discuss the findings relating to its reports upon request.
- The SEC adopted Form Custody, a new form that a broker-dealer must file with its examining authority that elicits information about the broker-dealer’s practices with respect to, among other things, the custody of securities and funds of customers and non-customers.
- A broker-dealer must verify its compliance with capital requirements and internal controls.

The FAQ includes, among other things, the following clarifications regarding the amendments to the Broker-Dealer Reporting Rule:

- A broker-dealer with a fiscal year beginning prior to June 1, 2014 need not certify compliance with the rules for the period before the beginning of that fiscal year.
- The independent public accountant’s report based on an examination of the compliance report can be used to satisfy the internal control reporting requirement under Rule 206(4)-2 of the Investment Advisers Act of 1940 (Custody Rule), but the accountant’s report cannot be used to satisfy the Custody Rule’s independent verification requirement or any other requirement of the Custody Rule.
- A broker-dealer that does not hold customer funds or securities may file an exemption report (and corresponding accountant’s report based on a review of the exemption report) rather than a compliance report (and corresponding accountant’s report based on an examination of the compliance report) if the broker-dealer does not claim an exemption from Rule 15c3-3 of the Exchange Act and its business activities are limited to one or more of the following: (1) proprietary trading; (2) effecting securities transactions via subscriptions; and (3) receiving transaction-based compensation for identifying potential merger and acquisition opportunities for clients, referring securities transactions to other broker-dealers, or providing technology or platform services.

The FAQ also includes additional guidance regarding the filing of Form Custody.

Click here to read the SEC's FAQ.

FINRA Requests Comment on Rules Regarding Communications with the Public and Gifts, Gratuities and Non-Cash Compensation

The Financial Industry Regulatory Authority (FINRA) has issued Regulatory Notice 14-14 and Regulatory Notice 14-15 announcing that it will initiate a review of certain of its rules to ensure that its rules remain relevant and appropriately designed to achieve their objectives. FINRA has indicated that it will prioritize rules for review, taking into consideration a number of factors, including: (i) feedback from FINRA's Member Relations and Education department as to rules most frequently identified by firms as raising questions or concerns; (ii) input from FINRA's advisory committees; (iii) observations and experiences of FINRA's operating departments, including examination findings, enforcement actions, interpretive requests and general questions; (iv) how recently the rule(s) have been amended or subjected to industry feedback; (v) the anticipated length of the review process based on the breadth and complexity of the rule or rule set; and (vi) federal laws, regulations or rules that may preempt or otherwise limit FINRA's ability to amend rules.

FINRA has identified the following for current review:

- The set of rules governing communications with the public, which includes FINRA Rule 2210 (Communications with the Public), FINRA Rule 2212 (Use of Investment Company Rankings in Retail Communications), FINRA Rule 2213 (Requirements for the Use of Bond Mutual Fund Volatility Ratings), FINRA Rule 2214 (Requirements for Use of Investment Analysis Tools), FINRA Rule 2215 (Communications with the Public Regarding Securities Futures) and FINRA Rule 2216 (Communications with the Public Regarding Collateralized Mortgage Obligations); and

- The set of rules governing gifts, gratuities and non-cash compensation, which includes FINRA Rule 3220 (Influencing or Rewarding Employees of Others), FINRA Rule 2310(c) (Direct Participation Programs), FINRA Rule 2320(g)(4) (Variable Contracts of an Insurance Company), FINRA Rule 5110(h) (Corporate Financing Rule – Underwriting Terms and Arrangements) and FINRA Rule 2830(l)(5) (Investment Company Securities).

FINRA seeks comments responsive to the following questions with respect to the foregoing rules, including any data or evidence in support of the comments:

- Have the rules effectively addressed the problem(s) they were intended to mitigate?

- What have been experiences with implementation of the rule set, including any ambiguities in the rules or challenges to comply with them?

- What have been the costs and benefits arising from FINRA's rules, and have they been in line with expectations described in the rulemaking?

- Can FINRA make the rules more efficient and effective, including FINRA's administrative processes?

The comment period for both rule sets expires May 8.

Click here to read FINRA Regulatory Notice 14-14.

Click here to read FINRA Regulatory Notice 14-15.

CFTC

CFTC Extends Relief to FCMs from Certain Commingling Requirements

On April 7, the Commodity Futures Trading Commission's Division of Swap Dealer and Intermediary Oversight (DSIO) issued CFTC No-Action Letter No. 14-45, extending to June 30 the relief previously granted in CFTC No-Action Letter No. 14-02. This relief is set to expire on April 14.

The earlier letter provided time-limited relief from the provisions of CFTC Regulations 1.20, 22.2 and 30.7, which prohibit the commingling of customer segregated funds, cleared swaps customer collateral and secured amount customer funds. The relief permits a futures commission merchant (FCM) to accept customer funds in a single payment for deposit into the customer's segregated funds, cleared swaps customer collateral or secured amount account without initially receiving the funds into the customer's segregated funds account and simultaneously recording book entry credits to the customer's cleared swaps collateral and/or secured amount account, as directed by the customer, upon the receipt and recording of cash into the customer's segregated funds account. An FCM relying on this relief is required to hold sufficient funds in its segregated funds, cleared swaps customer collateral and secured amount accounts to meet the net liquidating equities of all its customers in each respective account origin at all times.

Letter No. 14-02 was discussed in the *Corporate and Weekly Financial Digest* edition of January 17, 2014.

CFTC Letter No. 14-45 is available here.

CFTC Seeks Comments on ICE Clear Europe Petition

On April 7, the Commodity Futures Trading Commission requested public comment on a petition submitted by ICE Clear Europe Limited (ICE Clear Europe) to amend an earlier CFTC order permitting ICE Clear Europe and futures commission merchants that are clearing members of ICE Clear Europe to commingle in a US customer segregated funds account futures and options that are traded on ICE Futures US and ICE Futures Europe and related customer funds, as well as to permit portfolio margining between such positions. The previous order related to certain energy contracts, and ICE Clear Europe has now asked the CFTC to amend the order to also apply to certain interest rate, energy and financial contracts.

Comments must be filed on or before April 21.

The petition and associated documentation are available here.

CFTC Reissues and Clarifies Relief Regarding Swaps Trading on MTFs

On April 9, the Commodity Futures Trading Commission's Division of Market Oversight (DMO) and Division of Swap Dealer and Intermediary Oversight jointly issued CFTC No-Action Letter No. 14-46, which modifies the conditions for relief from certain specified business conduct and swap trading relationship documentation requirements under Part 23 of the CFTC's Regulations previously provided to (1) multilateral trading facilities (MTFs) seeking exemptions from swap execution facility (SEF) registration requirements of the Commodity Exchange Act (CEA), (2) parties executing swap transactions on qualifying MTFs from the trade execution and swap data reporting requirements of the CEA and Parts 43 and 45 of CFTC Regulations, respectively, and (3) swap dealers (SDs) and major swap participants (MSPs) executing swap transactions on MTFs. The conditional relief provided in Letter No. 14-46 generally tracks the conditional relief provided in CFTC No-Action Letter No. 14-16 (a Katten Client Advisory covering Letter No. 14-16 is available here), but makes several notable clarifications and changes to the conditions for relief, including, but not limited to, the following items:

- an MTF must report all swap transactions to a CFTC-registered or provisionally registered swap data repository as if it were a SEF, in compliance with Parts 43 and 45 of the CFTC Regulations, as a condition subsequent to qualifying for relief;
- an MTF must certify that it is subject to and compliant with regulations that require all MTF participants to consent to the MTF's jurisdiction, thereby enabling the MTF to effectively enforce its rules; and
- qualifying MTFs must submit monthly reports to the CFTC summarizing levels of participation and volume by US persons.

For such relief to become effective, the DMO must issue a letter to the MTF acknowledging receipt of the request for relief. CFTC No-Action Letter No. 14-31, which originally provided additional time for MTFs to comply with the conditions for obtaining relief under Letter No. 14-16 but now applies to the conditions for relief under Letter No. 14-46, will expire on May 14.

CFTC Letter No. 14-46 is available here.

LITIGATION

Foreign Judgment in Criminal Fraud Action Enforceable in New York

A New York Appellate Court held for the first time that a judgment issued by a foreign country's criminal court awarding monetary compensation to a fraud victim is civil, not penal in nature, and therefore enforceable in New York State.

In 2010, Prague's Municipal Court found Viktor Kozeny guilty of gross fraud for looting six funds associated with the Czech Republic's privatization of state-owned companies. Mr. Kozeny was sentenced to 10 years, and ordered to pay the equivalent of $410 million to Harvardsky Prumyslovy Holding, A.S.,-V Likvidaci (the Fund), one of the funds with approximately 250,000 investors, as "compensation for damage to the victim" under the Czech Code of Criminal Procedure (the Czech Judgment).

The Fund subsequently commenced an action in New York under CPLR article 53 to recognize and enforce the Czech Judgment against Mr. Kozeny. Specifically, the Fund sought to attach approximately $20 million held in a bank account in the name of Landlocked Shipping Company, a Turks and Caicos company alleged to be Kozeny's alter ego. The Supreme Court granted Landlocked's motion to dismiss on the grounds that New York courts do not recognize foreign judgments that are penal in nature.

A five-judge panel of the Appellate Division, First Department, unanimously reversed. Considering both Czech and New York law, the court rejected Landlocked's view that the Czech Judgment, "otherwise construed as compensatory [if] rendered by a civil court, must be regarded as an unenforceable penalty when issued by a criminal tribunal." The court also rejected Landlocked's claim that the Fund sought impermissibly to "reverse-pierce" and hold Landlocked liable for the debts of its shareholder, Kozeny, as the Fund adequately pleaded that Landlocked and Kozeny were alter egos of each other.

Harvardsky Prumyslovy Holding, A.S.,-V Likvidaci v. Kozeny, Index No. 651826/12, 2014 NY Slip Op 02250 (1st Dep't 2014).

SEC Obtains Settlement for Violations of Registration Rules and "Layering"

The Securities and Exchange Commission recently announced a settlement with two brokerage firms and certain of their executives for improper compensation-sharing and "layering," a strategy in which a trader places and later cancels orders he does not intend to have executed in order to induce others to transact at a price not representative of actual supply and demand.

From May 2008 through November 2011, Visionary Trading LLC, an unregistered brokerage, allegedly engaged in day-trading through accounts at Lightspeed Trading LLC (Lightspeed), a registered broker dealer. The SEC claimed that Visionary customers paid commissions to Lightspeed, and Lightspeed then split those commissions with Visionary's four owners. In total, the Visionary owners purportedly received $474,407 of the commissions generated by its customers' trading, and Lightspeed retained $330,000 in commissions.

The SEC also alleged that one of the Visionary owners, Joseph Dondero, engaged in "layering," or placing orders he did not intend to have executed, for the purpose of manipulating prices. Dondero purportedly placed hundreds of thousands of such orders and obtained profits of $984,398.

As part of the settlement, which did not require factual admissions, Dondero agreed to a permanent bar from the securities industry, and to pay $1,149,791.96 in disgorgement and interest, plus a civil penalty of $785,000. The other three Visionary owners each agreed to a two-year bar, $132,993.28 in disgorgement and interest, and a $35,000 civil penalty. Lightspeed's CEO during the relevant period agreed to a one-year bar from holding a supervisory role, and a civil penalty totaling $10,046.23. Lightspeed agreed to pay disgorgement and interest of $377,908.70, as well as a civil penalty totaling $100,308.22.

In the Matter of Visionary Trading LLC, et al., A.P. File No. 3-15823 (Apr. 4, 2014).

BANKING

Banking Agencies Adopt Enhanced Supplementary Leverage Ratio Final Rule

On April 8, the Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) (collectively, Agencies) adopted a final rule to strengthen the leverage ratio standards for the largest, most interconnected US banking organizations. The final rule applies to US top-tier bank holding companies with more than $700 billion in consolidated total assets or more than $10 trillion in assets under custody (covered BHCs) and their insured depository institution (IDI) subsidiaries. A covered BHC must maintain a leverage buffer greater than two percentage points above the minimum supplementary leverage ratio requirement of three percent, for a total of more than five percent, to avoid restrictions on capital distributions and discretionary bonus payments. An IDI subsidiary of a covered BHC must maintain at least a six percent supplementary leverage ratio to be considered “well capitalized” under the Agencies’ prompt corrective action framework. The final rule, which has an effective date of January 1, 2018, currently applies to eight large US banking organizations that meet the size thresholds and their IDI subsidiaries. The final rule is substantively the same as the rule proposed by the Agencies in July 2013.

Also on April 8, the Agencies issued a notice of proposed rulemaking (NPR) that would modify the denominator calculation for the supplementary leverage ratio in a manner consistent with recent changes agreed to by the Basel Committee on Banking Supervision. The revisions in the NPR would apply to all internationally active banking organizations, including those subject to the enhanced supplementary leverage ratio final rule. The Agencies believe the denominator changes in the NPR would more appropriately measure leverage capital requirements and would, in aggregate, increase the requirements across these institutions. The Agencies also issued a separate NPR proposing a technical correction to the definition of “eligible guarantee” in the Agencies’ risk-based capital rules. Comments on both NPRs will be welcomed through June 13, 2014.

In a separate action, the FDIC Board also adopted as final its Basel III interim final rule, which is substantively identical to the final rules adopted by the Federal Reserve Board and the OCC in July 2013.

Read more.

Federal Reserve Extends Compliance Deadline for CLOs

On April 7, the Federal Reserve Board (Board) announced that it intends to exercise its authority to give banking entities two additional one-year extensions to conform their ownership interests in, and sponsorship of, certain collateralized loan obligations (CLOs) covered by the Volcker rule. CLOs are securitization vehicles backed predominantly by commercial loans. The Volcker rule generally prohibits insured depository institutions and any company affiliated with an insured depository institution from engaging in proprietary trading and from acquiring or retaining ownership interests in, sponsoring or having certain relationships with a hedge fund or private equity fund. These prohibitions are subject to a number of statutory exemptions, restrictions and definitions.

“To ensure effective compliance,” the Board intends to grant banking entities two additional one-year extensions, which together would extend until July 21, 2017, to conform their ownership interests in and sponsorship of CLOs to the statute. Only CLOs in place as of December 31, 2013, that do not qualify for the exclusion in the final rule for loan securitizations would be eligible for the extension. The Board intends to act on these extensions in August of this year and the next year. A banking entity would not have to include ownership interests in CLOs to determine its investment limits under the final rule, and a banking entity would not be required to deduct CLO investments from tier 1 capital under the final rule until the end of the relevant conformance period.

The decision was immediately criticized by certain members of Congress and banking trade organizations for not fixing the problem, which relates not to an extension of time but rather to whether Congress intended such instruments to be captured by the Volcker rule.

Read more.

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