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SEC/CORPORATE

Court of Appeals for Third Circuit Overturns District Court Ruling Regarding Exclusion of Shareholder Proposal From Proxy Statement

On July 6, the United States Court of Appeals for the Third Circuit issued an opinion overturning the November 2014 ruling of the United States District Court for the District of Delaware that Wal-Mart Stores, Inc. had improperly excluded a shareholder proposal from its proxy statement. The Third Circuit's written opinion follows its prior order issued in April 2015 vacating the District Court's earlier decision.

As discussed in the *Corporate & Financial Weekly Digest* edition of December 12, 2014, the District Court previously ruled that Wal-Mart had improperly excluded a shareholder's request to include a proposal in Wal-Mart's 2014 proxy statement that would have required Wal-Mart's Compensation, Nominating and Governance Committee to evaluate, among other things, whether Wal-Mart should sell products that endanger public safety. The District Court issued its order even though Wal-Mart had previously been granted no-action relief with respect to such exclusion by the Office of Chief Counsel of the Securities and Exchange Commission's (SEC) Division of Corporation Finance. The District Court ruled that Wal-Mart's exclusion was improper on the grounds that the 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.

In its opinion, the Third Circuit noted that each determination as to whether a shareholder proposal is excludable under the SEC's rules from an issuer's proxy statement is fact specific. The Third Circuit analyzed the case by first determining whether the shareholder proposal related to Wal-Mart's ordinary business operations and, if so, whether the proposal focused on a significant policy issue that transcended Wal-Mart's daily business operations. With respect to the first prong of the analysis, the Third Circuit noted that the District Court placed excessive weight on the distinction between a request for Wal-Mart's board of directors to act and an explicit mandate to Wal-Mart's management. Allowing such a distinction would, in the Third Circuit's view, permit drafters to circumvent the SEC's rules by merely couching proposals as requesting "board oversight or review" rather than specific management action. Specifically, the Third Circuit ruled that so long as a proposal relates to an issuer's ordinary business operations, it is excludable under the SEC's rules unless an exception applies. The Third Circuit determined that the underlying subject matter of the Wal-Mart shareholder proposal was the way that Wal-Mart selects the products that it sells. The Third Circuit reasoned that the approach of a retailer, such as Wal-Mart, to its product offerings is so fundamental to its business that the proposal was excludable under the ordinary business exclusion.

In the second part of its analysis, the Third Circuit discussed whether the Wal-Mart shareholder proposal was not excludable, despite the subject matter being within Wal-Mart's ordinary business operations, on the grounds that the proposal's subject matter constituted a policy issue so significant that it would be appropriate for a shareholder vote. The Third Circuit explained that a court should inquire first, whether the proposal focuses on a significant policy—social or otherwise—and, if so, whether such policy is disengaged from the essence of the issuer's regular business operations. In the view of the Third Circuit, only if a proposal focuses on a significant policy issue and transcends the issuer's regular business operations would it then have to be included in the issuer's proxy statement under the SEC's rules. The Third Circuit deemed the Wal-Mart shareholder proposal to raise matters of sufficiently significant policy, without going into detail in its analysis as to precisely what constitutes a sufficiently significant policy. However, the Third Circuit determined that the proposal went directly to the mix of products that Wal-Mart offered to its customers, a decision that the Third Circuit viewed as the heart of management's responsibility. Noting that management weighs numerous factors when making its decision about which products to offer to satisfy consumer demand, the Third Circuit opined that shareholders were not well positioned to advise management on such business-related issues.

In closing, the Third Circuit noted that the SEC's proxy statement proposal exclusionary rules are difficult to define and interpret and suggested that the SEC consider revising its regulation of proxy contests and issuing new interpretive guidance.

Read more.

BROKER-DEALER

FINRA Updates Its Interpretation of the SEC's Financial Responsibility Rules

In June, the Financial Industry Regulatory Authority updated its interpretations of the Securities and Exchange Commission Rules 15c3-1 (net capital) and 15c3-3 (customer protection). Among other things, FINRA updated its Rule 15c3-3 interpretations concerning non-conforming subordination agreements for proprietary securities account of a broker or dealer (PAB account) exclusion, piggyback carrying arrangements, the aggregation of deposits for concentration calculation as it applies to cash deposits in reserve bank accounts, extensions of time and the calculation of the customer reserve formula as it pertains to short positions in non-customer accounts. FINRA also revised or rescinded 11 interpretations relating to Rule 15c3-1, including an interpretation relating to broker-dealers' deposits at foreign entities and clearing deposits of introducing brokers.

FINRA's Interpretations of Financial and Operational Rules are available here.

CFTC

CFTC's Energy and Environmental Markets Advisory Committee to Meet on July 29

The Commodity Futures Trading Commission's Energy and Environmental Markets Advisory Committee will hold a public meeting on July 29. The Advisory Committee will discuss how energy and environmental markets would be affected by the CFTC's proposed rules on position limits and trade options and the May 2015 interpretation, issued jointly by the CFTC and the Securities and Exchange Commission in consultation with the Board of Governors of the Federal Reserve System, relating to forward contracts with embedded volumetric optionality.

More information, including dial-in information, is available here.

NFA Requires Notice From CPOs that Consolidate Filings of Subsidiary Pools

National Futures Association (NFA) has issued a notice requiring all commodity pool operators (CPOs) that have filed a notice of claim under Commodity Futures Trading Commission Letter No. 14-112 to submit an additional notice with respect to each such claim through NFA's electronic Exemption System by no later than July 31. NFA is requiring these supplemental NFA notice filings in an effort to ensure that its records are accurate for purposes of applying CFTC financial reporting requirements to such CPOs. CFTC Letter No. 14-112, which was issued by the CFTC's Division of Swap Dealer and Intermediary Oversight (DSIO) in September 2014, permits a CPO of a commodity pool that wholly owns one or more subsidiary pools to consolidate the annual report and Form CPO-PQR filings for the parent and subsidiary pools into a single filing (rather than filing separate reports for each pool), provided that the CPO complies with certain conditions set out in the letter and files a notice of claim with DSIO.

In order to file the supplemental notices with NFA, affected CPOs should first ensure that any parent commodity pool and its wholly owned subsidiary pools have been appropriately identified as such on the CPO's Annual Questionnaire through NFA's website.

More information on the NFA filing process, including detailed instructions and a link to NFA's Exemption System, is available here.

LITIGATION

SEC Settles With Stock Promoters in Medical Marijuana Stock Manipulation Scheme

On July 9, the Securities and Exchange Commission settled with two stock promoters accused of reaping $2.5 million in illicit profits by manipulating stocks of medical marijuana microcap companies. According to the proposed judgments filed in the US District Court for the Western District of Washington, defendants Alexander Hawatmeh and Christopher Mrowca each consented to a permanent bar from participating in penny stock offerings and to a permanent restraint from further violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Section 9(a)(1) of the Exchange Act and Section 17(a) of the Securities Act. The SEC brought criminal and civil charges against Mr. Hawatmeh, Mr. Mrowca and two other stock promoters in August 2014, alleging that they engaged in a pump-and-dump scheme and used manipulative trading tactics, such as wash trading, and matched orders to artificially inflate the stock prices of certain thinly traded microcap companies. The SEC alleged that the scheme created the illusion of an active market in the stocks, which the defendants used to aggressively promote the stocks through social media and websites under their control. According to the complaint, the defendants misled potential investors that the stock price would rise substantially, knowing that two of the target companies had no business operations and no news suggested that the stock price of the other companies would significantly increase. The SEC alleged that the defendants sold their shares and reaped more than $2.5 million in profits, and the stocks subsequently collapsed and resulted in losses to investors. Earlier this year, Mr. Hawatmeh and Mr. Mrowca were sentenced to five and three years in prison, respectively, for their participation in the scheme. Under the proposed judgments, Mr. Hawatmeh and Mr. Mrowca are liable for disgorgement of approximately $2.1 million and $306,000 in illicit profits, respectively.

SEC v. Mikhail Galas et al., No. 3:14-cv-05621 (W.D. Wash.)

SEC Brings Complaint in $68 Million Affinity Fraud Scheme

On July 6, the Securities and Exchange Commission filed a complaint in connection with a $68 million affinity fraud scheme allegedly orchestrated by Bingqing Yang, through her wholly owned management companies, Luca International Group, LLC, Luca Resources Group, LLC and Luca Energy Fund, LLC (collectively, Luca Managers), with the help of Ms. Yang's chief fundraiser, Lei Lei. The SEC alleged that from 2007 to 2014, Ms. Yang and her co-defendants targeted Chinese-Americans and investors in China and Japan to purchase interests in Yang's oil and gas ventures (Luca Funds). According to the SEC, Ms. Yang and Ms. Lei used brochures and seminars to mislead investors into believing that they could expect annual rates of return of 20-30 percent, monthly distributions and a return of their principal in three to five years, even though they knew that the funds were losing millions of dollars in oil and gas investments. The defendants also allegedly pitched some of the investments as eligible for the EB-5 Immigrant Investor Pilot Program, under which foreign investors can obtain green cards by meeting certain investment requirements. The SEC claimed that the defendants' monthly reports to investors were materially false and misleading because these reports omitted that the cost of operations for the oil and gas wells at issue far exceeded the proceeds of oil and gas sales. The complaint alleged that the combined balance of the Luca Managers and Luca Funds in March 2015 was less than $12,000 despite $68 million in investments, and that Ms. Yang misappropriated millions for personal use and to make Ponzi-like payments to earlier investors. The complaint also alleged that the use of funds conflicted with the offering materials, citing a $510,000 golf junket for potential investors, which included a $200,000 speaking fee for a former president of the United States. The SEC alleges that these actions violate the Securities Exchange Act of 1934, the Securities Act of 1933 and the Investment Advisers Act of 1940, and it seeks, among other things, to enjoin defendants from future violations, disgorgement of profits and civil penalties.

SEC v. Luca International Group, LLC, et al., No. 3:15-cv-03101 (N.D. Cal filed July 6, 2015)

UK DEVELOPMENTS

Summer Budget 2015––Carried Interest: Abolition of Base Cost Shift

On July 8, the Right Honourable George Osborne MP, Chancellor of the Exchequer, introduced measures in his Summer Budget to abolish what is commonly known as the “base cost shift” as applied to sums received by individuals based in the United Kingdom involved in the investment management of private equity and other investment funds structured as partnerships, which is linked to the successful performance of a fund (carried interest); the stated purpose of such new measures being, to “make the tax system fairer by ensuring that individuals to whom a gain arises in the form of carried interest are taxed on their true, economic gain and that planning tools designed to ensure they are taxed on a lower figure, to achieve a lower effective rate of tax, are not effective.”

Historically, the application of capital gains tax to carried interest following the disposition of an asset by a partnership was calculated in accordance with Statement of Practice D12 (D12) published by Her Majesty’s Revenue and Customs (HMRC), which set out an agreed-upon interpretation of how the relevant tax legislation on chargeable gains should be applied. However, the application of D12 (together with tax planning techniques) could result in the relevant investment professionals being charged capital gains tax on amounts that were significantly less than their actual economic returns.

As a consequence of the changes implemented in the Summer Budget, D12 has been superseded and new legislation is to be introduced (New Legislation) so that in circumstances now where an individual performs investment management services for a collective investment scheme through an arrangement involving one or more partnerships, then the entire sum received by them in respect of carried interest under that arrangement will constitute a chargeable gain and be subject to capital gains tax at 28 percent (so that individuals are liable for tax on their actual profit). Under the New Legislation, deductions will only be allowed in calculating chargeable gains with respect to sums actually invested in the fund structure by individuals as consideration for acquiring the rights to that carried interest (as opposed to the amount that would have been permitted under D12). The New Legislation also provides that carried interest will only be construed as a foreign chargeable gain (and hence outside the scope of UK tax) for non-UK domiciled (but UK tax resident) individuals only to the extent that the recipient of the carried interest performed their services outside of the United Kingdom. The New Legislation does however give credit for employment income tax charges (where relevant). The New Legislation will not affect co-investment arrangements with funds made by investment managers on an arm’s length basis or the taxation of performance-linked rewards.

The New Legislation will be incorporated in the Finance Bill 2015, which will introduce new sections in the Taxation of Chargeable Gains Act 1992. It will have effect from July 8, on all carried interest, irrespective of when the arrangements were entered into so there are no grandfathering provisions applicable.

A tax impact note (together with draft legislation to implement the foregoing) can be found here.

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