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BROKER DEALER

FINRA Issues Annual Regulatory and Examination Priorities Letter for 2014

On January 2, the Financial Industry Regulatory Authority issued its annual letter to FINRA member firms outlining FINRA's regulatory and examination priorities for 2014. The letter is meant to highlight areas of significance to FINRA's regulatory programs.

In the letter, FINRA highlighted a number of business conduct priorities that are broadly consistent with themes from 2013. FINRA is continuing to focus on suitability for complex products, recidivist brokers who may bring illegal or unethical practices to a new firm, conflicts of interest management practices, cybersecurity of sensitive customer data, qualified plan rollover option disclosures, initial public offerings, general solicitation and advertising of private placements, due diligence of firm offerings, other issues relative to private placements, anti-money laundering programs, municipal advisory activity, regulation and oversight of crowdfunding portals, and policies regarding senior investors and investors approaching retirement. FINRA is also concerned about a number of fraud issues, particularly activities involving microcap and low-priced, over-the-counter securities, and procedural safeguards against insider trading.

FINRA's letter focused on financial and operational priorities, including risk control documentation and testing, the accuracy of a firm's financial statements and net capital records, auditor independence, and liquidity and funding risk. FINRA might ask larger firms to perform liquidity stress tests that would incorporate important factors FINRA believes aid understanding of the resiliency of the firm's liquidity. The framework for the test would stress four basic areas of the firm's business: (1) funding of proprietary positions, (2) repo book, (3) settlement payments and clearing deposits with customer banks, central counterparties and clearing organizations, and (4) funding loss of customer balances or increases in obligations to lend to customers. FINRA will explore whether a firm has incorporated these items into its framework and whether any funding gaps exist in the firm's contingent funding plan.

Finally, FINRA addressed regulatory priorities regarding trading and trade reporting. Among other issues, FINRA is concerned about algorithmic trading malfunctions and whether firms' testing and controls related to algorithmic trading is adequate in light of the Securities and Exchange Commission's Market Access Rule and other supervisory obligations. High-frequency trading abuses such as "momentum ignition strategies" will be of particular concern to FINRA. FINRA also wants to focus on deficiencies in audit trails, especially Large Options Positions Reporting, and firms' practices regarding best execution obligations with respect to equity, fixed income and options securities.

FINRA's letter is available here.

CFTC

CFTC Makes Comparability Determinations for Substituted Compliance Purposes

The Commodity Futures Trading Commission has approved comparability determinations for substituted compliance with six different non-US regulatory regimes. Pursuant to the substituted compliance determinations, the CFTC will permit non-US swap dealers (SDs) and non-US major swap participants (MSPs) to comply with regulations in their home jurisdiction in lieu of complying with comparable CFTC regulations.

The CFTC has provided a chart (available here) summarizing entity-level comparability determinations for Australia, Canada, the European Union, Hong Kong, Japan and Switzerland. Except as otherwise indicated in the chart, the substituted compliance determinations provide relief for certain non-US SDs and non-US MSPs from various CFTC entity-level requirements, including CFTC Regulations 3.3 (Chief Compliance Officer), 23.201 (Swap Data Recordkeeping), 23.203 (Swap Data Recordkeeping), 23.600 (Risk Management Program), 23.601 (Monitoring of Position Limits), 23.602 (Diligent Supervision), 23.603 (Business Continuity), 23.605 (Conflicts of Interest), 23.606 (Availability of Information for Disclosure) and 23.609 (Clearing Member Risk Management).

The CFTC additionally provided transaction-level comparability determinations for the European Union and Japan. For the European Union, the CFTC approved substituted compliance for CFTC Regulations 23.501 (Trade Confirmation), 23.502 (Portfolio Reconciliation and Compression) and 23.503 (Portfolio Compression), as well as parts of CFTC Regulations 23.202 (Daily Trading Records) and 23.504 (Swap Trading Relationship Documentation). For Japan, the CFTC approved substituted compliance for CFTC Regulation 23.202 and parts of CFTC Regulation 23.504.

All of the CFTC's comparability determinations are available here.

In making the comparability determinations, the CFTC declined to make determinations for CFTC Regulations 23.600(c)(2) (Periodic Risk Exposure Reports) and 23.608 (Restrictions on Counterparty Clearing Relationships) in all jurisdictions, and CFTC Regulation 23.609 (Clearing Member Risk Management) in Hong Kong and Switzerland. Accordingly, the CFTC's Division of Swap Dealer and Intermediary Oversight has issued temporary no-action relief from such requirements for non-US SDs and non-US MSPs established in the relevant jurisdictions until March 3, 2014. CFTC Letter No. 13-78 is available here.

CFTC Issues No-Action Relief from Certain Swap Data Reporting Requirements

The Commodity Futures Trading Commission's Division of Market Oversight has issued temporary no-action relief to non-US swap dealers (SDs) and non-US major swap participants (MSPs) established in Australia, Canada, the European Union, Japan or Switzerland from certain swap data reporting requirements in Parts 45 and 46 of CFTC regulations.

Pursuant to the no-action letter, such SDs and MSPs are exempt from the swap reporting requirements of Parts 45 and 46 of CFTC regulations for swaps with non-US counterparties that are not guaranteed/conduit affiliates of a US person until the earlier of December 1, 2014, or 30 days following the issuance of a swap data reporting comparability determination for the applicable jurisdiction. For swaps with non-US counterparties that are guaranteed/conduit affiliates of a US person, such SDs and MSPs are exempt from (1) Part 45 reporting obligations until March 3, 2014, and (2) Part 46 reporting obligations until April 2, 2014.

SDs and MSPs taking advantage of such relief must continue to comply with the recordkeeping requirements of CFTC Regulations 45.2, 45.6, 46.2 and 46.4.

Such relief does not extend to an SD or MSP that is part of an affiliated group in which the ultimate parent entity is a US SD, MSP, bank, financial holding company or bank holding company.

CFTC Letter No. 13-75 is available here.

CFTC Issues No-Action Relief Regarding Annual Reports by Chief Compliance Officers

The Commodity Futures Trading Commission's Division of Swap Dealer and Intermediary Oversight (DSIO) issued two no-action letters providing relief from certain chief compliance officer (CCO) annual report filing requirements.

Pursuant to No-Action Letter No. 13-84, DSIO will allow futures commission merchants, swap dealers (SDs), major swap participants and CCOs of such firms up to 90 days to file their CCO annual reports. Such firms and their CCOs are also exempt from the requirement to file the CCO annual report simultaneously with the Form 1-FR-FCM or FOCUS Report, as applicable. The relief is only valid during calendar year 2014. CFTC Letter No. 13-84 is available here.

In No-Action Letter No. 13-85, the DSIO provides relief to certain SDs and their CCOs from the requirement to file a CCO annual report for the fiscal year ending December 31, 2013. To qualify for such relief, an SD must (i) not have been required to register as an SD prior to December 31, 2013, and (ii) have a fiscal year-end of December 31, 2013. CFTC Letter No. 13-85 is available here.

CFTC Extends Relief from Oral Communication Recording Requirement

The Commodity Futures Trading Commission's Division of Swap Dealer and Intermediary Oversight and the Division of Market Oversight issued No-Action Letter No. 13-77, which extends the oral communications recording compliance date for commodity trading advisors (CTAs) that are members of a swap execution facility (SEF). A CTA that is a member of an SEF will now have until May 1, 2014 to comply with the requirement to record oral communications under CFTC Regulation 1.35(a). The requirement would otherwise have been effective December 21, 2013.

CFTC Letter No. 13-77 is available here.

CFTC Issues Advisory Concerning Commodity Trading Advisors and Swaps

The Commodity Futures Trading Commission's Division of Swap Dealer and Intermediary Oversight (DSIO) issued Advisory No. 13-79 to provide guidance to commodity trading advisors (CTAs) on new obligations relating to swaps. The DSIO presented the advisory in question-and-answer format covering three main areas: (1) Commodity Exchange Act provisions and CFTC regulations that are generally applicable to CTA activities; (2) a CTA's obligations with respect to swap risk disclosures; and (3) the requirements relevant to CTAs advising pension plans, governmental bodies and other "special entities" with respect to swap transactions.

CFTC Advisory No. 13-79 is available here.

LITIGATION

Delaware Court Limits Section 220(d) Books and Records Inspections to Current Directors

The Court of Chancery of the State of Delaware strictly held that a non-stockholder and alleged former director was not entitled to inspect a Delaware corporation's books and records as a matter of right under Delaware Code Section 220(d) and common law, despite assertions that the corporation had improperly, and without the plaintiff's knowledge and consent, previously represented that he was a corporate director. Plaintiff Robert L. King, a government official in the District of Columbia, sought to inspect Defendant DAG SPE Managing Member, Inc.'s (DAG) books and records to investigate generally whether his name had been used without authorization or he was liable for any actions taken while he was a director. DAG, a Delaware corporation, filed a motion to dismiss for failure to state a claim.

DAG, along with its affiliates, is in the business of owning and operating retail gas stations, convenience stores and car washes, including in areas of the District of Columbia under King's jurisdiction as a government official. King allegedly did not discover until March 2003 that he was named as an original director of DAG in 2000, and claims he was not informed until 2011 that he had been removed from DAG's board in December 2003 by the stockholders' unanimous written consent. King did not refute having given his written consent to a board action in March 2003, but denied having any knowledge that he was named a director prior to that date. Approximately one

year after learning in April 2011 that he had been removed from the board, King sought, under Section 220(d) and the common law, to assert a director's right to inspect DAG's books and records. DAG argued that King lacked standing to inspect their books because he was not a current director.

In analyzing Section 220(d) relating to a director's inspection rights, the court determined that King was not a "director" under the Delaware Code, because the meaning of the statute was plain and unambiguous in that only current directors have Section 220(d) inspection rights. While acknowledging that other jurisdictions have conferred limited books and records inspection rights on former directors, the court found no indication that Delaware adopted a similar broad reading of Section 220(d). The court was not swayed from this strict application of the statute by the plaintiff's assertions that equity required access to the books and records. The court similarly dismissed King's alternative claims under the common law, finding that former directors were able to exercise inspection rights under the common law only when pursuing or defending actual substantive claims and access was granted through the discovery process. Consequentially, the court dismissed the action.

King v. DAG SPE Managing Member, Inc., C.A. No. 7770-VCP (Del. Ch. December 23, 2013).

Seventh Circuit Remands to Correct a "Thoroughly Botched" Sentencing for a Fraudulent Commodity Pool Operator

In a case illustrating the complexity of sentencing white collar crimes, the US Court of Appeals for the Seventh Circuit Court ordered the resentencing of a commodity pool operator where the district court made a "cascade of mistakes" in sentencing the defendant for fraud and money laundering. Defendant Brant Rushton pleaded guilty to mail fraud and money laundering for operating a commodity pool that he used as a vehicle for a Ponzi scheme. The commodity pool, which comingled investor contributions and bought and sold futures contracts, included investments from vulnerable, unsophisticated victims. Among the victims were the elderly and disabled, as well as the defendant's own family members. Rushton used the stolen money to purchase personal luxury items, even spending $150,000 on horses. The district court ordered Rushton to pay $1.62 million in restitution to his victims and sentenced him to 96 months in prison.

Rushton appealed only the prison sentence, arguing that the district court misapplied the sentencing guidelines by applying an enhancement for abuse of trust in addition to the commodity pool operator fraud. On appeal, the government acknowledged that the guidelines preclude the abuse of trust enhancement in this context because commodity pool fraud requires proof of a violation of heightened fiduciary duties. However, the government argued that the lower court's error was not prejudicial, because any error was offset by the judge's failure to apply an equivalent sentencing enhancement due to the vulnerable victims of the fraud scheme.

The court ultimately found a "thoroughly botched sentencing" by the parties, the probation service and the sentencing judge, which required a "resentencing from scratch." The court found error in the district court's failure to consider the money laundering plea under the sentencing guidelines and failure to account for a vulnerable victim enhancement in that calculation. The court noted that on remand the district court's sentence could be of equal or greater length than the 96 months Ruston had originally received. If calculated with the inclusion of the vulnerable victim enhancement, Rushton could now face a prison sentence ranging from 97 to 151 months.

United States of America v. Rushton, No. 1:12-cr-10037-JES-JAG-1 (7th Cir. December 26, 2013).

BANKING

Agencies Appear to Signal Retreat on CDO TruPS Issue

In the wake of the American Bankers Association's lawsuit challenging the Volcker Rule's treatment of collateralized debt obligations (CDOs) backed by trust preferred securities (TruPS), the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Securities and Exchange Commission (the Agencies) have issued a statement which appears to signal that they are considering walking the rule back. The question is to what extent the Agencies will reverse themselves. The December 27 statement states in pertinent part as follows:

> [The Agencies] are currently reviewing this matter and are considering whether it is appropriate and consistent with the provisions of the Dodd-Frank Act not to subject pooled investment vehicles for

> TruPS, such as collateralized debt obligations (CDOs) backed by TruPS (TruPS CDOs), to the prohibitions on ownership of covered funds in section 619 of the Dodd-Frank Act. The Agencies are aware that the provisions of section 171(b)(4)(C) are important to community banking organizations and, based on information recently received, understand that the investments and capital levels of a number of these organizations might be adversely affected if pooling vehicles formed for the purpose of holding TruPS are treated as covered funds. *The Agencies are therefore evaluating whether it is appropriate not to cover pooling vehicles that invest in TruPS in order to eliminate restrictions that might otherwise have consequences that are inconsistent with the relief Congress intended to provide community banking organizations under section 171(b)(4)(C) of the Dodd-Frank Act.*

(Emphasis supplied.)

What remains to be seen is where the Agencies will draw the line, i.e., will a rule pullback encompass all financial institutions holding CDOs backed by TruPS, or will it merely grandfather the treatment of CDOs backed by TruPS for smaller institutions such as those that are less than $15 billion in footings? One potential clue may be found in the release itself, in which the Agencies stated:

> [A] provision of the Dodd-Frank Act, section 171, separately provides that [TruPS] issued by depository institution holding companies must be phased out of such companies' calculation of regulatory capital for purposes of determining Tier 1 capital. However, section 171 further provides for the permanent grandfathering of TruPS issued before May 19, 2010 by certain depository institution holding companies with total consolidated assets of less than $15 billion.

It is unknown at this writing whether the Agencies will attempt to leverage a compromise result in return for dismissal of the lawsuit. If the Agencies protect smaller institutions, but leave larger institutions subject to the rule as is, the American Bankers Association will have an interesting decision to make; i.e., will it dismiss the lawsuit it filed, or will it continue the lawsuit with a somewhat weaker case? The Agencies gave themselves a self-imposed deadline of January 15 to address the issue, which theoretically should leave institutions enough time to incorporate the effects of a change in policy into their call reports, which are due 30 days after year end. Meanwhile, it appears that proceedings have been stayed in the US Court of Appeals for the District of Columbia Circuit until January 17, two days after the Agencies are expected to take action.

Read more.

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