CORPORATE & FINANCIAL

WEEKLY DIGEST

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BROKER DEALER

SEC Approves FINRA Rule Regarding Verification of Member Assets at Non-Member Financial Institutions

New Financial Industry Regulatory Authority Rule 4160 will go into effect February 1 in an effort by FINRA to strengthen its ability to independently verify assets maintained by a FINRA member at a non-member financial institution. FINRA Rule 4160 will prohibit members from continuing to custody or retain record ownership of assets at non-member financial institutions that fail promptly to provide FINRA, upon FINRA's written request, with written verification of the FINRA member's assets maintained at such non-member financial institution. In the Regulatory Notice, FINRA encourages, although does not require, FINRA members to contract with non-member financial institutions maintaining the FINRA member's assets (whether proprietary or customer assets) to require such non-member financial institutions to oblige with verification requests from FINRA.

Click here to read FINRA Regulatory Notice 10-61.

New California Law Requires Lobbyist Registration for "Placement Agents" Soliciting California State Pension Plans

Effective January 1, new legislation in California (Act) will prohibit an individual or entity from acting as a "placement agent" in connection with any potential investment made by a California state public retirement system unless that person is registered as a lobbyist with the California Secretary of State and is in compliance with the California Political Reform Act of 1974 (PRA). The Act is aimed at ensuring that investment decisions of any California state public pension or retirement system are made in an impartial manner, free from any potential bias caused by gifts, campaign contributions or the financial interests of placement agents, retirement system officials and third parties who have supported these officials.

Under the Act, the definition of placement agent includes any person hired, engaged, retained by or serving on behalf of an external manager (for example, a hedge fund manager) who acts for compensation as a finder, solicitor, marketer, consultant, broker or other intermediary in connection with the offer or sale of the securities, assets or services of an external manager to a California state public pension or retirement system (or an investment vehicle in which a California public pension or retirement system is the majority investor). The placement agent definition covers broker-dealers or finders retained by an external manager and also extends to individuals employed by an external manager performing marketing functions or otherwise acting as an intermediary in connection with the offer or sale of securities, assets or services of an external manager to a California state public retirement system, unless an exemption would apply. The Act also prohibits the payment to registered broker-dealers of compensation that is contingent upon an investment being made by a California state public or pension retirement system.

Notably, the Act excludes from the placement agent definition certain individuals associated with an external manager who spend a third or more of their time, during a calendar year, managing the securities or assets owned, controlled, invested or held by an external manager. The Act also excludes from the definition of placement agent an employee, officer or director acting on behalf of an external manager (or its affiliate) that (1) is registered as an investment adviser or broker-dealer with the Securities and Exchange Commission or, if exempt or not subject to such registration, any appropriate state securities regulator, (2) was selected by and contracted with the California state public pension or retirement plan through a "competitive bidding process" (which is not specifically defined in the Act), and (3) agrees to a fiduciary standard of care defined by the standards of conduct applicable to the board of a California state public pension or retirement system.

By requiring placement agents to register as lobbyists, the Act subjects placement agents to the reporting and ethics rules that govern lobbyists under the PRA. The California Fair Political Practices Commission (FPPC), the agency tasked with adopting regulations and interpreting and enforcing the PRA, has not yet implemented rules for compliance with the Act. It is unknown when and to what extent the FPPC will be adopting more substantive rules regarding the Act before it becomes effective.

Click here for the text of the Act.

CFTC

CFTC Approves Sixth Series of Dodd-Frank Rulemakings

The Commodity Futures Trading Commission held a public meeting on December 1 to propose its sixth series of rules under the Dodd-Frank Wall Street Reform and Consumer Protection Act. The CFTC has published notification of (and, in most cases, requested public comment on) the following five rule proposals.

- **Further Definitions of *Swap Dealer*, *Major Swap Participant* and *Eligible Contract Participant:*** Section 721 of the Dodd-Frank Act creates basic definitions for the new categories of regulated entities "swap dealer" (SD) and "major swap participant" (MSP), and Section 712(d)(1) provides that the Securities and Exchange Commission and the CFTC, in consultation with the Federal Reserve Board, must further define these terms, as well as the term "eligible contract participant" (ECP).

  Swap Dealers. The proposed rules define a "swap dealer" similarly to the Dodd-Frank Act, as any person who: (a) holds himself out as a dealer in swaps, (b) makes a market in swaps, (c) regularly enters into swaps with counterparties in the ordinary course of business for its own account, or (d) engages in activity causing itself to be commonly known in the trade as a dealer or market maker in swaps. The CFTC states that it will interpret this definition such that the term would be able to evolve in the future as operations of the SDs and market practices develop. The proposal provides further information about the CFTC's current understanding of the distinguishing features of SDs, that they generally: (1) accommodate demand for and facilitate interest in entering into swaps from other parties; (2) enter into swaps on their own standard terms; and (3) are able to arrange customized terms for swaps upon request, or to create new types of swaps at their own initiative. The proposed rules also set forth a number of conditions that must be met for a person to qualify for the de minimis exemption from registration as an SD set forth in the Dodd-Frank Act. Finally, the proposal would limit the application of the exclusion for an insured depository institution "to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer," as set forth in the Dodd-Frank Act, to swaps connected to the financial terms of the loan itself.

  The CFTC has also contemplated and requested public comment on how swaps between persons under common control should be treated for purposes of the definition of SD and the application of the definition to persons that aggregate swap positions of other parties.

  Major Swap Participants. Under the Dodd-Frank Act, a person is an MSP if any of the following is true: (a) such person maintains a "substantial position" in any of the major swap categories, not including any positions held for "hedging or mitigating commercial risk" or positions maintained by certain employee benefit plans for hedging or mitigating risks in the operation of the plan; (b) such person's outstanding swaps create "substantial counterparty exposure" that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; or (c) such person is a "financial entity" that is "highly leveraged" in relation to the amount of capital it holds, is not subject to capital requirements promulgated by a federal banking agency, and maintains a "substantial position" in any of the major swap categories. The definition excludes SDs and certain financing affiliates.

Under the CFTC's proposal, a person has a "substantial position" in a major swap category if either of the following is true: (1) such person's daily average current uncollateralized exposure in the applicable major swap category exceeds $1 billion (other than the rate swap category, for which the threshold is $3 billion), or (2) the sum of such person's daily average current uncollateralized exposure *plus* potential future exposure in the applicable major swap category exceeds $2 billion (other than the rate swap category, for which the threshold is $6 billion). A person's daily average current uncollateralized exposure is measured by marking such person's swap positions to market (with a deduction for the value of posted collateral with respect to the swap positions) and calculating exposure on a net basis, according to the terms of any applicable master netting agreement. A person's potential future exposure is determined by multiplying the total notional principal amount of such person's swap positions by specified risk factor percentages (ranging from 0.5% to 15.0%, based on the type of swap and the duration of the position), discounting the amount of positions subject to master netting agreements (by a factor ranging between zero and 60%, depending on the effects of the agreement), and further discounting the amount of the positions by 80% if the swaps are cleared or subject to daily mark-to-market margining.

Under the proposed rules, positions held for "hedging or mitigating commercial risk" include any swap position that: (1) qualifies as bona fide hedging under Commodity Exchange Act (CEA) rules; (2) qualifies for hedging treatment under Financial Accounting Standards Board Statement No. 133; or (3) is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise (where the risks arise in the ordinary course of business due to certain specified causes). Positions would not qualify as held for "hedging or mitigating commercial risk" if such positions are held for a purpose that is in the nature of speculation, investing or trading.

Under the CFTC's proposal, a person's outstanding swaps create "substantial counterparty exposure" if (1) such person's daily average current uncollateralized exposure exceeds $5 billion, or (2) the sum of such person's daily average current uncollateralized exposure *plus* potential future exposure exceeds $8 billion. Substantial counterparty exposure would be calculated using the same method for "substantial positions," though the calculation would not be limited to major swap categories and no exclusions for hedging or positions in employee benefit plans are provided.

Finally, the proposed rules provide that the term "financial entity" is as defined in CEA Section 2(h)(7), as amended by the Dodd-Frank Act, and set forth two possible definitions of "highly leveraged," on which the CFTC requests comment: either an 8:1 or a 15:1 ratio of total liabilities to equity, as determined in accordance with U.S. generally accepted accounting principles.

Eligible Contract Participants. Under 723(a)(2) of the Dodd-Frank Act, a person that does not qualify as an ECP may only enter into swaps on designated contract markets. The CFTC proposal would amend the definition of an ECP to (a) include SDs and MSPs, and (b) clarify that in order for a commodity pool to qualify as an ECP, the pool must comply with the requirements of clause (iv) of the current definition, which is specific to commodity pools.

As required under the Dodd-Frank Act, these definitions were drafted jointly by the CFTC and the Securities and Exchange Commission.

- **Designated Contract Markets Core Principles and Other Requirements:** Section 723 of the Dodd-Frank Act requires that all swaps that can be cleared must be executed on designated contract markets (DCMs) or swap execution facilities (SEFs), unless no DCM or SEF will make the swap available for trading. Section 735 of the Dodd-Frank Act amends certain provisions of the CEA applicable to DCMs, which amendments include revising the core principles applicable to DCMs and introducing five new core principles: Core Principle 13 (disciplinary procedures), Core Principle 20 (system safeguards), Core Principle 21 (financial resources), Core Principle 22 (diversity of boards of directors) and Core Principle 23 (SEC). In connection with these statutory provisions, the CFTC has proposed new and amended rules, guidance and acceptable practices to implement the new and amended core principles and incorporate the trading and execution of swaps on DCMs. The proposals regulate the duties of DCMs in the following general categories: financial information and resource requirements, compliance obligations, operational capabilities, surveillance obligations and trading and products requirements. The proposed rules, guidance and acceptable practices will take effect 60 days after publication of the final rules in the *Federal Register*.

- **Derivative Clearing Organization Definitions, Procedures and Core Principles:** The CFTC has proposed rules applicable to derivatives clearing organizations (DCOs) under the Dodd-Frank Act. The proposal would amend the definitions of "clearing member" and "clearing organization" and introduce definitions for "customer initial margin," "initial margin," "spread margin," "variation margin," "margin call," "back test," "compliance policies and procedures," "key personnel," "stress test" and "systematically important derivatives clearing organization." The proposed rules would also implement a number of procedural changes applicable to DCOs by: (a) eliminating the 90-day expedited DCO application review schedule and establishing a 180-day review schedule for all DCO applications; (b) clarifying the procedures a DCO must follow when requesting a transfer of its registration in connection with a corporate change (including specifying what information must be included in such a request and requiring certain representations regarding compliance with the CEA); and (c) establishing the process a DCO must follow to seek CFTC approval of its rules to permit portfolio margining of futures and securities in a futures account. Additionally, the CFTC's proposal requires each DCO to designate a chief compliance officer (CCO) and sets forth the duties of the CCO (e.g., the preparation and submission of an annual compliance report to the CFTC). Finally, the proposed rules would codify Section 725(c) of the Dodd-Frank Act by implementing the following DCO Core Principles: Core Principle A (compliance), Core Principle H (rule enforcement), Core Principle N (antitrust considerations) and Core Principle R (legal risk).

- **Reporting, Recordkeeping, Public Information and Information Sharing Requirements for DCOs:** Section 731 of the Dodd-Frank Act amends certain DCO Core Principles set forth in the CEA. The CFTC's proposed rules would codify these amendments to the following Core Principles: Core Principle J (reporting), Core Principle K (recordkeeping), Core Principle L (public information) and Core Principle M (information sharing). With respect to Core Principle J, the proposed rule includes two categories of reporting requirements: (a) periodic reports, required daily, quarterly and annually; and (b) event-specific reports, the requirement for which is triggered by the occurrence of a specific event, such as significant financial changes at the DCO or a clearing member's difficulties (e.g., a default). The proposal would implement and clarify Core Principles K and J. In particular, with respect to Core Principle K, the proposed rule would require DCOs to maintain all records created pursuant to CFTC regulations governing DCOs, and, with respect to Core Principle J, the proposed rules impose an obligation on each DCO to publicly disclose certain information that would permit market participants to evaluate the risks associated with employing such DCO's services (such as clearing fees, margin methodology, financial resources, daily trading information and the DCO's rules and procedures). Finally, the proposal would codify Core Principle M in substantially the same form.

- **Reporting, Recordkeeping and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants:** Section 731 of the Dodd-Frank Act also establishes recordkeeping and reporting requirements for SDs and MSPs. The Dodd-Frank Act authorizes the CFTC to craft the details of these requirements, but states that all books and records of SDs and MSPs must be available for CFTC inspection and imposes daily trading recordkeeping, reporting and audit trail requirements for all swap transactions entered into by SDs and MSPs.

  The CFTC has proposed that SDs and MSPs be required to maintain (1) basic corporate records (including, e.g., meeting minutes); (2) certain financial records; (3) documentation of complaints against personnel; (4) marketing materials; (5) records of information required to be submitted to a swap data repository and reported on a real-time public basis; (6) full and complete transaction and position information for all swap activities, including all documents on which trade information is originally recorded; and (7) records of daily trade information related to pre-execution, execution and post-execution data sufficient to preserve all information necessary to conduct a comprehensive and accurate trade reconstruction for each swap. Pre-execution trade information includes all oral and written communications that lead to the execution of a swap. Transaction records set forth in item (6) above and all pre-execution trade data must be maintained in such a way that such information can be identified and searched by transaction and by counterparty. The proposed rules would require SDs and MSPs to report swap data in accordance with real-time public reporting rules proposed in the fifth series of CFTC rulemakings under the Dodd-Frank Act (discussed above).

Unless otherwise noted, the comment periods for these proposals will expire 60 days from the dates of their respective publications in the *Federal Register*. Information regarding all of the CFTC proposals, including the text of the CFTC releases, fact sheets and Q&As, can be found here.

CFTC Requests Comment on Application by CME Clearing Europe Limited for Registration as Derivatives Clearing Organization

The Commodity Futures Trading Commission has requested public comments on an application for registration as a derivatives clearing organization (DCO) filed by CME Clearing Europe Limited (CMECE) on November 26.

CMECE, which will be principally located in London and which is an indirect subsidiary of CME Group Inc., is requesting approval from the CFTC to clear over-the-counter derivatives, such as swaps, forwards and options, on energy products.

The public documents included in CMECE's DCO application can be found here.
Public comments regarding CMECE's application can be directed to the CFTC here.

LITIGATION

Commission Siphoning Supports Corporate Veil Piercing

The U.S. Court of Appeals for the Second Circuit affirmed a bench trial verdict in a breach of contract case, holding that the district court properly "pierced the corporate veil" and imposed liability on a defendant corporation under an "alter ego" theory.

Plaintiffs sued two corporate defendants, Private Label Sourcing, LLC and Second Skin, LLC, for breach of garment contracts, arguing that the two entities were jointly and severally liable as alter egos of one another. The Second Circuit concluded that there was sufficient evidence in the record to support the district court's conclusion that Second Skin dominated and controlled Private Label. In particular, the district court found that Christine Dente, a co-owner of Private Label and the sole owner of Second Skin, directed that plaintiffs pay commissions to Second Skin that should properly have been paid to Private Label. The court characterized this transfer of commissions as a "siphoning" of funds from Private Label to Second Skin and noted that defendants provided no commercially reasonable explanation. The improper transfer of funds exacerbated Private Label's insolvency and left that corporation less able to pay damages.

In addition to the improper transfers, the district court concluded that Private Label and Second Skin (1) failed to adhere to corporate formalities, (2) had overlapping owners and other personnel, and (3) shared office space and equipment. The Second Circuit concluded that the totality of the circumstances adequately supported the district court's imposition of joint and several liability based on corporate veil-piercing. (*Alateks Foreign Trade, Ltd. et al., v. Private Label Sourcing, LLC & Second Skin, LLC*, No. 09 Civ. 3146, 2010 WL 4923942 (2d. Cir. Dec. 6, 2010))

Tortious Interference Claims Dismissed

The U.S. District Court for the District of Columbia dismissed a claim for tortious interference with business relationships where the complaint accused the defendant of tortiously interfering with the very same contract the defendant was accused of breaching.

In early 2009, Geoplast S.p.A., an Italian plastics manufacturer, contracted with I Mark Marketing Services, LLC (IMARK), a U.S. marketing firm, to operate a U.S. Geoplast subsidiary and market Geoplast's products. Among other things, the original contract granted IMARK exclusive marketing rights to Geoplast's products in the United States.

In February 2010, Geoplast sent IMARK what IMARK characterized as a "new" contract to sign. IMARK refused to sign the "new" contract, Geoplast stopped paying under the original contract, and the subject litigation ensued.

In addition to breach of contract, IMARK alleged that Geoplast tortiously interfered with IMARK's business relationships by: (1) soliciting sales from entities in the United States despite IMARK's exclusive marketing rights, (2) contacting entities that IMARK had cultivated relationships with related to the sale and purchase of Geoplast's goods, and (3) directly pursuing business opportunities identified by IMARK. The court found that these allegations duplicated IMARK's claim for breach of contract, and that IMARK could not allege tortious interference with the very contract at issue in the case. Under District of Columbia law, only third parties to a contract may be liable for tortious interference. (*I Mark Marketing Services LLC v. Geoplast, S.p.A.*, No. 10 Civ. 347, 2010 WL 4925293 (D. D.C. Dec. 6, 2010))

BANKING

Banking Agencies Issue Final Appraisal and Evaluation Guidelines

On December 2, the federal financial regulatory agencies issued final supervisory guidance on sound practices by financial institutions for real estate appraisals and evaluations. The *Interagency Appraisal and Evaluation Guidelines*, which replace 1994 guidelines, explain the agencies' minimum regulatory standards for appraisals. The guidelines incorporate the agencies' recent supervisory issuances on appraisal practices, address advancements in information technology used in collateral valuation practices, and clarify standards for the industry's appropriate use of analytical methods and technological tools in developing evaluations. The agencies recommend that financial institutions review their appraisal and evaluation programs to ensure they are consistent with the guidance, which discourages institutions from using automated valuation models in transactions requiring an appraisal.

The guidelines emphasize that financial institutions are responsible for selecting appraisers and people performing evaluations based on their competence, experience and knowledge of the market and type of property being valued. Under the guidelines, institutions should demonstrate the independence of their processes for obtaining property values, and adopt standards for appropriate communications and information-sharing with appraisers and people performing evaluations. In promoting sound credit decisions, the guidelines also emphasize the importance of institutions maintaining strong internal controls to ensure reliable appraisals and evaluations. Institutions also are responsible for monitoring and periodically updating valuations of collateral for existing real estate loans and for transactions, such as modifications and workouts.

Read more.

UK DEVELOPMENTS

FSA Secures Winding-Up Orders Against Unauthorized Operators of Collective Investment Schemes

On December 9, the UK Financial Services Authority (FSA) announced that it had obtained winding-up orders in the High Court against two UK entities: Bio Partners Ltd and Zambia Alpha One LLP. Each was a firm that was not FSA authorized and was operating a collective investment scheme (CIS) in breach of the "general prohibition" of the UK Financial Services and Markets Act 2000.

The firms operated a CIS which invested in a bio-fuel crop grown in Africa. They had collected almost £1 million (approximately $1.6 million) from the UK. The FSA petitioned the High Court for winding-up orders in the interests of consumer protection.

Margaret Cole, the FSA's managing director of enforcement and financial crime, said: "Operating a collective investment scheme is a serious business requiring FSA authorization. Without the proper authorization, neither Bio Partners or Zambia Alpha had any business running one of these schemes and put [sic] investors' money at risk."

Read more.

UK Government to Introduce Bank Levy

On December 9, the UK Government announced its intention to introduce a levy on UK banks and the UK branches and subsidiaries of foreign banks. The bank levy will be implemented for all accounting periods ending on or after January 1, and will be charged at an annual rate of 0.05% for 2011 and 0.075% from 2012 onwards. The levy will be charged on the bank's equity and liabilities, subject to certain exceptions such as Tier 1 capital, segregated client money and customer deposits protected by a depositor protection or insurance scheme. The first £20 billion (approximately $32 billion) of liabilities will be exempt from the levy.

Read more.

EU DEVELOPMENTS

European Commission Publishes MiFID Review Consultation

On December 8, the European Commission published a public consultation on the review of the Markets in Financial Instruments Directive (2004/39/EC) (MiFID).

MiFID aims to create a single market in investment services and to increase investor protection. It came into force in November 2007. Developments in the financial markets since 2007 have highlighted areas where changes need to be made.

The consultation includes the following matters:

- **Developments in market structures:** This section discusses organized trading facilities, automated trading, proprietary trading, systematic internalizers, market surveillance and markets for small and medium sized enterprises (SMEs).
- **Transaction reporting:** Clarifications and extensions are suggested.
- **Data consolidation:** Potential improvements to market data consolidation, including raw trade data, post-trade data for investors and the introduction of a consolidated EU market tape.
- **Commodity derivative markets:** Requirements for commodity derivatives exchanges, review of MiFID exemptions for commodity firms and other issues.
- **Investor protection and provision of investment services:** Potential revisions relating to the scope of MiFID (including whether it should be expanded to cover proprietary traders), conduct of business obligations and authorization and organizational requirements.
- **Further convergence of the regulatory framework and supervisory practices:** Suggested changes aimed at narrowing or eliminating some member state options and discretion and increasing the effectiveness of supervision and enforcement.

The consultation is open until February 2. The Commission will use these responses as part of the preparation of a formal proposal for a new MiFID Directive, which is scheduled to be published in May 2011.

Read more.

CESR Publishes Call for Evidence on AIFMD Implementing Measures

On December 3, the Committee of European Securities Regulators (CESR) published a call for evidence seeking view on the “Level 2” implementing measures required under the Alternative Investment Fund Managers Directive (AIFMD). This input is designed to assist CESR and the European Securities and Markets Authority, which will replace CESR with effect from January 1, in the development of draft advice on the content of the AIFMD implementing measures, which will be published for consultation in 2011.

Responses to the call for evidence must be submitted by January 7.

Read more.

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