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CORPORATE & FINANCIAL
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SEC/CORPORATE

NASDAQ Proposes Internal Audit Function Requirement for Listed Issuers

On March 4, the Securities and Exchange Commission published notice that The NASDAQ Stock Market LLC (NASDAQ) had filed a proposed new rule that would require each NASDAQ-listed issuer to maintain an internal audit function. The internal audit function would be tasked with providing the issuer's management and audit committees with an ongoing assessment of the issuer's risk management processes and system of internal control. Under the proposed rule, an issuer would be permitted to outsource the internal audit function to any third party other than its independent auditor. Additionally, the audit committee would be required to meet periodically with the persons performing the internal audit function and should discuss the role of the internal audit function with the issuer's outside auditors.

NASDAQ stated in its rule proposal that the purpose of the new rule is to ensure that a listed issuer has a mechanism in place to regularly review and assess its system of internal control, and to ensure that the listed issuer's management and audit committees are provided with current information about risk management processes and systems of internal control. Additionally, NASDAQ believes that the rule will assist listed issuers in complying with their federal securities law obligations to maintain and evaluate, with the participation of their principal executive and financial officers, the effectiveness of the internal control over financial reporting.

Under its proposal, an issuer that is listed on NASDAQ on or before June 30, 2013 would be required to establish an internal audit function no later than December 31, 2013. An issuer that becomes listed after June 30, 2013 would be required to establish an internal audit function prior to listing on NASDAQ.

Read more.

BROKER DEALER

FINRA's Frequently Asked Questions on Electronic Blue Sheet Submissions Updated Regarding Order Execution Time

The Financial Industry Regulatory Authority issued frequently asked questions (FAQs) in connection with FINRA firms being required to submit new data elements for Electronic Blue Sheets (EBS) to correspond with the implementation of Rule 13h-1 under the Securities and Exchange Act of 1934 (SEC Large Trader Reporting Rule). FINRA updated the FAQs to, among other things, clarify that although under the SEC Large Trader Reporting Rule order execution time is required only for NMS securities, firms will be required to populate the Order Execution Time field for non-NMS securities (i.e., fixed income, options and other non-NMS securities) by May 1, 2013.

Click here to read the FAQs.

PRIVATE INVESTMENT FUNDS

Cayman Islands to Enter into a Model 1 IGA

The Cayman Islands announced on March 15 that it intends to enter into a Model 1 Intergovernmental Agreement (IGA) with the Internal Revenue Service for Foreign Account Tax Compliance Act (FATCA) compliance purposes. Accordingly, hedge funds and private equity funds that operate in the Cayman Islands will not have to enter into FATCA agreements with the IRS (although they still will have to obtain FATCA identification numbers). In addition, any FATCA reporting required of such funds will be to the Cayman Islands government, which in turn will provide information concerning direct and indirect ownership by US persons to the IRS. The IGA, when finalized, also may exempt certain funds (that are unlikely to have any direct or indirect US investors) from FATCA compliance.

CFTC

CFTC Grants Relief from Required Clearing for Swaps Resulting from Multilateral Portfolio Compression

On March 18, the Commodity Futures Trading Commission's Division of Clearing and Risk granted no-action relief relating to the clearing requirement for swaps resulting from multilateral portfolio compression exercises (as defined in CFTC Regulation 23.500(h)). The no-action relief provides that amended and replacement swaps that are generated as part of a multilateral portfolio compression exercise, where the original swap was not required to be cleared at the time of execution but is subsequently amended or replaced after the relevant clearing requirement compliance date (e.g., after March 11, 2013 for a swap between two swap dealers), are not required to be cleared if the following five conditions are met:

1. The multilateral portfolio compression exercise generating the amended and replacement swaps meets the definition set forth in CFTC Regulation 23.500(h) and involves more than two market participants.

2. The original swap(s) submitted as part of the multilateral portfolio compression exercise does not include any swap that has been cleared by a derivatives clearing organization.

3. The original swap(s) submitted as part of the multilateral portfolio compression exercise does not include any swap that is required to be cleared under 2(h)(1)(A) of the Commodity Exchange Act and Part 50 of CFTC Regulations because it was executed on or after an applicable compliance date.

4. Each amended swap or replacement swap generated by the multilateral portfolio compression exercise:

    a. is generated in accordance with a multilateral portfolio compression service provider's established rules and parameters for multilateral portfolio compression exercises;

    b. is entered into between the same counterparties as the original swap(s) that is amended or terminated;

    c. with the exception of reducing the notional amount, has the same material terms as the original swap(s), as defined in Part 45 of CFTC Regulations, including the reference entity, the maximum maturity of the swap, and the average weighted maturity of the swap; and

    d. is entered into for the sole purpose of reducing operational or counterparty credit risk.

5. Once the original swaps have been selected and submitted by market participants as part of the multilateral portfolio compression exercise, the multilateral portfolio compression methodology does not permit participants to specify which swaps may be amended or replaced.

Click here for the CFTC no-action letter.

CFTC Grants Relief from Required Clearing for Partial Novation and Partial Termination of Swaps

On March 20, the Commodity Future Trading Commission's Division of Clearing and Risk granted no-action relief from the clearing requirement for "stub" swaps that result when two counterparties agree to reduce the notional amount of their original swap, but all other terms of the swap remain the same as the original swap. The no-action relief provides that, where the original swap was not required to be cleared at the time of execution but is partially novated or terminated after the relevant clearing requirement compliance date, the resulting stub swap is not required to be cleared if the following conditions are met:

1. The original swap that is partially novated or partially terminated was not cleared by a derivatives clearing organization.
2. The original swap was executed prior to the compliance date for required clearing applicable to such a swap.
3. With respect to a partially terminated original swap:
    a. the records of the original swap that exist in the trading and/or recordkeeping systems of the original counterparties are amended solely to reflect the reduced notional amount of the original swap;
    b. the stated portion of the original swap that is terminated is fully terminated, apart from the stated portion that is the stub swap; and
    c. all other terms of the stub swap remain the same as the terms of the original swap.
4. With respect to a partially novated original swap:
    a. the records of the original swap that exist in the trading and/or recordkeeping systems of the original counterparties are amended solely to reflect the reduced notional amount of the original swap;
    b. all other terms of the stub swap remain the same as the terms of the original swap; and
    c. the novated swap (i.e., the portion of an original swap that is transferred from one of the original counterparties to a third party on or after an applicable compliance date) is submitted for clearing pursuant to section 2(h)(1)(A) of the Commodity Exchange Act and Part 50 of the CFTC's Regulations.

The no-action relief does not apply to circumstances where the original counterparties enter into and book a new swap that fully or partially offsets the risk of an existing uncleared swap and thereby achieve a similar economic result to a full termination, a partial novation or a partial termination.

Click here for the CFTC no-action letter.

Court Rules FERC Does Not Have Authority to Fine Trader for Manipulation of Futures Contracts

Pursuant to the Energy Policy Act of 2005, the Federal Energy Regulatory Commission (FERC) fined a natural gas trader $30 million for manipulating the settlement price for natural gas futures contracts on the New York Mercantile Exchange by selling a significant number of contracts in a manner designed to affect the settlement price for those contracts. According to the trader, the FERC could not fine him because the Commodity Futures Trading Commission has exclusive jurisdiction over all transactions involving commodity futures contracts. The trader petitioned the US Court of Appeals for the District of Columbia Circuit for review; the CFTC intervened in support of the trader. The court found that Congress intended Section 2(a)(1)(A) of the Commodity Exchange Act to give the CFTC exclusive jurisdiction over transactions conducted on futures markets. The court granted the trader's petition for review, finding that manipulation of natural gas futures contracts falls within the CFTC's exclusive jurisdiction and that nothing in the Energy Policy Act clearly repeals the CFTC's exclusive jurisdiction. *Hunter v. Federal Energy Regulatory Commission,* No. 11-1477 (March 15, 2013).

Click here for the opinion.

INVESTMENT COMPANIES AND INVESTMENT ADVISERS

SEC Publishes Guidance on Filing Requirements for Interactive Content

On March 15, the Security and Exchange Commission's Division of Investment Management issued guidance (Guidance) on when investment companies registered under the Investment Company Act of 1940 such as mutual funds and exchange traded funds (collectively, Investment Companies) are required to file with the SEC certain interactive content posted on real-time electronic forums such as chat rooms and other social media (Interactive Content).

Multiple filing requirements apply to the marketing materials used by Investment Companies, including Interactive Content. To the extent that they have not been filed with the Financial Industry Regulatory Authority pursuant to FINRA Rule 2210, an Investment Company's marketing materials may be subject to filing with the SEC pursuant to either Section 24(b) of the Investment Company Act of 1940 or SEC Rule 497 under the Securities Act of 1933 (SEC Filing Obligations). The Guidance notes that a fact-intensive inquiry is required to determine whether a particular marketing communication must be filed with the SEC.

To provide greater clarity, the Guidance lists (with examples) certain types of Interactive Content that generally are, and are not, subject to SEC Filing Obligations. The detailed examples included in the Guidance, along with additional information, are available here.

LITIGATION

Court Rejects "Core Operations" Theory of Scienter in Battery Manufacturer Fraud Case

The District Court of Massachusetts dismissed Section 10(b)(5) claims against executives of a battery systems company, holding that plaintiffs could not rely on the theory that knowledge of the falsity of the statements at issue could be imputed to senior officers of a public company because they concerned the company's "core operations."

Plaintiffs claimed that defendants, the CEO, CFO and interim CFO of A123 Systems Inc., a manufacturer of lithium ion batteries used to power electric vehicles, had made materially misleading statements concerning the market demand for, and the safety and durability of, certain of their batteries. In January 2010, A123 entered into a contract with Fisker Automotive to supply prismatic batteries for sports cars. This contract was expected to yield 25% of A1234's revenues for 2011. On December 21, 2011, the National Highway Traffic Safety Administration announced that Fisker was recalling 239 cars because of a defect in the A123 battery later discovered at A123's Michigan facility.

The court dismissed plaintiffs' complaint for failure to properly allege scienter. Plaintiffs proffered no allegations that any of the defendants had actual knowledge of, or were recklessly blind to, the Michigan plant's manufacturing problems. Instead, plaintiffs relied on the contention that the A123-Fisker relationship was crucial to the company's success. Relying on *Crowell v. Ionics, Inc.*, 343 F.Supp.2d 1 (D. Mass 2004), plaintiffs argued that knowledge of facts critical to a business's "core operations" may be attributed to corporate officers. The court refused to apply that doctrine, stating that without a "plus factor" creating an inference of knowledge (such as a communication to a defendant), the mere allegation that corporate executives should have known about certain company functions could not satisfy plaintiffs' pleading burden. Plaintiffs were granted leave to replead. *In re A123 Systems Inc. Securities Litigation*, No. 12-10591 (D. Mass. Mar. 14, 2013).

SEC Oversight of FINRA Exempt from FOIA Request

The District Court for the District of Columbia has held that the Securities and Exchange Commission is exempt from producing documents relating to its audit, inspections, and review of the Financial Industry Regulatory Authority (FINRA) in response to a Freedom of Information Act (FOIA) request.

An association of attorneys representing public investors in securities arbitrations requested that the SEC produce documents related to its oversight of FINRA's Dispute Resolution branch and examination of its administrative function. Specifically, the association sought documents concerning FINRA's arbitrator selection process. The

associations believed the arbitration selection process should be more transparent and fair. The SEC claimed Exemption 8 of FOIA did not require the SEC to produce responsive materials. The exemption protects documents “related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions.”

The court rejected the association’s arguments that Congressional intent weighed in favor of requiring the SEC to produce. Instead, the court found that the exemption was designed to safeguard the relationship between the financial institution and the reviewing agency in order to ensure that FINRA would continue to fully cooperate with the SEC. Coupled with the broad language of the exemption, the court concluded that SEC documents “related to” its oversight of FINRA need not be disclosed. The court nevertheless expressed reservations about the breadth of the SEC’s disclosure exemption, noting that the association “may be correct that Exemption 8 is overbroad because it extends to records related to the oversight of self-regulatory organizations,” but concluded that in light of the statutory language, “plaintiff’s arguments must be directed to Congress.” *Public Investors Arbitration Bar Ass’n v. S.E.C.*, No. 11-2285 (D.D.C. Mar. 14, 2013).

BANKING

Banking Agencies Issue Guidance on Leveraged Lending

On March 21, federal bank regulatory agencies released updated supervisory guidance on leveraged lending, “which has been increasing since 2009 after declining during the financial crisis.” The guidance from the Federal Reserve Board, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency (the Agencies) covers transactions characterized by a borrower with a degree of financial leverage that significantly exceeds industry norms. The guidance replaces guidance issued in April 2001.

According to the Agencies, “Before the financial crisis, the volume of leveraged credit transactions grew tremendously and participation by non-regulated investors willing to accept looser terms increased. While leveraged lending declined during the crisis, volumes have since increased and prudent underwriting practices have deteriorated.”

The guidance issued March 21 focuses attention on the following key areas:

- Establishing a sound risk-management framework: The Agencies expect that management and the board of directors identify the institution’s risk appetite for leveraged finance, establish appropriate credit limits and ensure prudent oversight and approval processes.
- Underwriting standards: An institution’s underwriting standards should clearly define expectations for cash-flow capacity, amortization, covenant protection, collateral controls and the underlying business premise for each transaction, and should consider whether the borrower’s capital structure is sustainable, regardless of whether the transaction is underwritten to hold or to distribute.
- Valuation standards: An institution’s standards should concentrate on the importance of sound methods in the determination and periodic revalidation of enterprise value.
- Pipeline management: An institution should be able to accurately measure exposure on a timely basis, establish policies and procedures that address failed transactions and general market disruptions, and ensure periodic stress tests of exposures to loans not yet distributed to buyers.
- Reporting and analytics: An institution should ensure that management information systems accurately capture key obligor characteristics and aggregates them across business lines and legal entities on a timely basis, with periodic reporting to the institution’s board of directors.
- Risk rating leveraged loans: An institution’s risk rating standards should consider the use of realistic repayment assumptions to determine a borrower’s ability to de-lever to a sustainable level within a reasonable period of time.
- Participants: An institution that participates in leveraged loans should establish underwriting and monitoring standards similar to loans underwritten internally.

- Stress testing: An institution should perform stress testing on leveraged loans held in portfolio as well as those planned for distribution, in accordance with existing interagency issuances.

This guidance applies to financial institutions supervised by the Agencies that engage in leveraged lending activities. Presumably, in light of the criticism by Congress of the regulatory burdens on community banks, the Agencies found it appropriate to explain that "the number of community banks with substantial involvement in leveraged lending is small and they should be largely unaffected by this guidance."

Read more.

Agencies Release Proposed Revisions to Interagency Questions and Answers Regarding Community Reinvestment

On March 18, the Federal Reserve Board, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency (the Agencies) requested comment on proposed revisions to "Interagency Questions and Answers Regarding Community Reinvestment." The Questions and Answers document "provides additional guidance to financial institutions and the public on the Agencies' Community Reinvestment Act (CRA) regulations."

The proposed revisions focus primarily on community development. Community development activities are considered as part of the CRA performance tests for large institutions, intermediate small institutions and wholesale and limited purpose institutions. Small institutions may use community development activity to receive consideration toward an outstanding CRA rating. Among other things, the proposed amendments would:

- Clarify how the Agencies consider community development activities that benefit a broader statewide or regional area that includes an institution's assessment area.
- Provide guidance related to CRA consideration of, and documentation associated with, investments in nationwide funds.
- Clarify the consideration of certain community development services.
- Address the treatment of qualified investments to organizations that use only a portion of the investments to support a community development purpose.
- Clarify that community development lending should be evaluated in such a way that it may have a positive, neutral or negative impact on the large institution lending test rating.

The notice that will be published in the *Federal Register* is attached here. Comments will be due 60 days after that publication, which is expected shortly.

UK DEVELOPMENTS

FSA Publishes Second AIFMD Consultation Paper

On March 19, the UK Financial Services Authority (FSA) published Consultation Paper CP13/9, its second consultation on the rules and guidance required for the UK transposition of the EU Alternative Investment Fund Managers Directive (AIFMD).

CP13/9 covers many of the issues that the FSA was unable to address in its first AIFMD consultation paper (CP12/32 issued in November 2012, as reported in *Corporate and Financial Weekly Digest* of November 16, 2012). A further consultation paper will be issued by the FSA's successor regulator, the Financial Conduct Authority (FCA), after April 1. This further consultation will cover marketing and management passports for non-EU funds and managers as well as changes required to bring the FCA Handbook into line with rules previously consulted on in CP12/32 and CP13/9.

The FSA proposes to permit UK firms marketing alternative investment funds (AIFs) in the United Kingdom to make full use of the AIFMD's twelve-month transitional period ending on July 21, 2014. The FSA acknowledges that certain firms' business may potentially be impacted if they are not authorized under AIFMD by July 22, 2013, and accordingly that it may need to permit firms to apply for authorization or variation of permissions prior to July 22, 2013 in order for firms to be able use the EU marketing passport beginning July 22, 2013. A further announcement on this will be made by the FCA after April 1.

The matters addressed in CP13/9 include:

- How the FSA proposes to give guidance about the scope of the AIFMD and the FSA's regulatory perimeter under AIFMD.
- The FSA's current views on delegation by AIF managers and on what is meant by "letterbox entity."
- Proposed modifications to current organizational and conduct of business rules (SYSC and COBS) that will affect full-scope UK AIF managers.
- Further proposals for prudential rules and guidance supplementing those set out in CP12/32.
- Proposals to adapt the rules and guidance in the Client Assets Sourcebook (CASS) to apply to depositaries of AIFs.
- The FSA's approach to marketing for AIFMD purposes and how AIF managers may exercise single-market passporting rights, as well as its approach to registering funds to be marketed in the United Kingdom by private placement.

The deadline for responses to the consultation is May 10.

Read more.

EU DEVELOPMENTS

ESMA Publishes EMIR Q&As

On March 20, the European Securities and Markets Authority (ESMA) published Questions & Answers (Q&A) relating to the implementation of the Regulation on OTC Derivatives, Central Counterparties (CCPs) and Trade Repositories (Regulation EU 648/2012, generally known as EMIR).

The Q&A states that its purpose is to promote common supervisory approaches in the application of EMIR among national regulators. Responses are provided to questions posed by market participants and regulators in relation to the practical application of EMIR grouped under three broad headings: OTC Derivatives, Central Counterparties and Trade Repositories. Issues addressed include the definition of OTC derivatives, clearing threshold calculation and notification requirements for non-financial counterparties, trade confirmations and requirements on CCPs with respect to recording of client assets and collateral portability.

Read more.

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