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DERIVATIVES

New Law Aligns Clearing and Margin Exceptions for Swaps

On January 13, President Obama signed legislation that aligns the rules relating to swap clearing and mandatory margin for uncleared swaps so that any entity that qualifies for an exemption from clearing its swaps also is exempt from any rules requiring mandatory margin for the resulting over-the-counter transaction. The Business Risk Mitigation and Price Stabilization Act of 2015, which was embedded as Title III of the Terrorism Risk Insurance Program Reauthorization Act of 2015, amends both the Commodity Exchange Act (CEA) and the Securities Exchange Act of 1934 to achieve this result for both swaps and security-based swaps.

The margin rules for non-cleared swaps re-proposed last autumn by the banking regulators and the Commodity Futures Trading Commission already generally exempted non-cleared swaps executed by non-financial end users from mandatory margin, but the new law increases the legal certainty of that result and, more importantly, extends the exemption to non-cleared swaps involving: (1) cooperatives that are exempted from clearing by action of the CFTC; (2) captive finance companies; (3) financial affiliates of non-financial end users exempt from clearing under CEA Section 2(h)(7)(D); and (4) small financial institutions with total assets of $10 billion or less (which can be exempt from swap clearing under CEA Section 2(h)(7)(A) because they are exempt from the definition of “financial entity” under CFTC Regulation 50.50(d)).

However, nothing in this legislation affects the traditional commercial right of a swap dealer to require collateral from a counterparty as a condition to executing swaps in order to manage the credit risk of the transactions.

Click here to read the text of the new law.

CFTC

CFTC Staff Extends No-Action Relief to Certain Reporting Counterparties Masking Identifying Information Pursuant to Non-US Law

On January 8, the Commodity Futures Trading Commission’s Division of Swap Dealer and Intermediary Oversight (DSIO) granted an extension of previously issued no-action relief for parties required to report identifying information relating to their swap counterparties.

CFTC Letters 13-41 and 14-89 granted time-limited no-action relief for certain CFTC reporting counterparties to mask legal entity identifiers and other enumerated identifiers and identifying terms in reports made to swap data repositories pursuant to Parts 45 and 46 of CFTC Regulations and to the CFTC pursuant to Part 20 of CFTC Regulations. A reporting party may rely on the extension of relief only to the extent that it previously satisfied the conditions set forth in CFTC Letter No. 13-41, which includes receiving a formal response from the applicable non-US regulator or governing authority.

The extension of relief expires on the date the reporting party no longer holds the requisite reasonable belief regarding the privacy law consequences of reporting or 12:01 a.m. (ET) on January 16, 2016, whichever occurs first.

CFTC Letter No. 15-01 is available here.

INVESTMENT COMPANIES AND INVESTMENT ADVISERS

SEC 2015 Examination Priorities Focus on Liquid Alternatives and Fixed-Income Funds

On January 13, the Securities and Exchange Commission's Office of Compliance Inspections and Examinations (OCIE) released its 2015 examination priorities for investment companies, investment advisers, broker-dealers and transfer agents. The examination priorities highlight new and continuing areas of interest, including, but not limited to, liquid alternatives, fixed-income funds and retirement investing by retail investors.

Retail Investors' Investment in Liquid Alternatives and Fixed-Income Funds

OCIE notes that retail investors are investing in alternative and institutional private funds, illiquid investments and structured products. It will focus on fee arrangements, improper or misleading sales practices, suitability and branch office supervision.

OCIE also will assess alternative investment companies with respect to: (1) leverage, liquidity and valuation issues; (2) adequacy of such funds' internal controls; and (3) marketing issues. It also will review fixed-income mutual funds with respect to compliance policies and procedures and internal controls to ensure that disclosures are not misleading.

Market-Wide Risks and Data Analytics

OCIE's market-wide risk assessment will focus on large firm monitoring, systemically important clearing agencies, financial firms' cybersecurity systems and best execution order routing. OCIE will use data analytics to uncover fraudulent activity such as individual misconduct, microcap fraud, excessive trading and money laundering. Other examination areas include, but are not limited to, municipal advisors, proxy services, registered investment companies that have never been examined and private equity fees and expenses.

Click here to read the 2015 SEC Examination Priorities.

LITIGATION

Delaware Court Rules That Beneficial Stockholder May Seek Appraisal in its Own Name

On January 5, the Delaware Court of Chancery ruled that a beneficial stockholder has standing to bring an action for appraisal in its own name when the record stockholder's actions have perfected the right of appraisal. The court found that Merion Capital LP, the beneficial owner of 1.25 million shares of Ancestry.com held in fungible bulk by the record holder Cede & Co. did not need to prove that the stock it purchased after the record date merger of Ancestry.com had been voted against the deal.

In so holding, the court focused its analysis on 8 Del. C. § 262, which establishes the right to appraisal of stock. The Delaware General Assembly amended Section 262(e) in 2007 to add that beneficial stockholders may file petitions for appraisal in their own names. The General Assembly left unchanged the standing requirement of Section 262(a) that the petitioner need only show that the record holder of the stock for which appraisal is sought: (1) held those shares on the date it made an appraisal demand; (2) continuously held the shares through the date of the merger; (3) has made a proper and timely appraisal demand; and (4) has not voted in favor of the merger with regard to those shares.

Seeking to thwart Merion's appraisal demand, Ancestry.com argued that in allowing beneficial stockholders to bring appraisal petitions, such beneficial stockholders, and not the record holders, must show that they did not vote in favor of the merger. The court rejected Ancestry.com's motion and allowed the appraisal to go forward, reasoning that Cede, the record holder who held the shares in fungible bulk, had perfected its standing by having sufficient shares not voted in favor of the merger to cover the number of shares for which Merion sought appraisal. Thus, having perfected its appraisal rights through the record holder, Merion could file in its own name in light of the 2007 amendment to Section 262(e).

The court further reasoned that, even if Section 262(a) imposed a voting prohibition on beneficial stockholders, Delaware law does not require a post-record date purchaser like Merion to establish that the previous owner of the shares did not vote in favor of the merger.

In re Appraisal of Ancestry.com, Inc., C.A. No. 8173-VCG (Del. Ch. Jan. 5, 2015)

Government Seeks Extended Prison Term in Securities Fraud Case

In a sentencing memorandum filed January 2, the United States Attorney's Office in Washington asked the US District Court for the Western District of Washington to sentence Dickson Lee, the former chief executive of L&L Energy Inc., to 60 months in prison despite sentencing guidelines that recommend 41–51 months.

Lee is awaiting sentencing after pleading guilty to two counts of securities fraud in violation of 18 U.S.C. § 3148. In anticipation of having L&L Energy listed on the NASDAQ exchange, Lee fabricated the existence of a chief financial officer in documents provided to the Securities and Exchange Commission. Furthermore, Lee fraudulently issued shares of L&L Energy to associates in China in the midst of an SEC investigation in order to make it appear that the sales were not directed by the company and to avoid further disclosure requirements.

In requesting the longer sentence, the memorandum states that "the frauds committed by Lee are so brazen and unique, they have no known precedent." The government also contends that the sentencing guidelines here do not constitute a wholly adequate basis for gauging the extent of Lee's criminal conduct. The sentencing guidelines, according to the memorandum, are driven by the notion of direct economic loss to the shareholders.

In this case, the government conceded that it could not establish economic loss to investors as a result of Lee's actions. However, making note of the exceptional nature of Lee's crime and the heightened need for deterrence in securities fraud cases committed by public companies, the US Attorney's Office sought the heightened penalty.

U.S. v. Dickson Lee, No. CR 14-0024RAJ (W. D. Wash. Jan. 2, 2015)

EU DEVELOPMENTS

ESMA Recommends to the European Commission That All MiFID Firms Have a Full-Time Compliance Function

The European Securities and Markets Authority's (ESMA's) final advice to the European Commission, which may (if the European Commission concurs) be transposed into new rules under the revised and re-cast Markets in Financial Instruments Directive (MiFID II), recommends that all MiFID firms should be required to have a permanent compliance function. Such firms include investment advisory firms, asset managers (which are not regulated as Alternative Investment Fund Managers (AIFMs) under the Alternative Investment Fund Managers Directive (AIFMD)), and proprietary trading firms.

ESMA recommends that the "permanent compliance function" at such firms should:

- monitor and assess on a regular basis the adequacy and effectiveness of the firm's measures and procedures to comply with its obligations under MiFID II;
- advise and assist the relevant persons responsible for carrying out investment services and activities to comply with the firm's MiFID II obligations;
- report, at least annually, to the management body on the implementation and effectiveness of the firm's overall control environment for investment services and activities; and
- monitor the operations of the complaints-handling process and consider complaints as a source of relevant information in the context of its general monitoring responsibilities.

In addition, the compliance function should:

- have the necessary authority, resources, expertise and access to all relevant information;
- be appointed and replaced by the firm's management and be responsible for the compliance function and for any reporting required by MiFID II;
- report on an *ad hoc* basis directly to the firm's management whenever it has detected a significant risk of failure by the firm to comply with its MiFID II obligations;
- not be involved in the performance of the firm's investment services; and
- be remunerated in such a way that they are not inappropriately incentivized in a manner that would compromise their objectivity.

Many of the new proposals appear to have been copied from the AIFMD, and the ESMA guidance suggests that firms that can show that it would be disproportionate for them to have a dedicated compliance officer may be permitted to register someone from their administrative team as their permanent compliance function, effectively disapplying the final two bullet points above on the basis of their small scale and complexity—as is the case in practice for small AIFMs under AIFMD.

MiFID II takes effect in two years and there are likely to be many more developments and changes that investment advisory firms, asset managers and proprietary trading firms will need to address in their systems and controls. Firms are advised to keep a watchful eye on developments in MiFID II and be ready later this year or in early 2016 to put the necessary changes in place.

ESMA's final advice to the European Commission is available here.

ESMA Publishes First Annual Review of CCP Colleges Under EMIR

On January 8, the European Securities and Markets Authority (ESMA) published its first annual review of the colleges required to be established under Article 18 of the European Market Infrastructure Regulation (EMIR). The colleges are established for the purpose of reviewing and approving applications by central counterparties (CCPs) for authorization to clear one or more classes of financial instruments under EMIR.

College participants include ESMA and the applicant's national competent authority, as well as the competent authorities responsible for supervising the applicant's clearing members, trading venues, central securities depositories and other CCPs with which the applicant maintains interoperability arrangements. In 2014, 15 CCPs were authorized under EMIR.

Article 30 of Regulation (EU) No 1095/2010 requires that ESMA annually review the supervisory activities of the national competent authorities participating in the CCP college, including, in particular, an assessment of the degree of convergence reached in the application of EMIR's provisions and in supervisory practices across the national competent authorities.

Based on its review, ESMA was satisfied that the activities of the CCP colleges were characterized by cooperation and a commitment to meeting relevant deadlines. However, ESMA noted that certain members appeared to "free ride" on the substantive reviews undertaken by other, more active members, and certain college chairpersons appeared not to share relevant information promptly with other college members.

The report also includes a discussion of ESMA's role in facilitating the work of the CCP colleges, including the publication of guidelines and recommendations on written agreements between members of CCP colleges and clarifications on the voting procedures of CCP colleges. ESMA also identified certain substantive areas where applicants for CCP authorization were required to modify certain of their business or risk management practices in order to maintain a consistent application of EMIR across the European Union.

ESMA's report on CCP colleges can be found here. The list of designated competent authorities participating in CCP colleges can be found here.

ESMA Announces Open Hearing on MiFID II and MiFIR

The European Securities and Markets Authority (ESMA) announced on January 12 that it will hold an open hearing on the issues identified in its December 2014 consultation paper and proposed regulatory technical standards regarding the amendments to the Markets in Financial Instruments Directive (MiFID II) and the Markets in Financial Instruments Regulation (MiFIR). The open meeting will be held on Thursday, February 19 in Paris.

ESMA's announcement can be found here.

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