Katten
KattenMuchinRosenman LLP
Corporate & Financial
Weekly Digest
June 2, 2017 Volume XII, Issue 21

SEC/CORPORATE

Delaware Chancery Court Decision Demonstrates Continuing Risk to "Appraisal Arbitrage"

In a stark application of the adage that one should be careful what one wishes for—because one may get it—on May 30, Vice Chancellor Sam Glasscock III of the Delaware Chancery Court issued an opinion in *In re Appraisal of SWS Group, Inc.* (C.A. No. 10554-VCG), a stockholder lawsuit seeking appraisal for the shares of SWS Group, Inc. (SWS), a financially struggling bank and broker-dealer firm. The appraisal claim arose out of the merger of SWS with Hilltop Holdings Inc. (Hilltop) in January 2015. The court's decision on the fair value of the SWS shares reduced the price paid to dissenting stockholders from the merger price of $6.92 per share, payable in a mixture of cash and stock, to $6.38, payable in cash. This decision, and the resulting 7.8 percent reduction in consideration, demonstrates the risks inherent in "appraisal arbitrage."

Appraisal claims permit dissenting stockholders to pursue a claim for the fair value of their shares, based on the value of the corporation as a going concern, not as a merger target. Such claims have become increasingly popular in recent years, as investors use the appraisal process strategically to generate returns in the form of (1) potentially huge dividends if a court assigns a fair value in excess of the deal price and (2) interest on any gain from the appraisal at 5 percent plus the federal discount rate compounded monthly. This strategy, sometimes known as "appraisal arbitrage" and driven by the opportunity to generate above-market returns, has been more frequently employed in recent years.

The dissenting SWS stockholders argued that SWS was worth more than the $6.92 per-share price paid by Hilltop, emphasizing both SWS's excess capital of nearly $194 million (ironically, created by Hilltop when it exercised SWS warrants in advance of the merger) and other offers received by SWS that were well above the Hilltop offer. Hilltop, now the controlling stockholder of SWS, argued that the focus on the excess capital created an inaccurate perception of SWS' value, as the capital "created" by the exercise of the stock warrants did not actually provide any additional real money to SWS. As a result, SWS was worth only $5.71 per share under Hilltop's analysis.

Recent decisions such as *In re Appraisal of PetSmart Inc.* and *Merion Capital LP et al. v. Lender Processing Services Inc.* serve to highlight one risk in appraisal proceedings: that a well-constructed auction process will lead to an efficient pricing outcome and to the court giving deference to the merger price. *SWS Group* highlights a different, but equally, significant risk. Vice Chancellor Glasscock declined to give deference to the merger price, saying that in this case, the merger process was unreliable. Instead, the court undertook its own analysis, ultimately siding largely with SWS, and determined SWS's fair value was $6.38 per share, less than the per-share price paid by Hilltop and far below the per-share price sought by the dissenting stockholders. Vice Chancellor Glasscock noted that "when the merger price represents a transfer to the sellers of value arising solely from a merger, these additions to deal price are properly removed from the calculation of fair value." In other words, mergers that present unique value to the parties involved due to synergies that are not available to the target on a stand-alone, going-concern basis are very risky transactions in which to engage in appraisal arbitrage. Once committed to an appraisal proceeding, a stockholder forgoes the ability to receive the merger consideration and instead is left with whatever value the court assigns to the dissenting stockholder's shares. Particularly in synergies-driven mergers, this means that stockholders may receive less than the merger consideration, in addition to having to bear the cost of the appraisal proceeding.

SWS Group may be part of a legislative and judicial trend that may curb the use of appraisal rights. While it gets there by a different route, in that the court did not give deference to the merger price, the outcome of *SWS Group* is consistent with a developing line of Delaware cases, which have supported a merger price less synergies approach in appraisal cases. When coupled with legislative restrictions adopted in Delaware restricting their use to cases like *PetSmart* and *Lender Processing Services*, which also showed deference to the merger price, it may be that the hey-day of opportunistic appraisal proceeding has passed.

DERIVATIVES

See "CFTC Extends No-Action Relief to SEFs and DCMs From Certain Error Correction Regulations" and "NFA Issues Notice Regarding Monthly Risk Data Reporting Requirements for Swap Dealers" in the CFTC section.

CFTC

CFTC Issues Order of Registration Permitting Eurex Zurich AG to Engage in Direct Access Trading From the United States

On May 30, the Commodity Futures Trading Commission (CFTC) issued an Order of Registration (Order) permitting Eurex Zurich AG (Eurex Zurich), a foreign derivatives exchange authorized by and subject to regulation by Switzerland's Financial Market Supervisory Authority (FINMA), to provide identified members and other US-based participants with direct access to its electronic order entry and trade matching system. Factors considered by the CFTC in issuing the Order included, but were not limited to, Eurex Zurich being subject to a regulatory and supervisory regime under FINMA that is similar to that of the CFTC.

The Order of Registration is available here.

CFTC Extends No-Action Relief to SEFs and DCMs From Certain Error Correction Regulations

On May 30, the Commodity Futures Trading Commission's (CFTC) Division of Market Oversight and Division of Clearing and Risk (Divisions) issued Staff Letter 17-27, extending previously granted no-action relief to swap execution facilities (SEFs) and designated contract markets (DCMs) from restrictions on using pre-arranged trades to correct clerical or operational errors that (1) caused a swap to be rejected for clearing and thus become void or (2) were discovered after a swap has been cleared. (For a more complete discussion of the previously granted no-action relief, see the June 17, 2016, edition of Corporate and Financial Weekly Digest). The original no-action relief had been set to expire on June 15. To allow the Divisions to consider a permanent solution to regulating the correction of such errors, no-action relief will be extended until the effective date of any revised CFTC regulations regarding methods of execution requirements and pre-arranged trading.

Staff Letter 17-27 is available here.

NFA Issues Notice Regarding Monthly Risk Data Reporting Requirements for Swap Dealers

On May 30, the National Futures Association (NFA) issued Interpretive Notice I-17-1 (Notice), which sets forth the specific list of risk metrics that swap dealers (SDs) will be required to electronically report to NFA on a monthly basis, beginning with the initial January 31, 2018, reporting deadline. NFA intends to use this information to assess the market and credit risk exposure of member SDs. Metrics covered by the reports will include, but are not limited to: (1) interest rate sensitivity, (2) credit spread sensitivity and (3) commodity market sensitivities. Because of the differing business models used by member SDs, NFA has provided non-financial SDs with alternative reporting metrics with respect to certain reporting categories, such as total stressed VaR and commodity market sensitivities. NFA intends to offer educational programs regarding these requirements prior to their December 31effective date.

Interpretive Notice I-17-10 is available here.

BANKING

Federal Banking Agencies Issue Advisory on the Availability of Appraisers

On May 31, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the National Credit Union Administration jointly issued an advisory addressing concerns from the financial industry regarding its perceived shortage of state certified and licensed appraisers, particularly in rural areas. The advisory addresses the appraiser shortage and the subsequent delays in obtaining an appraisal by highlighting two existing options: temporary practice permits and temporary waivers.

Pursuant to Section 1122(a) of Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (Title XI), a state appraiser certifying or licensing agency is required to recognize the certification or license of an appraiser issued by another state on a temporary basis for federally related transactions (FRT). Subject to state law limitations, temporary practice permits could allow state certified or licensed appraisers to provide their services in states where they are not certified or licensed, including those experiencing a shortage of appraisers. Appraisers must apply to the relevant state appraiser regulatory agency for a temporary practice permit.

In addition, many states allow reciprocity and recognize the appraiser certification and licensing of another state, which allows state certified and licensed appraisers to perform appraisals across state lines.

Moreover, Section 1119 of Title XI authorizes the Federal Financial Institutions Examination Council's (FFIEC) Appraisal Subcommittee, with the approval of the broader FFIEC, to grant temporary waivers of any requirement relating to certification or licensing of individuals to perform appraisals under Title XI in states or geographic political subdivisions where there is a shortage of appraisers leading to significant delays in obtaining appraisals when certain conditions are met.

Waiver requests may be submitted by any of the following: (1) a state appraiser certifying or licensing agency; (2) a federal bank regulatory agency; (3) a regulated financial institution or credit union; or (4) other persons or institutions with demonstrable interest in appraiser regulation. Regardless of who initially requests a waiver, if granted, the requirement to use a certified or licensed appraiser on FRTs would be waived for all regulated institutions engaging in FRTs in the affected geographic area.

The Interagency Advisory is available here.

BREXIT/EU DEVELOPMENTS

ESMA Publishes Opinion on Determining Third-Country Trading Venues

On May 31, the European Securities and Markets Authority (ESMA) published an opinion (Opinion) regarding whether third-country trading venues are within scope of the post-trade transparency regime of the Markets in Financial Instruments Regulation (MiFIR).

ESMA believes that information on transactions concluded by EU investment firms that are truly OTC, i.e., bilateral transactions with non-EU firms, or that are concluded on third-country trading venues that would not be subject to a certain level of post-trade transparency, should be made public in the EU through an approved publication arrangement (APA), as set out in Articles 20 and 21 of the MiFIR .

The Opinion states therefore, that, for the purposes of the post-trade transparency requirements of the MiFIR, EU investment firms should not be required to publish information about transactions that are concluded on a third-country trading venue that meets the following criteria:

- It operates a multilateral system, i.e., a system or facility in which multiple third-party buying and selling interests in financial instruments are able to interact;

- It is subject to authorization in accordance with the legal and supervisory framework of the third-country;
- It is subject to supervision and enforcement on an ongoing basis in accordance with the legal and supervisory framework of the third country by a competent authority that is a full signatory to the IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information; and,
- It has a post-trade transparency regime in place, which ensures that transactions concluded on that trading venue are published as soon as possible after the transaction was executed or, in clearly defined situations, after a deferral period.

ESMA will publish a list of trading venues that meet the above criteria, published as an annex to the Opinion, which will be updated on an ongoing basis.

The Opinion is available here.

ESMA Updates MIFID II Q&A on Commodity Derivatives

On May 31, the European Securities and Markets Authority (ESMA) updated a question and answer document relating to commodity derivatives (Q&A) under the revised Markets in Financial Instruments Directive (MiFID II) and the Markets in Financial Instruments Regulation (MiFIR).

The updated Q&A contains questions and answers relating to the following topics:

- position limits—specifically the definition of 'lot' for energy products;
- ancillary activity—including questions on who has to annually notify the relevant competent authority that they make use of the ancillary activity exemption, who it should be made to and by when it needs to be made. Also included are new questions relating to the privileged transactions exemption and the capital employed test; and
- third country issues—specifically whether economically equivalent contracts traded on a third-country venue should be considered economically equivalent over-the-counter derivatives (EEOTC) for position limit and position reporting purposes under MiFID II.

The Q&A is available here.

European Commission Publishes Draft of EU Position Papers for Brexit Negotiations

On May 29, the European Commission (EC) published two draft papers (Position Papers) setting out the position that it will take in negotiations with the United Kingdom relating to citizens' rights (CR Paper) and the financial settlement to be reached with the United Kingdom (FS Paper).

The CR Paper contains general principles relating to the treatment and status of EU and UK citizens after Brexit. It states that both EU and UK nationals should have the same level of protection they currently enjoy, including the right to permanent residency after five years of continuous residence; reciprocal equal treatment for EU citizens in the UK and vice versa; and legal residence being respected at the time of the UK's withdrawal. The CR Paper also states that the EC should have full monitoring powers and the European Court of Justice should have jurisdiction relating to such rights.

The FS Paper sets out general principles relating to the financial statement, which will need to be made between the UK and EU on the UK's withdrawal. The FS Paper envisages a single settlement and contains a list of the multitude of entities who will be included in the financial settlement, such as the European Central Bank, who will reimburse paid-in capital to the Bank of England.

The Position Papers are available here.

For additional coverage on financial and regulatory news, visit *Bridging the Week*, authored by Katten's Gary DeWaal.

For more information, contact:

FINANCIAL SERVICES

Janet M. Angstadt	+1.312.902.5494	janet.angstadt@kattenlaw.com
Henry Bregstein	+1.212.940.6615	henry.bregstein@kattenlaw.com
Kimberly L. Broder	+1.212.940.6342	kimberly.broder@kattenlaw.com
Wendy E. Cohen	+1.212.940.3846	wendy.cohen@kattenlaw.com
Guy C. Dempsey Jr.	+1.212.940.8593	guy.dempsey@kattenlaw.com
Gary DeWaal	+1.212.940.6558	gary.dewaal@kattenlaw.com
Kevin M. Foley	+1.312.902.5372	kevin.foley@kattenlaw.com
Jack P. Governale	+1.212.940.8525	jack.governale@kattenlaw.com
Arthur W. Hahn	+1.312.902.5241	arthur.hahn@kattenlaw.com
Christian B. Hennion	+1.312.902.5521	christian.hennion@kattenlaw.com
Carolyn H. Jackson	+44.20.7776.7625	carolyn.jackson@kattenlaw.co.uk
Fred M. Santo	+1.212.940.8720	fred.santo@kattenlaw.com
Christopher T. Shannon	+1.312.902.5322	chris.shannon@kattenlaw.com
Robert Weiss	+1.212.940.8584	robert.weiss@kattenlaw.com
Lance A. Zinman	+1.312.902.5212	lance.zinman@kattenlaw.com
Krassimira Zourkova	+1.312.902.5334	krassimira.zourkova@kattenlaw.com

BANKING

Christina J. Grigorian	+1.202.625.3541	christina.grigorian@kattenlaw.com

BREXIT/EU DEVELOPMENTS

David A. Brennand	+44.20.7776.7643	david.brennand@kattenlaw.co.uk
Carolyn H. Jackson	+44.20.7776.7625	carolyn.jackson@kattenlaw.co.uk
Neil Robson	+44.20.7776.7666	neil.robson@kattenlaw.co.uk
Nathaniel Lalone	+44.20.7776.7629	nathaniel.lalone@kattenlaw.co.uk

** Click here to access the* Corporate & Financial Weekly Digest *archive.*

Attorney advertising. Published as a source of information only. The material contained herein is not to be construed as legal advice or opinion.
©2017 Katten Muchin Rosenman LLP. All rights reserved.

Katten
Katten Muchin Rosenman LLP www.kattenlaw.com

AUSTIN | CENTURY CITY | CHARLOTTE | CHICAGO | HOUSTON | IRVING | LONDON | LOS ANGELES | NEW YORK | ORANGE COUNTY | SAN FRANCISCO BAY AREA | SHANGHAI | WASHINGTON, DC

Katten refers to Katten Muchin Rosenman LLP and the affiliated partnership as explained at kattenlaw.com/disclaimer.