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CORPORATE & FINANCIAL
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BROKER DEALER

Federal Agencies Seek Comment on Joint Proposed Rule Regarding Credit Risk Retention

In 2011, the Board of Governors of the Federal Reserve System, the Department of Housing and Urban Development, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Office of the Comptroller of the Currency and the Securities and Exchange Commission (collectively, the Agencies) issued a notice of proposed rulemaking to implement the risk retention requirement in the Dodd-Frank Wall Street Reform and Consumer Protection Act. On August 28, the Agencies issued a notice revising the proposed rule that would require sponsors of asset-backed securities (ABSs) to retain risk in those transactions. The new proposal revises the options provided to sponsors to satisfy the risk retention requirements. While the original proposal generally measured compliance with the risk retention requirements based on the par value of ABSs issued in a securitization transaction and included a premium capture provision, the new proposal generally bases risk retention on the fair value of the assets in an ABS without a premium capture provision.

The new proposal continues to exclude the following ABSs from credit risk retention requirements: commercial loans, commercial mortgages, automobile loans of low credit risk or fully guaranteed Fannie Mae and Freddie Mac loans while such loans are in conservatorship or receivership and have capital support from the US government.

The Agencies are requesting comment on the revised proposed rule by October 30, 2013.

Click here for the proposed rule.

SEC Grants Request for No-Action Relief with Respect to Multi-Day Pre-Fail and Post-Fail Credit Under Rule 204 of Regulation SHO

The Securities and Exchange Commission has granted a September 6 joint request for no-action relief submitted by the Financial Industry Regulatory Authority, the Chicago Board Options Exchange (CBOE) and C2 Options Exchange, Incorporated (C2, and together with the CBOE, the Exchanges) with respect to claiming credit for closing out a fail to deliver under Rule 204 of Regulation SHO (Rule 204) based on net purchases aggregated over multiple days. Pursuant to the requested relief, the SEC's Division of Trading and Markets will not recommend enforcement action under certain circumstances with respect to multi-day pre-fail and post-fail credit under Rule 204.

Under Rule 204, participants in a registered clearing agency must deliver securities to a registered clearing agency for clearance and settlement on a long or short sale transaction in any equity security by the settlement date, or must close out a fail to deliver at a registered clearing agency in any equity security for a long or short sale transaction in that equity security by borrowing or purchasing securities of like kind and quantity. Such participants must close out a fail to deliver for a short sale transaction by no later than the beginning of regular trading hours on the settlement day following the settlement date, referred to as T+4. If any such participant has a fail to deliver that the participant can demonstrate on its books and records has resulted from a long sale, or is attributable to bona fide market-making activities by a registered market maker, options market maker or other market maker obligated to quote in the over-the-counter market, the participant must close out the fail to deliver by no later than the beginning of regular trading hours on the third consecutive settlement day following the settlement date, referred to as T+6.

In its September 6 letter, the SEC indicated that its Division of Trading and Markets will not recommend enforcement action if FINRA and the Exchanges enforce compliance with Rule 204 consistent with an approach that would generally permit participants of a US registered clearing agency, or US registered broker dealers to which a participant allocated a fail to deliver position pursuant to Rule 204(d) of Regulation SHO, to claim credit for closing out a fail to deliver position at a registered clearing agency in any equity security prior to the applicable close-out date based on net purchases aggregated over multiple days.

Click here to read the September 6 No-Action Request and Letter Granting Relief.

DERIVATIVES

Global Regulators Adopt Final Margin Requirements for Uncleared Derivatives

On September 2, the Basel Committee on Banking Supervision of the Bank for International Settlements (BIS) and the Board of the International Organization of Securities Commissions (IOSCO) jointly published a document entitled "Margin Requirements for Non-Centrally Cleared Derivatives" that sets out globally agreed minimum standards for the collateralization of uncleared over-the-counter swaps. Under these standards, all financial firms and systemically important non-financial entities that engage in non-centrally cleared derivatives will have to exchange initial and variation margin commensurate with the counterparty risks arising from such transactions. It is expected that the Commodity Futures Trading Commission, Securities and Exchange Commission and banking regulators in the United States will adopt these margin standards for swaps in lieu of the ones that they have previously proposed as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Among the highlights of the new margin framework are the following points:

- Variation margining will commence December 1, 2015. Initial margining will be phased in starting on that date for the largest market participants, with full initial margining coming into effect on December 1, 2019.
- Initial margin can be calculated using percentages from a standard schedule or an approved model.
- Initial margin must be exchanged on a gross basis and must generally be held at an independent custodian.
- National regulators will determine eligible collateral based on general guidance from BIS and IOSCO.
- Collateral haircuts can be set by reference to percentages from a standard schedule or an approved model.
- Variation margin must be exchanged on a zero threshold basis; initial margin can have a threshold of up to €50 million applied on a consolidated basis across all entities in the same corporate family.
- Rehypothecation is permitted for variation margin but not for initial margin (except under limited circumstances).
- Variation margin calculations can take into account legally enforceable netting arrangements.

For more information, please see the press release or the final report.

CFTC

CFTC Issues Concept Release on Automated Trading

The Commodity Futures Trading Commission has issued a concept release on risk controls and system safeguards for automated trading environments. The release provides an overview of recent market events and existing industry practices regarding automated trading systems (ATSs), and requests comment on a series of questions relating to a number of potential risk controls and safeguards, including:

- Pre-trade risk controls, such as message and execution throttles, volatility awareness alerts, self-trade controls, price collars, maximum order sizes, trading pauses and credit risk limits;
- Post-trade reports and other post-trade measures, such as standardized order, trade and position reporting and trade cancellation or adjustment policies; and
- System safeguards, such as order cancellation capabilities, repeated automated execution throttles, policies

and procedures for the design, testing and supervision of ATSs, the advisability of mandatory “kill switches” for ATSs, self-certifications and notifications and data reasonability checks.

The concept release also includes a handful of other proposals, notably including potential registration of firms operating or providing ATSs, market quality data, market quality incentives, policies and procedures to identify “related contracts,” order type standardization and simplification and the definition of high-frequency trading.

Comments on the concept release must be filed by December 11, 2013. The concept release is available here.

CFTC Grants Relief to CPOs Trading Through Subsidiaries

The Commodity Futures Trading Commission’s Division of Swap Dealer and Intermediary Oversight (DSIO) has granted no-action relief from certain reporting obligations to commodity pool operators (CPOs) of registered investment companies (RICs) that trade commodity interests through wholly owned subsidiaries known as controlled foreign corporations (CFCs). This coincides with the CFTC’s recent rule release harmonizing compliance obligations for RICs (and CFCs) that are also regulated as commodity pools. More information regarding the CFTC’s recent rule release is available here.

Pursuant to the no-action letter, a CPO of an RIC that uses a wholly owned CFC to trade commodity interests would not be required to separately report to National Futures Association under CFTC Regulations 4.22(c) and 4.27(c) for such CFC, but rather would be permitted to file consolidated information for the RIC and its CFC(s). To obtain such relief, among other requirements, the CPO of the CFC must also be the CPO of the RIC, and must file a claim of relief with the DSIO via electronic mail pursuant to the instructions set out in the no-action letter.

CFTC Letter No. 13-51 is available here.

INVESTMENT COMPANIES AND INVESTMENT ADVISERS

Please see “CFTC Grants Relief to CPOs Trading Through Subsidiaries” in **CFTC** above.

LITIGATION

Sixth Circuit Affirms Dismissal of Shareholder Class Action Due to Plaintiff’s Failure to Plead Recklessness

The US Court of Appeals for the Sixth Circuit recently affirmed an Ohio district court’s decision to dismiss a securities fraud putative class action accusing Defendant Zoo Entertainment, Inc. (Zoo), a video game software company, of publishing financial statements with reckless disregard of their falsity. The court found that the allegations did not support the strong inference of scienter required under the Private Securities Litigation Reform Act.

The complaint concerned financial statements Zoo issued during 2010, the year the company went public. After claiming record revenues in its 2010 Securities and Exchange Commission filings, Zoo issued a press release in April 2011 stating that a year-end audit revealed errors in recording certain transactions and that its 10-Q statements for the first three quarters of 2010 should no longer be relied upon. Zoo lowered its 2010 quarterly revenues, causing its stock value to plummet. Plaintiff shareholder Bruce E. Ricker (Ricker) sued, relying, in part, on information allegedly from a confidential witness, a former employee in Zoo’s accounting department. It was alleged that the confidential witness had informed Zoo’s CEO and CFO of payment problems with Zoo’s most significant customer account, which prevented the accountant from accurately projecting cash flow. Ricker also alleged that, despite knowing about these problems, the CEO and CFO took no action. Ricker additionally alleged that Zoo’s awareness of its weak internal controls and the departure of high-ranking Zoo officials following the restatement further supported a strong inference of scienter.

After applying a “holistic analysis” of the shareholder’s amended complaint, the district court dismissed the complaint finding that Ricker had not presented information tying the confidential witness’s allegations to the need to restate revenue. Even assuming Zoo knew about problems with its largest account, the district court held that did not support a strong inference that the company should have known its financial statements were false. The Sixth Circuit agreed, holding that Ricker failed to meet the pleading standard of alleging "unreasonable conduct that was an extreme departure from the standards of ordinary care." The court recognized its duty to consider the whole of the complaint and opposing plausible inferences, and found that the inference that Zoo recklessly disregarded internal revenue recognition problems with its largest account was not as strong as the opposing plausible inference: that Zoo is a small company with an understaffed and unsophisticated accounting department that simply miscalculated revenues. Further, despite a "long list of alleged errors," the court found that Zoo failed to allege the "multiple, obvious red flags" the court typically requires to infer recklessness.

Ricker v. Zoo Entm't Inc. et al., No. 12-3951 (6th Cir. Aug. 27, 2013).

Former Head of Investor Relations Penalized by SEC for Selectively Disclosing Material Nonpublic Information, While Self-Disclosing Company Escapes Charges

The selective and early disclosure of material non-public information resulted in a Securities and Exchange Commission cease and desist order and civil penalties against the former head of investor relations at First Solar, Inc. (First Solar or the Company), an Arizona-based solar energy company. The SEC determined that Lawrence D. Polizzotto violated Section 13(a) of the Securities Exchange Act of 1934 and Regulation FD by informing certain analysts and investors ahead of the market that First Solar would likely not receive an important and much anticipated loan guarantee commitment of nearly $2 billion from the US Department of Energy (DOE). The day after those disclosures, the Company publicly disclosed this information in a press release, causing its stock price to dip six percent.

On September 13, 2011, First Solar's then-CEO publicly expressed confidence at an investor conference that the Company would receive three loan guarantees of close to $4.5 billion, which the DOE previously committed to granting upon satisfaction of certain conditions. Polizzotto and several other First Solar executives learned a couple of days later that the Company would not receive the largest of the three guarantees. An in-house lawyer expressly advised a group of First Solar employees, including Polizzotto, that they could not answer questions from analysts and investors until the Company both received official notice from the DOE and issued a press release or posted an update on the guarantee to its website. According to the SEC, notwithstanding this instruction, Polizzotto and a subordinate, acting at Polizzotto's direction, had one-on-one phone conversations with approximately 30 sell-side analysts and institutional investors prior to First Solar's public disclosure. In the conversations, they conveyed the low probability that First Solar would receive one of the three guarantees. In some instances, Polizzotto went further and said that a conservative investor should assume that the guarantee would not be granted.

Polizzotto agreed to pay $50,000 to settle the charges without admitting or denying any of the SEC's findings. He, however, was not subject to even a temporary industry bar. The SEC did not bring an enforcement action against First Solar due to the Company's cooperation with the investigation, as well as its self-disclosure to the SEC promptly after discovering Polizzotto's selective disclosure. In addition, the SEC emphasized the strong "environment of compliance" at the Company, including the "use of a disclosure committee that focused on compliance with Regulation FD" and the fact that the Company took remedial measures to address improper conduct, including conducting additional compliance training.

In the Matter of Lawrence D. Polizzotto, File No. 3-15458 (Sept. 6, 2013).

BANKING

FDIC Issues Final Rule Clarifying That Deposits in Foreign Branches of US Banks Are Not Insured

On September 12, the Board of Directors of the Federal Deposit Insurance Corporation (FDIC) approved a final rule clarifying that deposits in foreign branches of US banks are not FDIC-insured, even though they can be deposits for purposes of the national depositor preference statute enacted in 1993. Currently, under the Federal Deposit Insurance Act, funds deposited in foreign branches of US banks are not considered deposits, unless the funds are dually payable in the United States. In response to regulatory action from the UK regulator, the Prudential Regulation Authority, it is expected that some large US banks will change their deposit agreements to make their UK branch deposits payable in both the United Kingdom and the United States to provide depositor preference to UK branch deposits in foreign branches of US banks. The final rule clarifies that these UK branch deposits are not FDIC insured.

The final rule does not affect deposits in overseas military banking facilities governed by regulations of the Department of Defense. According to the FDIC, these funds "will continue to be insured by the FDIC to the same extent that they have been."

Read more.

CFPB Bulletin Warns Employers Against Exclusive Use of Payroll Cards

On September 12, the Consumer Financial Protection Bureau (CFPB) published a bulletin reminding employers that they cannot require their employees to receive wages on a payroll card. The bulletin also explains some of the federal consumer protections that apply to payroll cards, such as fee disclosure, access to account history, limited liability for unauthorized use and error resolution rights. The CFPB has heard

> reports of employers, particularly in the retail and food service industries, distributing wages solely through payroll cards. Federal law, however, prohibits employers from mandating that employees receive wages exclusively on a payroll card.… Some employees receiving wages on employer-sponsored payroll cards have complained of unexpected fees for activities such as ATM use, teller withdrawals, and checking the balance of a card.… Payroll card holders are entitled to receive disclosures of any fees that they may incur for electronic transfers of funds to or from the card. These disclosures must be clear, in writing, and in a form that consumers may keep.

A complete copy of the bulletin is available here.

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