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SEC/CORPORATE

Council of Institutional Investors Issues Report on Board Evaluation Disclosure

The Council of Institutional Investors (CII), an advocacy group for corporate governance and shareholder rights, has published a report that highlights two approaches to disclosure regarding a board's process of self-evaluation that CII's members (employee benefit funds, endowments and foundations, among others) consider "best-in-class." According to the report, CII's members want to better understand the process by which a board seeks to assess and improve its performance. In-depth disclosure regarding the board evaluation process is not, however, a common practice in the United States, where proxy disclosure regarding the self-assessment process is typically limited to statements that such a process exists. Comparatively robust disclosure of the evaluation process is more common in non-US jurisdictions, including Canada, the United Kingdom, Europe and Australia, where companies often detail what the evaluation process entails. According to CII, its members "are eager for details about the board evaluation process at U.S. companies."

Based on an informal survey in which CII gathered a selection of what its members considered "exemplary disclosure about the board evaluation process," CII identified two approaches to disclosure that its members find particularly useful. The first approach identified in the survey focuses on the mechanics of the board evaluation process. Although this type of disclosure does not discuss the findings of specific evaluations, it details who evaluates whom, how often evaluations are conducted, who reviews the results and how the board decides to address the results. The second approach noted in CII's report goes beyond a discussion of the board evaluation process to also include discussion of high-level, board-wide findings and remedial steps for areas identified for improvement in the most recent self-assessment. This second approach includes disclosure of key takeaways from the board's review of its own performance, including areas where the board determines it performs effectively, areas for improvement and a plan of action to address these points in the coming year. To be clear, neither of the approaches advocated in CII's report included, and shareholders generally do not expect, disclosure that reveals the details of individual director evaluations.

Click here to view the full text of CII's report, which includes examples of board evaluation disclosure determined by CII and its members to be "particularly effective."

BROKER-DEALER

FINRA Revises Proposal to Adopt Consolidated FINRA Rule 2231

On September 16, the Financial Industry Regulatory Authority, Inc. requested comments on a revised proposal to adopt consolidated FINRA Rule 2231 regarding Customer Account Statements. The proposed rule consolidates current NASD Rule 2340 and Incorporated NYSE Rule 409. In April 2009, FINRA initially proposed Rule 2231 with significant changes to the current rules, such as changing the requirement to send account statements from quarterly to monthly and allowing the direct transmission, upon the customer's written consent, of customer account statements and other documents to third parties. The revised proposal (1) retains the quarterly account statements provision and (2) allows customers to instruct that their account statements and other documents be sent directly by the FINRA member firm to third parties, as long as duplicates are sent directly to the customer and the customer provides written consent. The proposed rule also adds certain additional obligations on member firms including, *inter alia*, certain disclosure requirements to the account statements, including the identity of the introducing and clearing firm (if different), disclosures if the account statement includes assets that are not on the member firm's books and records, and requirements for when a member firm sends summary statements that consolidate assets held in different accounts. The proposed rule also allows member firms to use electronic media to fulfill their delivery obligations, provided that such use complies with the relevant Securities and Exchange Commission standards.

Click here to read more about the proposed rule.

PRIVATE INVESTMENT FUNDS

IRS Considers Whether Management Fees of an LLC Are Subject to Self-Employment Tax

A recent response by the Internal Revenue Service Chief Counsel (CCA) to an inquiry from one of its field office agents addressed the question of whether management fees earned by an investment manager organized as a limited liability company (LLC) and allocated to its members—all individuals—were subject to self-employment tax. (The CCA response is not a formal ruling and is not reviewed by the Treasury Department before its issuance, but does indicate the current thinking of the IRS National Office.) The CCA concluded that the individual members of the LLC could not exclude their share of the LLC's income from self-employment tax because they are actively participating in the LLC's provision of management services to the investment funds paying the applicable management fees. By statute (Internal Revenue Code Section 1402(a)(13)), a "limited partner's" share of partnership income generally is not subject to self-employment tax. The CCA determined that LLC members are not "limited partners" under local law and that the individuals in question were not receiving allocable shares of the LLC's management income in a passive capacity. The CCA did not address whether management fee income earned by a limited partnership and allocated to its limited partners is subject to self-employment tax. It is possible that the IRS may issue future guidance in this area, and is therefore important to make sure that individuals who are limited partners in investment managers formed as limited partnerships should be careful not to perform services for the partnership in their capacity as partners in the partnership.

CFTC

Judge Rules in Favor of CFTC on Cross-Border Application of Dodd-Frank Rules

On September 16, Judge Paul L. Friedman of the US District Court for the District of Columbia denied a challenge to the extraterritorial application of certain Commodity Futures Trading Commission rules promulgated under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Title VII Rules), and the CFTC's Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations (Cross-Border Guidance), in which the CFTC articulated its intentions regarding the extraterritorial application of the Title VII Rules. The complaint filed by the Securities Industry and Financial Markets Association, International Swaps and Derivatives Association, and Institute of International bankers (collectively, Plaintiffs) alleged, *inter alia*, that the CFTC violated the notice-and-comment requirements of the Administrative Procedure Act (APA) and the cost-benefit analysis requirements of the Commodity Exchange Act in promulgating the Title VII Rules and the Cross-Border Guidance. Plaintiffs sought a declaratory judgment that the Title VII Rules and Cross-Border Guidance were procedurally and substantively infirm, and requested that the court vacate the Cross-Border Guidance and Title VII Rules to the extent of their extraterritorial application.

The District Court accepted the CFTC's view that nothing in the Cross-Border Guidance created new obligations or made substantive changes to existing law. The District Court characterized the Cross-Border Guidance as a non-binding policy statement and interpretive rule that was not, in the absence of CFTC action to enforce the Cross-Border Guidance, "final agency action" subject to review under the APA. The District Court also held that the Plaintiffs did not have standing to challenge the CFTC's "made available to trade" (MAT) rules, which require that swaps that are MAT be traded only on a CFTC-registered swap execution facility (SEF) or designated contract market because the Plaintiffs failed to demonstrate how the MAT rules harm any members of their organizations that might otherwise have standing to challenge the CFTC directly.

In addressing the remaining Title VII Rules, the District Court found that the CFTC had not adequately performed a cost-benefit analysis with respect to the cross-border application of the following CFTC regulations: Part 43 (real time reporting), Part 45 (swap data reporting), Part 46 historical swap data reporting, swap dealer (SD) and major swap participant (MSP) registration, the SD and MSP definitions, SD and futures commission merchant internal business conduct requirements, SD portfolio reconciliation and documentation, and SEF registration. The District Court stated that the CFTC must "consider" and "evaluate" the costs of each rule, but could do so by specifying which costs and benefits in its previously conducted analyses apply to the extraterritorial application of each of those rules. Because the CFTC's error was one of form and not substance, the District Court remanded to the CFTC for further cost-benefit analysis but did not vacate those rules.

The District Court's opinion is available here.

CFTC Proposes Margin Rules for Uncleared Swaps

On September 17, the Commodity Futures Trading Commission issued proposed rules that would impose margin requirements on certain market participants with respect to their transactions in uncleared swaps. Similar to the proposal that was recently issued by the Board of Governors of the Federal Reserve system and other federal prudential regulators (Prudential Regulators) (as summarized in the September 5, 2014 edition of *Corporate and Financial Weekly Digest*), the CFTC's proposed rules would require swap dealers (SDs) and major swap participants (MSPs) to post and collect initial margin with respect to the swaps they transact with other SDs and MSPs, as well as with respect to the swaps they transact with financial end users whose level of trading activity in the foreign exchange and swap markets exceeds certain thresholds. The proposal would also establish mandatory variation margin requirements for swaps between SDs, MSPs and financial end users (without regard to their level of trading activity). The proposed rules do not impose mandatory margin requirements for transactions involving commercial end users, but leaves this matter to be negotiated between the parties. Like the Prudential Regulators' margin proposal, the CFTC's proposal would require variation margin to be collected in cash commencing on December 1, 2015, while initial margin requirements would be phased in over a four-year period commencing on that date.

More information on the proposed rule is available here.

LITIGATION

Delaware Court Denies Dismissal for Disinterested Directors When Entire Fairness Applies

The Delaware Court of Chancery recently addressed the pleading standard for claims against disinterested directors arising out of transactions involving a controlling stockholder, where the transaction has been alleged to be unfair to the minority shareholders. The court held that the entire fairness standard of review applies to an allegedly unfair, interested shareholder transaction and precludes dismissal of the disinterested director at the pleading stage, even in the face of an exculpatory charter provision under 8 Del. Code § 102(b)(7). The court found that specific allegations of breaches of loyalty or bad faith are not required to overcome a motion to dismiss. Further, the determination whether the disinterested directors are insulated from liability under the exculpatory provision may only be made on a fully developed factual record.

The lawsuit arose out of a merger between Cornerstone Therapeutics, a publicly traded Delaware pharmaceutical company, and Chiesi Farmaceutici, a privately held Italian drug manufacturer. When Chiesi was the beneficial owner of 65.4 percent of Cornerstone common stock, it offered to acquire all of the outstanding shares of Cornerstone common stock. The Cornerstone board formed a Special Committee of five disinterested directors to review the offer. After months of negotiations over the terms of the acquisition, Chiesi and the Special Committee reached an agreement, and the merger was thereafter approved by more than 80 percent of the minority stockholders. This was not a pre-existing condition of the deal. Plaintiffs subsequently filed complaints alleging three counts against the directors, Chiesi and the company, including claims of breach of fiduciary duty against the disinterested directors who either served on the Special Committee or voted to approve the transaction. The disinterested directors moved to dismiss, arguing that plaintiffs failed to plead specific facts to suggest that each individual disinterested director breached a non-exculpated duty.

The court denied the motion after thorough consideration of the underpinnings and development of the Delaware doctrine of entire fairness review, which applies where a controlling shareholder stands on both sides of a transaction. In that circumstance, proof that the transaction is entirely fair to the corporation is necessary and the deference of the business judgment rule is unavailable. A recent Delaware Supreme Court decision refined the law further, holding that if a transaction involving a controlling shareholder is conditioned *at the outset* on the approval of *both* a special committee of disinterested shareholders *and* a majority of minority stockholders, the business judgment rule is applicable, thereby putting the burden on the plaintiff to allege a breach of fiduciary duty by the disinterested shareholder. In this case, both conditions were not met and the court found that the pleading was sufficient to withstand a motion to dismiss even without specific allegations of breached duties of loyalty or bad faith with respect to each individual director. The complaint alleged that the interested shareholder had control over the corporate machinery (the majority of votes and composition of the board), which was used to review and approve the deal and the disinterested directors negotiated or facilitated an unfair transaction. The determination of whether the directors were exculpated in the event the transaction was found to be unfair would be made only after a fully developed factual record.

In re Cornerstone Therapeutics Inc. Stockholder Litig., No. 8922-VCG (Del. Ch. Sept. 10, 2014).

UK DEVELOPMENTS

Insider Dealers Ordered to Pay Confiscation Orders in Excess of the Profits Generated from Insider Dealing

On September 15, the UK Financial Conduct Authority (FCA) published a press release in which it announced that a group of persons found guilty of insider dealing in 2012 and 2013 have now been ordered to pay more than £3.2 million in confiscation orders.

The confiscation orders were made between September 10 and 15 against Ali Mustafa, Paresh Shah, Neten Shah, Bijal Shah, Truptesh Patel and Richard Joseph. The £3.2 million ordered to be confiscated by the English courts far exceeds the profits generated directly from the insider dealing (which amounted to £732,044.59 (accrued by Mustafa, the Shahs and Patel) and £591,115 (Joseph)) and is the clearest indication to date that the English courts are now prepared to assume that persons found guilty of insider dealing must have profits from other illegal trading activity that took place within the same period.

Mustafa, the Shahs and Patel were all employed in the print room at JP Morgan Cazenove and were sentenced to jail terms totalling 16 years in July 2012 following the largest and most complex insider dealing investigation that the Financial Services Authority (FSA) (the FCA's predecessor) had ever been involved in prosecuting. The defendants used information obtained from the print room to place spread bets on proposed or forthcoming takeover bids involving JP Morgan Cazenove's clients. Joseph, an unemployed futures trader, was found guilty of six counts of conspiracy to deal as an insider and sentenced to four years' imprisonment on each count (to be served concurrently) in March 2013. He had been supplied with inside information from Mustafa, who was a print room manager at JP Morgan Cazenove and who subsequently fled the country and remains on the run from police (it is believed he is in North Cyprus).

Tracey McDermott, director of Enforcement and Financial Crime at the FCA, said, "These individuals engaged in a sophisticated scheme to try and make easy money by exploiting inside information. As a result they have not only lost their liberty, their livelihoods and their reputations but they have also now been ordered to pay significant sums in confiscation. This should be a clear message to others that insider dealing does not pay."

If the individuals do not pay the amounts ordered under the confiscation order they face further jail sentences in default of payment:

For many years the FSA was seen as a soft-touch for its failure to crack down on what many people considered to be flagrant abuses of the UK financial markets. However, the 2012 enforcement action against Mustafa, the Shahs and Patel was seen by many as too little, too late, as the FSA was broken up into the FCA and the Prudential Regulation Authority on April 1, 2013. As a new regulatory authority in the United Kingdom, the FCA has taken a hard and serious stance on insider dealing and is currently prosecuting eight more individuals for insider dealing with trial dates set for January 2016.

EU DEVELOPMENTS

US, EU Regulators Voice Hopes for Deal on Clearinghouse Oversight

Top US and EU regulators have indicated in the last week a shared desire to agree on a framework for the trans-Atlantic supervision of clearinghouses. The impetus for the current round of discussions is the upcoming deadline of December 15, 2014, which is the date on which new European capital requirements threaten to impose significant capital charges on EU banks with subsidiaries that are clearing members of non-EU clearinghouses that have not been recognized as equivalent under the European Market Infrastructure Directive (EMIR). The European Commission (EC) has already extended the deadline for the imposition of the new capital rules from June 15, 2014 in order to provide sufficient time to reach an agreement.

On September 12, Michel Barnier, the member of the EC responsible for financial services, noted in a speech to the Eurofi Financial Forum that he is in “daily discussions” with Timothy Massad, the new chairman of the US Commodity Futures Trading Commission. Barnier indicated his intention to “find practical solutions,” but also warned that “it takes two to tango” and that “the American side must also deliver.” In his opening statement to the September 17 public meeting of the CFTC, Chairman Massad responded by noting that he is “firmly committed” to working with the EC and stated that “it is very important that [the EC] recognize our exchanges and clearinghouses” in order to prevent any interruption in the trans-atlantic derivatives markets. In particular, Chairman Massad noted with approval the existing system of “dual registration” of clearinghouses, where a single entity is simultaneously subject to registration and regulation by both the US and European authorities. It is within the context of dual registration, according to Massad, that the requirements relating to effective recognition of US clearinghouses under EMIR will be addressed. Both Barnier and Massad suggested that a deal could be struck within a matter of weeks.

Commissioner Barnier’s speech can be found here. Chairman Massad’s statement can be found here.

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