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SEC/CORPORATE

SEC Proposes Rules for Security-based Swap Activity of Non-US Persons in the United States

On April 29, the Securities and Exchange Commission (SEC) proposed some additional rules for security-based swaps (SBS) that reflect a firm belief (shared by the Commodity Futures Trading Commission) that derivatives activity that takes place in the United States must be subject to relevant US regulation even if the resulting transaction will be one involving only non-US persons.

The key points of the proposed rules are as follows:

1. A non-U.S. person must include in its SBS dealer and major SBS participant calculations any SBS connected with its dealing activity that it arranges, negotiates or executes using its own personnel, or personnel of an agent, in each case located in the United States.

2. An SBS involving a non-US person is subject to Regulation SBSR's regulatory reporting and public dissemination requirements if it meets any of the following conditions:

    a. It is executed on a platform having its principal place of business in the United States;
    b. It is effected by or through a registered broker-dealer (including a registered security-based swap execution facility); or
    c. It is connected with a non-US person's SBS dealing activity and is arranged, negotiated or executed by personnel of a non-US person located in a US branch or office, or by personnel of an agent of a non-US person located in a US branch or office.

3. A non-US person that is registered with the SEC as an SBS dealer must comply with the external business conduct standards for any SBS arranged, negotiated or executed by US-based personnel or agents.

Although these three points collectively will add significant additional US regulation to some SBS transactions between non-US persons, the SEC takes the position in the preamble to the proposed rules that mandatory clearing and trade execution are *not* applicable to such transaction solely because one or both counterparties arrange, negotiate or execute the security-based swap using personnel located in the United States.

The concepts of "arranging" and "negotiating" an SBS are not specifically defined in the proposed regulations, but the SEC explains in the preamble that these terms are intended to encompass only market-facing activity of sales or trading personnel in connection with a particular transaction, including interactions with counterparties or their agents, as opposed to the activities of persons involved in swap operations or documentation. The SEC also explains that the term "execute" refers to the market-facing act that, in connection with a particular transaction, causes a party to become irrevocably bound to the terms of an SBS under applicable law.

The SEC states in the preamble that it has consulted and coordinated with the CFTC as well as with banking and foreign regulators in formulating its proposal. That statement suggests that the next iteration of CFTC cross-border guidance may take a similar approach to regulating swap activity of non-US persons that takes place in the United States.

The deadline for comments on the proposed regulations is 60 days after they are published in the Federal Register (which has yet to occur).

The proposed rules are available here.

BROKER-DEALER

FINRA Proposes Exemption From the TAF for Proprietary Trading Firms

On March 25, the Securities and Exchange Commission proposed amendments to Rule 15b9-1 under the Securities Exchange Act of 1934 to require broker-dealers that engage in off-exchange proprietary trading to become members of a registered national securities association such as FINRA (the *Corporate & Financial Weekly Digest* article describing this proposal is available here). On May 4, the Financial Industry Regulatory Authority released Regulatory Notice 15-13 to request comment on a proposal that would exempt proprietary trading firms, that would be required to become FINRA members under the SEC's proposed amendments, from FINRA's Trading Activity Fee (TAF).

The TAF is based on trading activity and generally applies to all sales of a covered security regardless of where it is executed. FINRA has analyzed the potential impact that the TAF would have on proprietary trading firms and believes that, for certain trades, the resulting costs incurred by these firms would be disproportionate to FINRA's anticipated costs of monitoring these transactions. As such, FINRA is requesting comments on a proposed exemption to the TAF for transactions effected by proprietary trading firms on those exchanges at which they are a member. The comment period ends June 19.

FINRA Regulatory Notice 15-13 is available here.

SEC Approves Pilot to Assess Tick Size Impact for Smaller Companies

On May 6, the Securities and Exchange Commission approved a proposal by the national securities exchanges and the Financial Industry Regulatory Authority to implement a two-year pilot program that widens the permissible minimum quoting and trading increments—or tick sizes—for stocks issued by smaller companies.

The pilot program will include approximately 1,400 securities consisting of stocks issued by companies with $3 billion or less in market capitalization, an average daily trading volume of one million shares or less and a volume weighted average price of at least $2.00 for every trading day. The stocks in the pilot program will be divided into a control group and three test groups with 400 securities in each test group. Pilot securities in the control group will continue to be quoted and traded at any price increment currently permitted. Securities in the first test group will be quoted in $0.05 minimum increments, but orders priced to execute based on the midpoint could be ranked and accepted in increments of less than $0.05. Securities in the second test group also will be quoted in $0.05 minimum increments, and will trade at $0.05 minimum increments, subject to certain exceptions. Securities in the third test group will be subject to the same conditions as the second test group, but will be subject to a trade-at prohibition to prevent price matching by a trading center that is not displaying the best bid or offer.

Data generated during the pilot program will be made public to assist in determining the program's impact on smaller capitalization stocks. The exchanges and FINRA will submit their initial assessments of the pilot program's impact 18 months after the program begins based on data generated during the first 12 months of its operation.

Notice of the SEC's order of approval is available here.

CFTC

CFTC Determines That Wholly Owned Securitization SPVs of Captive Finance Companies May Elect End-User Exception

In an interpretive letter published on May 4, the Commodity Futures Trading Commission's Division of Clearing and Risk (Division) confirmed that a securitization special purpose vehicle (SPV) that is wholly owned by, and consolidated with, a finance company that meets the criteria set out in the "captive finance company exception" found in Section 2(h)(7)(C)(iii) of the Commodity Exchange Act (CEA), may elect the End-User Exception from a clearing requirement determination issued under Section 2(h) of the CEA. The Division's letter responds to an inquiry of Ford Motor Credit Company LLC (Ford Credit), which sought confirmation that its securitization SPVs satisfy the first element of Section 2(h)(7)(C)(iii) of the CEA, i.e., that the entity's "primary business" is "providing financing."

Ford Credit, a wholly owned subsidiary of Ford Motor Company (Ford), provides financing for the purchase and lease of Ford-manufactured vehicles. Ford Credit finances a number of its receivables through securitization transactions where it sells pools of its receivables to wholly owned SPVs. Each SPV's sole purpose is to facilitate the securitization. The SPV sells debt securities and the SPV's trustee pays interest on debt securities to investors. If the SPV issues floating-rate debt obligations, the SPV will enter into an interest rate swap with a swap dealer to mitigate its interest rate exposure between the cash flow from the SPV's receivables, which are fixed-rate obligations, and the interest due on the debt securities, which are floating-rate obligations.

The End-User Exception generally is not available to a "Financial Entity." However, Section 2(h)(7)(C)(iii) of the CEA permits a finance company to elect the End-User Exception if it meets a four-prong test: (1) the company's primary business is providing financing; (2) the company uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures; (3) 90 percent or more of the interest rate and currency exposures for which the entity is using derivatives to hedge the related underlying commercial risks arise from financing that facilitates the purchase or lease of products; and (4) 90 percent or more of the products, the purchase or sale of which are being facilitated by the financing, are manufactured by the parent company or another subsidiary of the parent company.

Because (1) Ford Credit qualifies for the captive finance company exception, (2) Ford Credit's securitization SPVs are wholly owned by Ford Credit, (3) its SPVs' financial statements are consolidated with Ford Credit's, and (4) its SPVs' sole activity is facilitating financing undertaken by Ford Credit, the Division determined that Ford Credit's securitization SPVs are primarily involved in "providing financing" and, therefore, satisfy the first element of Section 2(h)(7)(C)(iii) of the CEA. Consequently, Ford Credit's securitization SPVs also are treated as captive finance companies and are eligible to elect the End-User Exception of the CEA. The Division further noted that its determination covers any similarly situated securitization SPV that is wholly owned by, and consolidated with, a captive finance company.

CFTC Letter No. 15-27 is available here.

Katten Muchin Rosenman LLP advised Ford Credit in connection with its interpretive request to the CFTC.

CFTC's Market Risk Advisory Committee to Meet on June 2

The Commodity Futures Trading Commission's Market Risk Advisory Committee (MRAC) will hold a public meeting at the CFTC's headquarters in Washington, DC on June 2. MRAC will consider issues including the appropriate industry response to cybersecurity threats and the concentration of futures commission merchants and its effect on market liquidity. Members of the public may attend the meeting on a first-come, first-served basis, watch the live webcast at www.cftc.gov, or listen to the meeting via a live, toll-free conference call.

CFTC's Press Release 7170-15 is available here.

LITIGATION

District Court Dismisses Securities Class Action Against Electronic Arts

The US District Court for the Northern District of California recently dismissed with prejudice a securities fraud class action against Electronic Arts, Inc. (EA) and its officers, holding that the plaintiffs' amended complaint failed to identify any actionable misstatements by the defendants. The court had dismissed the plaintiffs' prior complaint in 2014 with leave to amend.

The complaint arises out of the 2013 release of the game "Battlefield 4" (BF4). According to the complaint, EA and its executives made a series of statements suggesting to the market that the company had learned from technical problems associated with prior new game releases, and that Battlefield 4 was less likely to experience a problematic launch. In particular, the plaintiffs challenged statements suggesting that EA had "de-risked" its technology for transitioning to new games and new game systems.

Following the game's release, however, customers complained that Battlefield 4 suffered from technical defects and crashes. The complaint alleges that EA's stock price declined due to these customer complaints and certain negative press associated with the release of Battlefield 4.

The court granted EA's motion to dismiss on the ground that the challenged statements were inactionable "corporate optimism and puffery." First, the court found that the term "de-risk" was too vague to be actionable and that plaintiffs did not establish that the term had a specialized and concrete meaning in the video game industry. The court also held that the additional statements regarding lessons learned from past launches were non-actionable optimism and puffery. Lastly, the court held that the statements made by EA's chief executive officer regarding the "unfinished" character of the platform, when taken in context, referred to the new hardware systems on which BF4 was meant to run, and not the platform that EA used to develop the game.

Kelly v. Electronic Arts, Inc., 13-cv-05837-SI (N.D. Cal. April 30, 2015).

District Court Denies Motion to Dismiss Securities Class Action Against Urban Outfitters

The US District Court for the Eastern District of Pennsylvania recently denied a motion to dismiss filed by Urban Outfitters, Inc. and its senior executives in a securities fraud class action. The court found that the plaintiffs' claims were sufficiently particularized under the heightened pleading standard of the Private Securities Litigation Reform Act of 1995 (PSLRA).

The plaintiffs' complaint alleges that in 2013, the defendants made a series of statements to the market suggesting that the company's sales growth in its retail stores was steady, and that it was reducing its use of price markdowns. According to the plaintiffs, in contrast to Urban Outfitters' representations, sales growth was declining, the company was experiencing excess inventory and stores were marking down their prices on merchandise.

The plaintiffs relied on a number of "confidential witnesses" who are or were purportedly employees at Urban Outfitters' retail stores. The complaint alleged that these employees were able to observe declining sales figures and increasing markdowns because Urban Outfitters tracked this information in an internal Intranet available to all employees.

The court held that the plaintiffs' allegations were sufficiently particularized to survive a motion to dismiss. The court held that, while plaintiffs did not provide details such as the dates on which their confidential witnesses learned of their information, they did provide sufficient details regarding their access to such information through the company's Intranet. Additionally, the court noted that, according to the complaint, one senior executive sold $50 million of stock during the class period, while another officer sold 99 percent of his holdings shortly before the company announced negative results.

In re Urban Outfitters, Inc. Securities Litigation, No. 13-5978 (E.D. Penn. May 4, 2015).

EU DEVELOPMENTS

ESMA Releases Final Guidance on the Definition of Physically Settled Commodity Derivatives Under MiFID I

On May 7, the European Securities and Markets Authority (ESMA) issued final guidelines (Guidelines) clarifying the definition of physically settled commodity derivatives under the Markets in Financial Instruments Directive (MiFID) I. Because MiFID I is a directive and not a regulation, the definition of derivative, which includes physically settled commodity derivatives, has not been uniformly adopted by each of the national competent authorities. These national discrepancies have complicated a uniform application of the European Market Infrastructure Regulation (EMIR) because EMIR, in turn, defines a derivative in reference to the definition under MiFID. Without a single definition of “derivative”, EMIR, a regulation, cannot be implemented uniformly across the European Union. ESMA issued the Guidelines as a bridge measure until the European Commission issues its delegated acts in relation to the definition of derivatives under MiFID. II.

The Guidelines clarify the definition of derivative by specifying what is meant by “physically settled,” and that physically settled commodity forwards traded on a regulated market or a multilateral trading facility are included in the MiFID I definition. The Guidelines also clarify that the exemption applicable to physically settled commodity derivatives entered into for commercial purposes only applies to a limited number of energy transactions.

A copy of the Guidelines can be found here.

Further Delays in Transatlantic Clearing Accord

Commodity Futures Trading Commission Chairman Timothy Massad, and Jonathan Hill, European Commissioner for Financial Stability, Financial Services and Capital Markets Union, released a joint statement on May 7 relating to the ongoing discussions between the CFTC and the European Commission (EC) on an equivalence determination in respect to CFTC-registered derivatives clearing organizations located in the United States (US DCOs). The European Market Infrastructure Regulation (EMIR) provides that a central counterparty located outside the European Union (non-EU CCP) may only be granted the status of “recognized CCP” by the European Securities and Markets Authority (ESMA) where the EC has previously made a determination that the legal and regulatory requirements applicable to such non-EU CCPs in its home jurisdiction are equivalent to those imposed by EMIR. The EC adopted equivalence decisions in respect to Australia, Hong Kong, Japan and Singapore in late 2014, but has not yet made a decision in respect to the United States. In their joint statement, Massad and Hill state that discussions are “constructive and progressing” and they share the goal of reaching an agreed approach by this summer.

The inability of US DCOs to obtain recognized CCP status under EMIR poses risks to the transatlantic swaps markets. In particular, over-the-counter derivatives subject to a European mandatory clearing determination may not be submitted for clearing to a US DCO until such time as it becomes a recognized CCP. It also threatens to trigger consequences under the EU Capital Requirements Regulation (CRR), which requires European banks to hold capital for exposures to CCPs. These capital charges are significantly higher for exposures to any non-EU CCP that is not a recognized CCP under EMIR. In order to avoid the impact of these additional costs, clearing member subsidiaries of European banks could, therefore, withdraw from US DCOs, which could further fragment the transatlantic financial markets. In light of the ongoing discussions between the CFTC and the EC on CCP equivalence, the European Banking Committee (EBC) voted on April 24 to push back the compliance deadline for holding capital against CCP exposures under the CRR to December 15. The EBC already had granted an extension that would have expired on May 15.

This joint statement follows ESMA’s announcement last week that it had granted final recognition under EMIR to the following 10 non-EU CCPs located in Australia, Hong Kong, Japan and Singapore: ASX Clear (Futures) Pty Limited; ASX Clear Pty Limited; Hong Kong Securities Clearing Company Limited; HKFE Clearing Corporation Limited; OTC Clearing Hong Kong Limited; The SEHK Options Clearing House Limited; Japan Securities Clearing Corporation; Tokyo Financial Exchange; Central Depository (Pte) Limited; and Singapore Exchange Derivatives Clearing.

The joint Massad-Hill statement is available here. The list of third-country recognized CCPs maintained by ESMA is available here.

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