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BROKER DEALER

SEC and CFTC Adopt Joint Rules to Help Protect Investors from Identity Theft

The Securities and Exchange Commission, jointly with the Commodity Futures Trading Commission, adopted rules and guidelines to require certain entities regulated by the SEC and CFTC, such as broker-dealers, mutual funds and investment advisers, to establish and implement a written identity theft program. The SEC and CFTC adopted the rules in accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The rules require that the written identity theft program be designed to detect, prevent and mitigate identity theft in connection with certain existing accounts or the opening of new accounts. The program should include policies and procedures designed to: (i) identify relevant types of identity-theft red flags; (ii) detect the occurrence of those red flags; (iii) respond appropriately to the detected red flags; and (iv) periodically update the identity theft program. The rules require entities to provide such things as staff training and oversight of service providers. The rules include guidelines and examples of red flags to help firms develop and administer programs that would satisfy the requirements of the rules.

The final rules will become effective 30 days after publication in the *Federal Register*. The compliance date for the final rules will be six months after the effective date.

Click here to read the final rules.

CFTC

CME Block Trade Advisories Clarify Nonpublic Information Restrictions

In two recent market regulation advisory notices (RA1303-3 and RA1307-4), CME Group clarified its rules regarding the disclosure and use of nonpublic information based upon a solicitation to participate in a block trade. The advisories make clear that, while the counterparties to a block trade are permitted to initiate trades to hedge or offset the risk associated with the trade preceding the public report of the block trade by the exchange, they may do so only after the consummation of the block trade. Thus, pre-hedging or anticipatory hedging of any portion of a block trade in the same product or a closely related product based upon a solicitation to participate in a block trade is not permitted. The advisories further provide that parties who have been solicited to participate in a block trade may continue to transact in the marketplace in the context of their normal business, but may not use actionable nonpublic information regarding an imminent block trade or report of a block trade to their advantage.

Advisory notice RA1303-3 is available here.

Advisory notice RA 1307-4 is available here.

CFTC Staff Issues No-Action Letters

Commodity Futures Trading Commission staff recently released three no-action letters providing relief relating to swap data reporting requirements with respect to trade options, inter-affiliate swaps and real-time reporting for financial and non-financial entities.

- **Trade Options by End-Users**: In CFTC Letter No. 13-08, the Division of Market Oversight (DMO) granted no-action relief from certain reporting and recordkeeping requirements under the trade option exemption provided by CFTC Regulation 32.3 to entities that are not swap dealers or major swap participants (Non-SD/MSP). A Non-SD/MSP relying on this exemption must comply with all other trade option requirements and satisfy additional conditions, including the requirement that the Non-SD/MSP (i) report the commodity option transaction on Form TO (for relief from reporting requirements) and (ii) obtain a legal entity identifier (LEI) and provide such LEI to its swap dealer or major swap participant counterparty (for relief from recordkeeping requirements). CFTC Letter No. 13-08 is available here.

- **Inter-affiliate Swaps**: In CFTC Letter 13-09, DMO and the Division of Clearing and Risk issued no-action relief from certain swap reporting requirements with respect to swaps entered into between affiliates of certain wholly or majority-owned market participants. In particular, swaps entered into between wholly owned affiliates are not required to be reported; swaps entered into between majority-owned affiliates (or between a wholly owned and a majority-owned affiliate) may be reported on a quarterly, as opposed to a trade-by-trade, basis. In order to be eligible for such relief, market participants must satisfy several conditions. For example, an affiliated swap counterparty must not be a swap dealer or major swap participant, or be affiliated with such entities. This relief does not apply to swaps executed on a swap execution facility or designated contract market (DCM) or to swaps that are subject to mandatory clearing. Letter 13-09 also provides relief with respect to historical swaps between affiliates, which are exempt from all reporting requirements, provided the swaps were not executed on a DCM or submitted for clearing. Letter 13-09 is available here.

- **Swap Data Reporting Requirements for Non-SD/MSPs**: In CFTC Letter 13-10, DMO issued time-limited no-action relief from certain swap data reporting requirements to swap counterparties that are Non-SD/MSPs. As adopted, CFTC rules would have required Non-SD/MSPs to fully comply with the swap data reporting rules by April 10. Letter 13-10 provides relief under Parts 43 and 45 of the CFTC's regulations with respect to interest rate and credit swaps for Non-SD/MSPs that are not "financial entities," as defined in Section 2(h)(7)(C)(i) of the Commodity Exchange Act (Non-Financial Swap Counterparties) until July 1. With respect to equity, foreign exchange and other commodity swaps, DMO granted relief to Non-SD/MSPs that are financial entities (Financial Swap Counterparties) until May 29 and to Non-Financial Swap Counterparties until August 19. Relief under Part 46 was granted for all swap asset classes until September 30 for Financial Swap Counterparties and October 31 for Non-Financial Swap Counterparties. A person relying on this relief must report all relevant swap transaction data that would have been required to be reported but for the no-action relief within one month after the end of any applicable relief period under this no-action letter. Letter 13-10 is available here.

CFTC Issues Proposed Rule to Clarify Responsibilities of Clerical Employees of SDs and MSPs

In general, Commodity Futures Trading Commission Regulation 23.22 prohibits a swap dealer (SD) or major swap participant (MSP) from permitting an associated person (AP) of the SD or MSP to effect or be involved in effecting swaps on behalf of such SD or MSP if the AP is subject to a statutory disqualification. The CFTC has now proposed to amend Regulation 23.22 to make it inapplicable to the clerical or ministerial employees of an SD or MSP. The CFTC proposal, therefore, would make it unnecessary for SDs and MSPs to conduct extensive background checks on those employees.

The proposed rule is available here.

ICE Clear Europe Authorized to Portfolio Margin Swaps and Security-Based Swaps

The Commodity Futures Trading Commission issued an order (Order) permitting ICE Clear Europe Limited (ICE Clear Europe) and its clearing members that are registered both as broker-dealers under the Securities Exchange Act of 1934 and as futures commission merchants under the Commodity Exchange Act to hold customer collateral securing positions in cleared credit default swaps (CDS) and cleared security-based credit default swaps (SB CDS) in the same Commodity Exchange Act Section 4d(f) cleared swaps account. The Order further permits the portfolio margining of such CDS and SB CDS in the cleared swaps account. The CFTC Order follows a complementary order issued by the Securities and Exchange Commission permitting SB CDS to be commingled and portfolio margined with CDS in a cleared swaps account.

The Order is available here.

LITIGATION

Court Finds Section 15(a) of the Exchange Act Only Applicable in Domestic Transactions

The US District Court for the Northern District of Illinois recently granted defendants' motion to dismiss one count of a Securities and Exchange Commission complaint, finding that the registration requirement under Section 15(a) of the Securities and Exchange Act of 1934 (Exchange Act) did not apply to a foreign transaction.

The SEC charged certain defendants with having acted as brokers or dealers in connection with the foreign sales of stock without having been registered with the SEC pursuant to Section 15(a). Defendants moved to dismiss this claim arguing that because their activities did not involve the domestic sale of stock, they were not required to register under Section 15(a)(1). Defendants' argument was largely based on the 2010 decision by the US Supreme Court in *Morrison v. National Australia Bank Ltd.*, which found that Section 10(b) of the Exchange Act and Rule 10b-5 thereunder were not intended to provide a cause of action in federal courts for fraudulent conduct in connection with the sale of foreign securities, even if part of the fraudulent activities occurred in the United States. The Court in *Morrison* had held that the Exchange Act gave no indication that Congress intended it to have extraterritorial effect, and that whether a transaction was subject to Section 10(b) depended on whether it was a domestic or foreign transaction.

Here, defendants argued that because the regulatory purpose of Section 15(a) was virtually the same as that of Section 10(b), the same rationale should be applied and registration should only be required where a broker or dealer engaged in a domestic transaction. The SEC argued that unlike Section 10(b), Section 15 focuses on the "registration and regulation of brokers," not the underlying securities transactions, and therefore does not implicate *Morrison*.

The District Court agreed with defendants and found that given the intent of the Exchange Act, and in light of *Morrison,* a broker's failure to register under Section 15(a) was not actionable in cases where the ultimate transaction was foreign.

SEC v. Benger, No. 09 C 676 (N.D. Ill. Mar. 28, 2013).

Second Circuit Bars Criminal Defendant from Accessing Assets Frozen by Regulators

The US Court of Appeals for the Second Circuit recently upheld a district court's refusal to release nearly $4 million in assets frozen by the Securities and Exchange Commission and the Commodity Futures Trading Commission to help a defendant fund his criminal defense.

Stephen Walsh, a defendant in a criminal fraud case, had requested the release of $3.7 million in assets stemming from the sale of a house that had been seized by regulators in a parallel civil enforcement action. In denying Walsh's motion to access the frozen funds, the US District Court for the Southern District of New York found that the government had shown probable cause that the proceeds had been tainted by defendant's fraud, and were therefore subject to forfeiture. Though Walsh and his wife had purchased the home in question using funds unrelated to the fraud, Walsh ultimately acquired title to the home pursuant to a divorce settlement in exchange for a $12.5 million distributive award paid to his wife, at least $6 million of which, according to the court, was traceable to the fraud.

Agreeing with the District Court, the Second Circuit found that although the house itself was not a fungible asset, it was "an asset purchased with" the tainted funds from the marital estate by operation of the divorce agreement and affirmed the denial of defendant's request. Further, since Walsh's assets did not exceed $6 million at the time of his arrest, under the Second Circuit's "drugs-in, first-out" approach, all of his assets became traceable to the fraud.

U.S. v. Stephen Walsh, No. 12-2383-cr (2d Cir. Apr. 2, 2013).

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