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SEC/CORPORATE

Delaware Court of Chancery Rejects Controlling Stockholder Claims and Applies Business Judgment Rule to Merger Suits

In *In re KKR Financial Holdings LLC Shareholder Litigation*, C.A. No. 9210 (Del. Ch. Oct. 14, 2014), the Delaware Court of Chancery dismissed a shareholder derivative suit brought by shareholders of KKR Financial Holdings LLC (KFN) alleging, among other claims, a breach of fiduciary duties by each of (1) KKR & Co. L.P. (KKR), as an alleged controlling stockholder, and (2) KFN's board of directors, in connection with the acquisition by KKR of KFN in a stock-for-stock merger.

In dismissing plaintiff's claims, Chancellor Bouchard held that the business judgment rule, rather than the entire fairness standard, applied because (1) KKR, as a stockholder with less than a one percent ownership interest in KFN and no control over KFN's board of directors at the time the merger was approved, was not a controlling stockholder of KFN as a matter of law, and (2) plaintiffs failed to show that a majority of the KFN board was not disinterested in the transaction or independent from KKR. The court provided further that, even if a majority of the KFN board was not independent, the business judgment rule still would have applied because the merger was approved by a majority of shares held by disinterested stockholders in a fully informed vote.

Under the seminal case on controlling stockholders under Delaware law, *Kahn v. Lynch Communications Systems, Inc.*, 638 A.2d 1110 (Del. 1994), a stockholder may be considered controlling even if it owns less than 50 percent of the voting power of a company, so long as it nonetheless "exercises control over the business affairs of the corporation." In relying on recent decisions analyzing the scenarios under which a stockholder may be considered "controlling" under Delaware law, Chancellor Bouchard held that whether a stockholder exercises control over a company turns on whether the stockholder controls the company's board of directors. The court stated: "[I]n deciding whether a stockholder owes a fiduciary obligation to the other stockholders of a corporation in which it owns only a minority interest, the focus of the inquiry is on whether the stockholder can exercise actual control over the corporation's board."

In this case, the court held that KKR was not a controlling stockholder because (1) KKR's less than one percent ownership interest in KFN would not create any concern among KFN's directors that it possessed sufficient voting power to remove them from their positions and (2) KKR did not possess any contractual rights to appoint any (let alone a majority) of the members of the KFN board or to direct any action by the KFN board and could not exercise actual control over the KFN board. The court did not find it persuasive that an affiliate of KKR exercised day-to-day control over KFN's business operations since the ultimate authority to manage KFN remained with KFN's board.

The full opinion can be found here.

BROKER-DEALER

FINRA Remarks at the National Society of Compliance Professionals Conference

On October 20, Carlo di Florio, chief risk officer and head of strategy of the Financial Industry Regulatory Authority, gave a speech at the National Society of Compliance Professionals regarding risk and regulatory issues in the markets and FINRA's risk-based exam program, Comprehensive Automated Risk Data System (CARDS), the Consolidated Audit Trail (CAT) and FINRA's efforts to improve transparency.

Mr. di Florio cited algorithmic trading malfunctions that caused substantial market disruptions in recent years and said that FINRA and the Securities and Exchange Commission are focused on assessing whether firms' testing and controls related to high-frequency trading and other algorithmic trading strategies and trading systems are adequate. Mr. di Florio cautioned firms "to be prepared to address whether they conduct separate, independent, and robust pre-implementation testing of algorithms and trading systems."

Mr. di Florio mentioned that FINRA's board last month approved a proposal, for which FINRA will soon seek comment, that would require those who design, develop or direct the significant modification of an algorithmic strategy, and those who supervise such persons, to register with FINRA. FINRA will also publish guidance reminding firms of their existing supervisory obligations with regard to the development and deployment of algorithmic trading strategies and provide additional guidance to firms on effective controls and practices to monitor for and prevent potential adverse impacts on the market. The guidance will also cover firms' obligations in these areas, and supervision and control practices for firms and market participants that use algorithmic trading strategies.

Mr. di Florio said that FINRA and the SEC believe that more oversight is needed for dark pools, high-frequency trading and algorithmic trading and mentioned that FINRA's board last month approved a proposal for FINRA to publish volume information on equity securities in the over-the-counter market that is reported to FINRA's equity trade reporting facilities to be available for non-industry professionals.

With respect to cross-market surveillance, Mr. di Florio said that FINRA's initiative to implement CAT will enable it to collect, identify and link every customer order, cancellation, modification and trade execution for all exchange-listed equities, options and fixed income products across all US markets. With respect to CARDS, Mr. di Florio said that CARDS will allow FINRA to collect information in a standardized format across all firms on a regular basis and that the information that FINRA would collect through CARDS is substantially consistent with the information collected through exams. Mr. di Florio added that CARDS will help FINRA better understand the business profile of a firm and incorporate that understanding into FINRA's examination, surveillance, cycle planning and risk-assessment functions.

Mr. di Florio concluded the speech by discussing how firms should address conflicts of interest. Mr. di Florio said that FINRA believes an effective conflicts management framework should address the following considerations:

- establishing new product review processes that include perspectives independent from the business proposing products, that identify potential conflicts raised by new products, that restrict distribution of products that may pose conflicts that cannot be effectively mitigated and that periodically re-assesses products through post-launch reviews;
- making independent decisions in the wealth management business about the products offered without pressure to favor proprietary products or products for which the firm has revenue-sharing agreements;
- minimizing conflicts in compensation structures between customer and broker or firm interests where possible and including heightened supervision when conflicts remain; for example, around thresholds in a firm's compensation structure;
- mitigating conflicts of interest through disclosures and other information that enables customers to understand the factors that may affect a product's financial outcome—such as the use of scenarios and graphics for a particular product; and
- including "best-interest-of-the-customer" standards in codes of conduct that apply to brokers' personalized recommendations to retail customers in order to maintain and increase investor trust.

Click here for the full text of Mr. di Florio's speech.

CFTC

CFTC Issues Interpretation Regarding Accounting for Customer Margin Payments Using Automated Clearing House Payment Processing

On October 23, the Commodity Futures Trading Commission's Division of Swap Dealer and Intermediary Oversight (DSIO) issued an interpretation regarding the appropriate treatment of customer margin payments made to a futures commission merchant (FCM) using the Automated Clearing House (ACH) transaction system for purposes of compliance with CFTC Regulations 1.17, 1.22, 22.2, and 30.7. CFTC Regulations 1.22, 22.2, and 30.7(f) require each FCM to compute, as of the close of each business day, the amount by which each customer's account may be undermargined. An FCM must also maintain a sufficient amount of its own funds (i.e., the FCM's Residual Interest) equal to or in excess of the total customer undermargined amount. If the total customer undermargined amount exceeds an FCM's Residual Interest, the FCM must increase its Residual Interest prior to the clearing settlement cycle on the next business day for cleared swaps accounts (CFTC Regulation 22.2), and by 6:00 p.m.. Eastern Time the next business day for futures accounts (CFTC Regulation 1.22) and for foreign futures accounts (CFTC Regulation 30.7).

DSIO's interpretation confirms that, in computing the extent to which a customer's account may be undermargined, an FCM may credit a customer's trading account for a margin payment upon the FCM's initiation of an ACH withdrawal from the customer's bank account and is not required to wait until the funds are available in the FCM's customer funds accounts. To take advantage of this interpretation, an FCM must: (1) enter into a written agreement with the customer authorizing the FCM to initiate ACH withdrawals; (2) conduct adequate due diligence of the customer's credit risk; (3) establish a sufficient amount of Residual Interest as required by CFTC Regulation 1.11; (4) establish criteria to determine when certain customers must meet margin calls to ensure same-day receipt of funds; and (5) not have information that a customer's account will have insufficient funds to meet an ACH withdrawal or margin call. Further, if an ACH transaction is subsequently rejected by the customer's bank for any reason, the FCM must reverse the margin credit and may only credit the customer's account upon actual receipt of the margin payment.

DSIO has also confirmed that, for purposes of computing undermargined capital charges as required by CFTC Regulation 1.17(c)(5)(viii), an FCM may consider a customer's margin obligation met upon initiation of an ACH withdrawal by the FCM and is not required to take a capital charge for pending ACH transactions that ultimately clear into the customer's trading account.

Finally, DSIO addressed inquiries from FCMs regarding maintenance of Residual Interest on business days when futures markets are open but banking systems are closed. On such days DSIO stated that, for futures and cleared swaps customer accounts subject to the US banking system, an FCM is required to maintain Residual Interest sufficient to cover the total customer undermargined amount on the next business day the banking system is open and US derivatives clearing organizations conduct a settlement cycle.

With respect to foreign futures and options accounts, an FCM is required to maintain Residual Interest in the 30.7 accounts in an amount sufficient to cover the total customer undermargined amount computed as of the close of business each day by 6:00 p.m. Eastern Time on the next business day. Because holidays on foreign markets will vary, an FCM carrying foreign futures accounts is responsible for ensuring it maintains sufficient Residual Interest to cover the total customer undermargined amount as of 6:00 p.m. Eastern Time on the next business day.

CFTC Letter no. 14-129 is available here.

INVESTMENT COMPANIES AND INVESTMENT ADVISERS

SEC Denies Two Proposed Applications for Non-Transparent Active ETFs

The Division of Investment Management (Division) of the Securities and Exchange Commission took an unprecedented action on Wednesday in issuing a preliminary denial to two exemptive relief applications under the Investment Company Act of 1940 for the operation of a non-transparent active exchange-traded fund (ETF). The exemptive relief applications, filed by Precidian Investments (Precidian) for Precidian ETFs Trust and BlackRock

Fund Advisors for Spruce ETF Trust, relied upon a patented methodology developed by Precidian. Applications for non-transparent active ETFs filed by other managers that use different methodologies remain pending before the Division.

Precidian's non-transparent active ETF methodology relied upon authorized participant arbitrage between the published indicative intraday value per share of a fund's underlying assets and the current trading price of that fund's shares. Authorized participants could then create and redeem shares through a blind trust to preserve the identity of the non-transparent portfolio holdings.

The Division's releases noted specific issues related to the methodology, particularly in respect of the proposed arbitrage mechanism. Unless the SEC grants a request for a public hearing to discuss the issues, the Division's denial of the two applications is expected to stand.

SEC Release on Precidian ETFs Trust, et al.

SEC Release on Spruce ETF Trust, et al.

LITIGATION

SEC Sanctions Athena in First High-Frequency Trading Manipulation Case

On October 16, in a groundbreaking trading manipulation case, the Securities and Exchange Commission entered an Order instituting a settled administrative proceeding against high-frequency trading firm Athena Capital Research, LLC (Athena). The SEC claimed that from June through December 2009, on almost a daily basis, Athena engaged in a practice called "marking the close," buying or selling stocks shortly before the close of trading in order to push the market price and closing price. The SEC asserted that Athena used sophisticated algorithms and rapid trades to manipulate the closing price of tens of thousands of stocks to its benefit. Despite Athena's relatively small size, as a result of its high-frequency trading strategy, its trades constituted 70 percent of the total NASDAQ trading volume of the affected stocks in the final seconds of the day. According to the SEC, Athena designed a strategy to exploit order imbalances, which occur when there are more on-close orders to buy certain shares than to sell them, or the converse. Shortly before close of trading, NASDAQ releases information regarding the size and direction of potential imbalances to encourage market participants to fill imbalances. Athena would typically fill the imbalance immediately after NASDAQ's first imbalance message, and then engage in a series of rapid fire transactions on the opposite side of its order over the remaining minutes of the trading day. As a result, the SEC claimed Athena manipulated the prices of targeted stocks. These "manipulated" prices, in turn, were used by NASDAQ to set closing prices for on-close orders during its closing auction. Athena's internal email communications, quoted in the SEC Order, indicated that the firm was aware that the strategy might raise regulatory concerns. For example, one manager emailed another after the firm received a regulatory alert, "let's make sure we don't kill the golden goose."

Athena settled with the SEC and agreed to a censure, without admitting or denying the SEC's finding of violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Athena also agreed to cease and desist from further violations and pay a $1 million penalty.

SEC Announces Record Number of Enforcement Actions in FY 2014

Last week, the Securities and Exchange Commission provided a summary of its enforcement activities for its fiscal year 2014 (ending in September). The SEC announced that it brought a record 755 enforcement actions and obtained orders totaling $4.16 billion in disgorgement and penalties. This was a jump from the 686 enforcement actions and $3.4 billion in disgorgement and penalties obtained in FY 2013. More than 135 parties were charged with reporting and disclosure violations, and 80 individuals were charged with insider trading. FY 2014 also marked the highest penalties to date against individuals who violated the Foreign Corrupt Practices Act. The SEC touted litigation successes, included jury verdicts against individuals who used offshore trusts to conceal shares of public companies, and against a hedge fund manager who funneled money to a Ponzi scheme.

Several matters were first-time actions that highlighted new areas of focus for the SEC. Among these actions included an action involving risk controls required to provide customers with market access, an action under the

investment adviser “pay-to-play” rule, and claims against a private equity firm alleging fraud regarding allocation of the funds’ fees. The SEC also brought its first action under its new Municipalities Continuing Disclosure Cooperation Initiative, which encourages municipal issuers and underwriters to self-report violations. Further, the SEC’s whistleblower program saw increased activity, as nine whistleblowers received a total of $35 million, and the SEC brought anti-retaliation charges for the first time.

The SEC emphasized its intention to continue its aggressive enforcement strategy across a broad range of securities markets. It stressed its imposition of stiff penalties and demands for admissions in FY 2014, and attributed the record number of enforcement actions to improved and innovative use of technology to detect misconduct.

EU DEVELOPMENTS

Recap and Update: AIFM Directive for US Private Fund Managers

Now that three months have passed since the Alternative Investment Fund Managers (AIFM) Directive became binding law in all European Union jurisdictions, US private fund managers (whether hedge funds, private equity funds or other fund types) should ensure that they understand how the AIFM Directive applies to their activities, if at all, and what they need to do to comply with it.

As a starting point, US private fund managers should know that they are only within the scope of the AIFM Directive requirements if:

(1) they are managing one or more EU alternative investment funds (the definition of alternative investment fund (AIF) excludes managed accounts and UCITS funds); or

(2) they are marketing one or more AIFs to investors in the EU.

If a US manager does not conduct either of these activities, then the AIFM Directive will not be applicable to that manager *at all*.

Those US managers who are managing EU AIFs should already be fully compliant with the specific requirements of the AIFM Directive. However, those managers who have only recently begun considering conducting marketing activities in the EU should take advice on a country-by-country basis (depending on where they wish to conduct marketing in the EU) because the act of marketing an AIF in the EU will bring their activities for that specific AIF within the scope of the AIFM Directive. Before any marketing can take place the manager needs to ensure that it registers or files with the appropriate regulator(s), updates the marketing materials and incorporates a list of mandated disclosures, prepares for EU Annex IV filings, which are broadly akin to the SEC’s Form PF, and is prepared to make report disclosures annually, including audited accounts for the AIF and information regarding the compensation of the AIFM and its senior staff.

Furthermore, if the AIF marketed into the EU together with other funds managed by the same manager takes a control position in certain EU companies (generally defined as 50% or more of the voting rights), then there are far-reaching implications and compliance obligations that have to be complied with, including disclosure obligations regarding the shareholding level, negotiations and disclosures to employee/union representatives, and a requirement in certain circumstances not to facilitate, support or instruct any distribution, capital reduction, share redemption and/or acquisition of its own shares by the EU company.

For more detail, please refer to Katten’s October 2014 Client Briefing here.

CPMI-IOSCO Recovery of Financial Market Infrastructures Report

On October 15, the Committee on Payments and Market Infrastructures (CPMI) and the International Organization of Securities Commissioners (IOSCO) published a final report entitled, “Recovery of Financial Market Infrastructures” (the FMI Report). The FMI Report provides guidance to financial market infrastructures (FMIs) for designing recovery plans from market threats to prevent severe systematic disruptions or failures. FMIs include central counterparties, payment systems, trade repositories, and settlement systems.

The FMI Report, which was originally issued for consultation in August 2013, supplements the international standards for FMIs published by the Committee on Payment and Settlement Systems (now the CPMI) and IOSCO in April 2012 entitled, “Principles for Financial Market Infrastructures” (PFMIs). The FMI Report does not impose any additional standards, but rather provides guidance on how to implement those standards to establish effective recovery plans.

The FMI report mandates that FMIs should develop comprehensive and effective recovery tools to allocate any uncovered losses and to cover any liquidity shortfalls. Additionally, FMIs should put in place measures to address unbalanced positions and the replenishment of financial resources, including using the FMI’s own capital. The recovery plan should also set appropriate incentives for the FMI’s owners, participants and other relevant stakeholders to control and monitor any risk-taking activities of the FMI.

A copy of the FMI report can be found here. A copy of the PFMIs can be found here.

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