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# Market Solutions

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## In This Issue



**Market Solutions**

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*Market Solutions* is a quarterly newsletter about the activities of the Financial Markets Association as well as legislative/regulatory developments of interest to FMA members. The opinions expressed in this publication are those of the authors, not necessarily those of the Association and are not meant to constitute legal advice. *Market Solutions* is provided as a membership service of the **Financial Markets Association**, 333 2nd Street, NE - #104, Washington, DC 20002, *dp-fma@starpower.net*, 202/544-6327, *www.fmaweb.org*. Please let us have your suggestions on topics you would like to see addressed in future issues.



FINANCIAL MARKETS ASSOCIATION

# Weeding Out Bad Actors: The Rule 506 Bad Actor Provisions and Capital Markets Practice–One Year Later

*By Bradley Berman*
*Morrison & Foerster LLP*

As we approach the anniversary of the effectiveness of the Rule 506 bad actor provisions (if you don't happen to have it marked on your calendar, the new rules went into effect on September 23, 2013), it is a good time to survey how issuers and placement agents have adapted in response to the new rules.

Since the new rules became effective, the Securities and Exchange Commission Division of Corporation Finance has issued several sets of Compliance and Disclosure Interpretations (C&DI 260.14 –260.32).[1] Some of the C&DIs are applicable to Rule 506 continuous offering programs.

## The Compliance and Disclosure Interpretations

For example, C&DI 260.14 states, in part:

When is an issuer required to determine whether bad actor disqualification under Rule 506(d) applies?

**Answer:** Rule 506(d) disqualifies an offering of securities from reliance on a Rule 506 exemption from Securities Act registration. Issuers must therefore determine if they are subject to bad actor disqualification any time they are offering or selling securities in reliance on Rule 506... An issuer may reasonably rely on a covered person's agreement to provide notice of a *potential or actual* bad actor triggering event pursuant to, for example, contractual covenants, bylaw requirements, or an undertaking in a questionnaire or certification. However, if an offering is continuous, delayed, or long-lived, *the issuer must update its factual inquiry periodically* through bring-down of representations, questionnaires, and certifications, negative consent letters, periodic re-checking of public databases, and other steps, depending on the circumstances. [Emphasis added.]

A placement agent in a continuous offering program should consider including an issuer covenant in the placement agent agreement to the effect that the issuer has exercised reasonable care to determine whether any covered person is subject to a bad actor disqualification, and that the issuer will notify the placement agent in writing of any bad actor disqualification relating to any covered person, or any event that would, with the passage of time, become such a disqualification event. The placement agent may wish to include in the placement agent agreement an issuer covenant

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# Legislative/Regulatory Actions

*This column was written by lawyers from Morrison & Foerster LLP to update selected key legislative and regulatory developments affecting financial services and capital markets activities. Because of the generality of this column, the information provided herein may not be applicable in all situations, and should not be acted upon without specific legal advice based on particular situations.*

In this issue, we address various selected developments from the **Banking Regulators**, the Dodd-Frank Act's **Title VII**, and the **Consumer Financial Protection Bureau (CFPB)**.

## BANKING REGULATORS

### U.S. Banking Regulators Issue Finalized Liquidity Coverage Ratio

On September 3, 2014, the Federal Reserve Board, FDIC, and the OCC (the "Agencies") issued the final Liquidity Coverage Ratio (LCR) rule to strengthen the liquidity positions of large financial institutions. The rule requires banking organizations subject to the rule to maintain high quality, liquid assets (HQLA), such as central bank reserves and government and corporate debt, that can be converted easily and quickly into cash in an amount equal to or greater than its projected cash outflows minus its projected cash inflows during a 30-day stress period. Similar to the proposal, the final rule sets forth three categories of eligible HQLA, the lower two of which would be assigned haircuts. The rule also restricts the amounts of the lower two HQLA that comprise the total HQLA amount, and specifies methods for calculating net cash outflows.

The rule applies to banking organizations having total consolidated assets of $250 billion or more or total consolidated on-balance sheet foreign exposure of $10 billion or more, and any subsidiary depository institutions with $10 billion or more of total consolidated assets ("covered companies"). The rule will also apply a less stringent, modified LCR to bank holding companies and savings and loan holding companies without significant insurance operations that, in each case, have $50 billion or more in total assets but do not meet the above thresholds ("modified companies"). The final rule does not apply to foreign banking organizations or U.S. intermediate holding companies that are required to be established under the Board's Regulation YY, other than those companies that are otherwise considered to be covered companies.

The final rule also establishes a framework for a flexible supervisory response when a covered company's LCR falls below 100 percent. Under the final rule, a covered company must notify the appropriate Agency on any business day that its LCR is less than 100 percent. In addition, if a covered company's LCR is below 100 percent for three consecutive business days, the covered company must submit a plan for remediation of the shortfall. The LCR will complement existing supervisory guidance and the more qualitative and internal stress test requirements in the Board's Regulation YY.

Covered companies with $700 billion or more in consolidated assets or $10 trillion or more in custodied assets must begin daily LCR calculations on July 1, 2015. Other covered companies have until July 1, 2016 to comply with the daily calculation requirement. All covered companies must calculate their LCR at the end of each month starting on January 1, 2015, the effective date of the final rule. Modified companies are only required to calculate their LCR at the end of each month, beginning on January 1, 2016.

For more information, please read our client alert at ***http://www.mofo.com/~/media/Files/ClientAlert/2014/09/140904FinalizedLiquidityCoverageRatio.pdf.***

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## FMA Welcomes New Members!

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| Jordan Costa | JPMorgan Chase & Co. |
| Kurt Eidemiller | U.S. Dept of the Treasury |

## *Weeding Out Bad Actors…*

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to periodically update its factual inquiries of any covered persons. Similarly, the issuer may want to include a mirror representation from the placement agent regarding periodic inquiries of any of the placement agent's covered persons.

The timing of periodic updates by an issuer or a placement agent in a continuous offering program remains open; the SEC has not, and probably will not, identify a specific timeline. The SEC previously stated that "[t]he timeframe for inquiry should also be reasonable in relation to the circumstances of the offering and the participants."[2]

> *"A placement agent in a continuous offering program should consider including an issuer covenant in the placement agent agreement to the effect that the issuer has exercised reasonable care to determine whether any covered person is subject to a bad actor disqualification…."*

Despite careful diligence by an issuer of its covered persons, there may be times during a continuous offering program when the issuer discovers that a covered person is subject to a disqualification. If, despite the exercise of reasonable care, the issuer was unable to determine the existence of a disqualifying event or that a particular person was a covered person, or initially reasonably determined that the person was not a covered person but subsequently learned that that determination was incorrect, then the reasonable care exception of Rule 506(d)(2)(iv) will be available for the issuer. The issuer must then consider what steps are appropriate upon discovery of the Rule 506 disqualifying event. The SEC suggested that those steps might include seeking waivers of disqualification, termination of the relationship with the covered person or persons, providing Rule 506(e) disclosure, or taking other remedial steps to address the disqualification to ensure that the Rule 506 exemption will remain available.[3,4]

Many continuous offering programs have multiple placement agents. Any of those agents may have agreements with other registered dealers to place the securities. Not all of these agents and dealers may be involved with a particular placement of the issuer's securities. At a reasonable time prior to the sale of the securities, the issuer must determine which agents and dealers will be involved in the sale. If any of these agents and dealers were the subject of any matters that would have disqualified them from using Rule 506 prior to the effectiveness of Rule 506(d) (i.e., prior to September 23, 2013), then Rule 506(e) disclosure must be made to all investors in the offering – whether or not they purchased the securities from the issuer through the particular agent or dealer that is the subject of the disclosure. No disclosure of such pre-effective bad actor events relating to a placement agent on the program that is not involved in the offering need be made to investors in that offering.[5]

Other valuable guidance was provided by the new C&DIs, some of which is summarized below:

- An "affiliated issuer," for purposes of Rule 506(d), is an affiliate (as defined in Rule 501(b)) of the issuer that is issuing securities in the same offering, including offerings subject to integration pursuant to Rule 502(a).[6]
- Persons whose sole involvement with a Rule 506 offering is as members of a compensated solicitor's deal or transaction committee that is responsible for approving such compensated solicitor's participation in the offering are not "participating" in a Rule 506 offering, for purposes of Rule 506(d)(1).[7]
- Actions taken in jurisdictions other than the United States, such as convictions, court orders, injunctions in a foreign court, or regulatory orders issued by foreign regulatory authorities will not trigger a disqualification under Rule 506(d).[8]
- Rule 506(e) does not mandate disclosure of past events that would no longer trigger a disqualification under Rule 506(d), such as a criminal conviction that occurred more than ten years prior to an offering or a bar that is no longer in effect at the time of the offering.[9]
- A shareholder that becomes a 20% beneficial owner of the issuer's voting equity securities upon completion of the sale of securities in a Rule 506

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## Weeding Out Bad Actors…

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offering is not a 20% beneficial owner at the time of the sale, for purposes of determining who is a covered person with respect to that offering.[10]

- The term "beneficial owner," as used in Rule 506(d), is interpreted the same way as under Rule 13d-3 under the Securities Exchange Act of 1934; beneficial ownership includes both direct and indirect interests, determined as under Rule 13d-3. Consequently, one must look through entities to their controlling persons.[11]
- If there is 20% beneficial ownership of the issuer's voting equity securities by shareholders that have formed a group, the disqualification or disclosure obligations will apply to triggering events that apply only to the group itself, assuming that no member of the group is a 20% beneficial owner. Here, the SEC used the example of a group being formed by means of a voting agreement. If any party to the voting agreement has or shares power to vote or direct the vote of shares beneficially owned by other parties to the agreement, then beneficial ownership of such shares will be attributed to that party.[12] In those circumstances, one would look not only at the group itself, but also through the group to the parties to the voting agreement and determine whether any such party is a 20% beneficial owner due to such aggregated voting power and whether that party is subject to a disqualification event.[13]

> *"The timing of periodic updates by an issuer or a placement agent in a continuous offering program remains open; the SEC has not, and probably will not, identify a specific timeline."*

There are still some open issues relating to Rule 506(d) offerings that have not been addressed by the new C&DIs. For example:

***Matchmaking portals***. Are operators of matchmaking portals compensated solicitors subject to the disqualification provisions?

- Most likely not, if they are not receiving transaction-based compensation. Section 4(b)(1) of the Securities Act of 1933 provides an exemption from broker-dealer registration for persons operating what is commonly known as a matchmaking portal for Rule 506 offerings of securities to accredited investors, provided, among other requirements, that those persons receive no compensation in connection with the purchase or sale of such securities. In C&DI 260.17, the SEC noted that compensated solicitors are not limited to brokers who are subject to registration under Section 15(a)(1) of the Exchange Act. The SEC stated that "all persons who have been or will be paid, directly or indirectly, remuneration for solicitation of purchasers are covered by Rule 506(d), regardless of whether they are, or are required to be registered under ... Section 15(a)(1) ...."14 Although not directly addressed by the SEC, it appears that a matchmaking portal that satisfies the exemption from broker or dealer registration provided by Section 4(b)(1) of the Securities Act could not be operated by a compensated solicitor.

***Diligence by placement agents.*** Most of what the SEC has said about diligence procedures is in the context of a reasonable investigation by the issuer. In the Adopting Release, the SEC stated that they anticipated that "financial intermediaries and other market participants will develop procedures for assisting issuers in gathering the information necessary to satisfy the issuer's factual inquiry requirement."[15]

- It seems reasonable that placement agents and other compensated solicitors in a Rule 506 offering should be able to rely on the same sources of information used by the issuer in making its factual inquiry. The SEC's advice in C&DI 260.14 (discussed above), that an issuer's reliance on a certification is reasonable, should also cut in favor of a placement agent or other compensated solicitor relying on a periodic certification by any of its directors, executive officers or other officers participating in the offering, its general partner or managing member (if so structured), or any director, executive officer, or other officer participating in the offering of such general partner or managing member.

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## Weeding Out Bad Actors…

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### Rule 506(d)(2)(ii) Waiver of Disqualification

Since September 23, 2013, the SEC has granted a number of waivers from the disqualification provisions of Rule 506(d) upon a showing of good cause.[16] The issuers and placement agents receiving waivers were subject to various SEC orders or judgments described in Rule 506(d)(1)(ii) or (iv), or, in one case, plead guilty to a felony or misdemeanor described in Rule 506(d)(1)(i). Each of those actions constituted a disqualifying event under Rule 506(d)(1). Waivers are granted under Rule 506(d)(2)(ii).

*"Despite careful diligence by an issuer of its covered persons, there may be times during a continuous offering program when the issuer discovers that a covered person is subject to a disqualification."*

The arguments presented in the waiver requests have common themes:

- None of the disqualifying events had to do with a Regulation D offering;
- The applicants had already paid fines to the SEC in connection with the disqualifying events pursuant to the relevant order or judgment;
- Some of the applicants had neither admitted nor denied the allegations in the order or judgment, or stipulated to some, but not all, of the facts therein;
- Most of the applicants took remedial action to address the alleged behavior;
- Disqualification from the use of Rule 506 would adversely and disproportionately affect the applicant and third parties, such as affiliates of an issuer for which Rule 506 would be unavailable and, for placement agents, potential clients/issuers contemplating Rule 506 offerings; and
- For a period of five years from the date of the judgment or order, the applicants agreed to furnish to potential investors a written description of the judgment or order a reasonable time prior to any sale.[17]

In each case, the Commission granted the waiver request and did not disqualify the applicant from the use of the Rule 506 exemption. Some large financial institutions that service hedge funds have made the argument in their waiver applications that a disqualification from future Rule 506 offerings would disproportionately harm them and their clients. Absent a waiver, these institutions would be shut out from acting as placement agents for hedge funds for which they act as placement agents. For example, one large financial institution had launched over 20 hedge funds that rely on Rule 506 for continuous offerings through that institution.[18]

Another large financial institution was recently barred from offering private equity and hedge fund investments to its clients. There, the bank was the victim of bad timing that caused the result of the original conduct to be bounced from what would have been just a disclosure obligation of past acts under Rule 506(e) to an outright disqualification event. The original "bad acts" occurred in 2006-2007 and had to do with selling collateralized debt obligations. The bank had reached a settlement with the SEC in 2011, which was rejected by the Southern District of New York. The Second Circuit overturned the district court in August 2014, resulting in the SEC disqualifying the bank from using Rule 506. If the district court had accepted the original settlement in 2011, which was prior to the effectiveness of the bad actor amendments, the bank would not have been disqualified and would have had to disclose the pre-effective bad acts to investors. This run of circumstances may be a factor in favor of the bank if the SEC grants a waiver from disqualification.[19]

At the present time, the SEC has not issued any written standards regarding waivers or what constitutes a showing of good cause. In the adopting release for the Rule 506 amendments, the SEC stated that "it would be premature to attempt to articulate standards for granting waivers, although we may consider doing so …."[20] The SEC put forth a non-exhaustive list of circumstances that could be relevant to a waiver request: "a change of control, change of supervisory personnel, absence of notice and opportunity for hearing, and relief from a permanent bar for a person who does not intend to apply to reassociate with a regulated entity …."[21]

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## Weeding Out Bad Actors…

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In a recent letter to The Honorable Sherrod Brown, SEC Chair Mary Jo White stated that a written policy statement regarding waivers under Rule 506 is currently under consideration by the staff, and that the staff is also completing a formal written policy setting forth the factors that it considers in determining whether good cause has been shown to grant relief from disqualifications that may arise under Regulation A, Rule 505 or 506.[22]

### Other Regulatory Schemes— Overlap, Harmony and Dissonance

Placement agents and other compensated solicitors will have on file various forms, such as FINRA Form U4 and Form ADV, which require disclosure by their employees and others of "bad acts" similar to those that may constitute a disqualification event under Rule 506(d). As discussed in our Client Alert cited above, a review of those forms will be helpful in identifying any covered person that may be subject to a disqualification event.[23] Some of the responses required by those forms, however, may sweep in past acts that would not constitute a disqualification event under Rule 506(d).[24] Consequently, a respondent who provides a "yes" answer to the disclosure questions of Form U4 or Form ADV will not necessarily be disqualified from participating in a Rule 506 offering. There are also some Rule 506(d) disqualification events that are not contemplated by Form U4 or Form ADV. These differences are due to the varying regulatory objectives of the Exchange Act, the Investment Advisers Act of 1940, and the Securities Act.

*"There are still some open issues relating to Rule 506(d) offerings that have not been addressed by the new C&DIs."*

In this regard, a covered person would be disqualified under Rule 506(d)(1)(i) if that person has:
been convicted, within ten years before such sale (or five years, in the case of issuers, their predecessors and affiliated issuers), of any felony or misdemeanor:

- In connection with the purchase or sale of any security;
- Involving the making of any false filing with the Commission; or
- Arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser, or paid solicitor of purchasers of securities.

A review of responses to Items 11A or 11B of Form ADV, or Questions 14A or 14B of Form U4, which require disclosure of criminal events, would be helpful in determining whether a covered person is subject to a disqualifying event under Rule 506(d)(1)(i). However, the disclosure items in those two forms cast a much wider net than does Rule 506(d)(1). Items 14A and 14B of Form U4 have no time limit on the requested criminal disclosure and cover, in addition to convictions, guilty pleas and pleas of no contest to any type of felony. Those items also cover felony and misdemeanor convictions, and pleas in foreign and military courts (foreign courts are specifically excluded from the scope of Rule 506(d)(1) under C&DI 260.20, as discussed above), and misdemeanors involving investments or investment-related business, or any fraud, false statements, or omissions, wrongful taking of property, bribery, perjury, forgery, counterfeiting, extortion, or conspiracy to commit any of those offenses. Item 11 of Form ADV covers the same events, but has a ten-year look-back period. Both Form U4 and Form ADV also cover being charged with any of the felonies or misdemeanors described in those items.

Item 14D(2) of Form U4, which has no counterpart in Form ADV, requests disclosure of final orders issued by various regulatory authorities. This item differs from Rule 506(d)(1)(iii) only in that a final order of the U.S. Commodity Futures Trading Commission ("CFTC") is not covered in Item 14D(2) of Form U4 and that item is open-ended in terms of past violations. Rule 506(d)(1)(iii) is limited to a ten-year look-back period. Consequently, a "yes" answer to Item 14D(2) might not constitute a disqualification event under Rule 506(d)(1)(iii), and a "no" answer might not capture a CFTC violation that would be a disqualification event. Also, a "final order" is defined somewhat differently by FINRA

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## Weeding Out Bad Actors…

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than in Rule 501(g).[25] The SEC definition requires that the statutory authority that issued the final order provided for notice and an opportunity for a hearing.

Further, a review of responses to Form U4 and Form ADV would not pick up disqualification events covered by Rule 506(d)(1)(vii) or (viii), which cover stop orders and orders suspending the Regulation A exemption, and U.S. Postal Service false representation orders, respectively.

> *"Most of what the SEC has said about diligence procedures is in the context of a reasonable investigation by the issuer."*

## Rule 506 Compliance Guide

The SEC posted a small entity compliance guide that summarizes the Rule 506 disqualification rules. The guide can be found at: **http://www.sec.gov/info/smallbus/secg/bad-actor-small-entity-compliance-guide.htm.** ■

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1 *The Compliance and Disclosure Interpretations can be found at: http://www.mofo.com/~/media/Files/Articles/140915CDI2601432Rule506BadActor.pdf.*
2 *Release 33-9414 (July 10, 2013) (the "Adopting Release") at 67. The Adopting Release is available at: http://www.sec.gov/rules/final/2013/33-9414.pdf.*
3 *See C&DI 260.23*
4 *A detailed discussion of the types of provisions that should be added to placement agent agreements for Rule 506 offerings, and other suggested diligence actions to be conducted as part of a program to ensure compliance with Rule 506, can be found in our Client Alert at: http://media.mofo.com/files/Uploads/Images/130715-Bad-Actor-Disqualifications.pdf under "Action Items for Issuers and Placement Agents."*
5 *See C&DIs 260.26-27*
6 *See C&DI 260.16*
7 *See C&DI 260.18*
8 *See C&DI 260.20*
9 *See C&DI 260.25*
10 *See C&DI 260.28*
11 *See C&DIs 260.29 and 260.30*
12 *The SEC stated, in another C&DI, that "in order for one party to the voting agreement to be treated as having or sharing beneficial ownership of securities held by any other party to the voting agreement, evidence beyond formation of the group under [Exchange Act] Rule 13d-5(b) would need to exist." See Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting C&DI 105.06.*
13 *See CD&I 260.31. The beneficial ownership rules should be carefully analyzed in more complicated situations, such as determining whether investment advisers to multiple funds or to a fund of funds, or certain trusts, depending on their structure, are subject to a disqualification event.*
14 *See C&DI 260.17*
15 *Adopting Release at 68.*
16 *The waivers can be found at http://www.sec.gov/divisions/corpfin/cf-noaction.shtml#3b under "Section 3(b) – Rules 262 and 505 Disqualification" commencing on November 25, 2013. These waivers also covered disqualifications under Regulation A and Rule 505.*
17 *This disclosure is required under Rule 506(e) for bad acts that would have been disqualifications under Rule 506(d), but occurred prior to September 23, 2013. Rule 506(e) does not have a look-back limitation. Rule 262 of Regulation A and Rule 505 do not have an analogous provision.*
18 *See Credit Suisse AG (Feb. 21, 2014) at http://www.sec.gov/divisions/corpfin/cf-noaction/2014/credit-suisse-group-ag-022114.pdf.*
19 *See "Bad actor rule is a 'big deal' for hedge funds," Risk.net (Sept. 9, 2014).*
20 *Adopting Release at 71.*
21 *Id. at 72.*
22 *Letter from Mary Jo White, Chair of the Securities and Exchange Commission, to The Honorable Sherrod Brown (Sept. 8, 2014), available at: http://www.mofo.com/~/media/Files/Articles/140908BrownSECPolicyReWaivers.pdf.*
23 *The SEC pointed to these types of forms as a source of information for financial intermediaries and other market participants when assisting an issuer in satisfying its factual inquiry requirement. See the Adopting Release at 68.*
24 *Many of the disclosure items in Form U4 and Form ADV are identical, or substantially identical.*
25 *The FINRA definition of "final order" can be found at: http://www.finra.org/web/groups/industry/@ip/@comp/@regis/documents/appsupportdocs/p468051.pdf.*

## *Legislative/Regulatory Actions*

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### FinCEN Proposes Customer Due Diligence Rules for Financial Institutions

On July 23, 2014, the Financial Crimes Enforcement Network issued a notice of proposed rulemaking that would clarify customer due diligence requirements under the Bank Secrecy Act, and include a new regulatory requirement to identify beneficial owners of legal entity customers, subject to certain exceptions. The NPR would apply to banks, brokers or dealers in securities, mutual funds, and futures commission merchants and introducing brokers in commodities ("covered financial institutions").

*A. Clarification of Existing CDD Requirements Under the BSA*

The NPR proposes to amend FinCEN's existing regulations to include explicit references to the pre-existing core requirements of an AML program under the BSA. While the first requirement, identifying and verifying the identity of customers, is already included in the existing regulatory requirement to have a customer identification program, the NPR would add explicit requirements with respect to understanding the nature and purpose of customer relationships and ongoing monitoring as components in each covered financial institution's core AML program requirements.

*B.New Beneficial Ownership Requirement*

The NPR also proposes a new, separate requirement to identify and verify the beneficial owners of "legal entity customers," defined to include a corporation, limited liability company, partnership or other similar business entity (whether formed under the laws of a state or of the United States or of a foreign jurisdiction) that opens a new account, subject to exclusions. Covered financial institutions would not be required to identify beneficial owners of new accounts for legal entities that are exempt under the current CIP rule, certain legal entities whose beneficial ownership information is generally available from other credible sources, and trusts that are not created through a filing with a state (*e.g.*, statutory business trusts).

The proposed rules would not require covered financial institutions to verify that the natural persons identified on the form are in fact the beneficial owners. Rather, the requirement focuses on verifying the *identity* of the beneficial owners. A "beneficial owner" is defined under the NPR to include natural persons who meet the "ownership" or "control" prongs set forth below:

***Ownership Prong:*** A covered financial institution must identify no more than four beneficial owners. A beneficial owner includes each individual, if any, who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, owns 25 percent or more of the equity interests of a legal entity customer. In effect, the rule would require financial institutions to look through to the ultimate natural person who controls the legal entity.

***Control Prong:*** A covered financial institution must identify only one person with significant responsibility to control, manage, or direct a legal entity customer, including:

- an executive officer or senior manager (*e.g.*, a Chief Executive Officer, Chief Financial Officer, Chief Operating Officer, Managing Member, General Partner, President, Vice President, or Treasurer); or
- any other individual who regularly performs similar functions.

The NPR would require financial institutions to satisfy the requirement to identify beneficial owners by obtaining, at the time a new account is opened,

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## FMA Welcomes *More* New Members!

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the standard certification form attached to the NPR. The obligation to identify beneficial owners of a "legal entity customer" would apply only to legal entity customers opening new accounts at the covered financial institution after the date of the rule's implementation, and not retroactively. Although the NPR would not require financial institutions to look back and obtain beneficial ownership information for pre-existing accounts, FinCEN notes that, when in the course of monitoring, the financial institution becomes aware of information relevant to assessing the risk posed by a customer, it is expected to update the customer's relevant information (including obtaining beneficial ownership information for existing customers on a risk basis).

The comment period for the NPR ends on October 3, 2014.

### Federal Reserve Issues Guidance on Implementation Plans and Other Enhanced Prudential Standards for Foreign Banking Organizations

On June 26, 2014, the Federal Reserve Board published on its website responses to frequently asked questions relating to enhanced prudential standards under Section 165 of the Dodd-Frank Act and its implementing Regulation YY. The FAQs were collected by Board staff during an industry outreach call or were otherwise asked by foreign banking organizations. The FAQs relate to the implementation plan, U.S. structure, regulatory reporting, capital adequacy, capital stress testing, risk management, liquidity, and other topics relating to Regulation YY applicable to FBOs. The Board indicated that additional categories may be added as these FAQs are updated, and that the FAQs are not official interpretations.

The 55 FAQs as of June 26, 2014 illustrate how select provisions of the regulation apply to specific situations, but do not necessarily address all provisions that may apply to any given situation. Among other issues, the FAQs provide guidance on the scope, level of detail, and length of an implementation plan that an FBO must submit to the Federal Reserve, which must be designed to evaluate whether the FBO is on a path toward compliance with the final rule by July 1, 2016.

The Board FAQs are available at ***http://www.federalreserve.gov/bankinforeg/topics/faq-enhanced-prudential-standards-fbo.htm***. For more information, please read our client alert at ***http://www.mofo.com/~/media/Files/ClientAlert/140630FederalReserveIssuesGuidance.pdf.***

### New York DFS Proposes Virtual Currency Licensing Scheme

On July 17, 2014, the New York State Department of Financial Services issued a proposed rule for public comment setting forth a novel and comprehensive "BitLicense" regulatory scheme for entities engaged in "Virtual Currency Business Activities." The BitLicense proposal broadly covers virtual currency activities that involve the state of New York or a New York resident in which a person:

- Receives or transmits virtual currencies on behalf of consumers;
- Secures, stores, or maintains custody or control of virtual currency on behalf of consumers;
- Performs retail conversion services, including converting or exchanging virtual currency for fiat currency or other virtual currency;
- Buys or sells virtual currency as a business; or
- Controls, administers, or issues virtual currency.

The BitLicense proposal would require such entities to obtain a license, submit to examinations by the DFS, comply with capital requirements and consumer protection requirements, and establish anti-money laundering compliance programs, among other requirements. For more information, please read our client alert at ***http://www.mofo.com/~/media/Files/ClientAlert/2014/07/140718NewYorkDFSVirtualCurrencyLicensing.pdf.***

The proposed DFS BitLicense framework is available at ***http://www.dfs.ny.gov/about/press2014/pr1407171-vc.pdf***.

## DODD-FRANK ACT TITLE VII UPDATE

The phase-in of Title VII of the Dodd-Frank Act and the regulations thereunder continues. In the big picture, much of the remaining work to be done,

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from a U.S. perspective, involves harmonizing largely existing Commodity Futures Trading Commission regulations with rules still forthcoming from other jurisdictions. That being said, the last several months have seen a number of significant U.S.-specific events. Among these are the SEC finalizing certain of its cross-border rules, the CFTC finalizing a new rule for certain swaps with utilities, the CFTC and prudential regulators proposing rules for margin for uncleared swaps, and the CFTC substantially prevailing in litigation brought by derivatives industry groups.

The SEC released certain of its cross-border rules for security-based swaps in late June 2014. The rules address when a cross-border security-based swap transaction (that is, a security-based swap between a U.S. and non-U.S. counterparty) must be counted toward the numerical thresholds contained in the definitions of security-based swap dealer (SBSD) and major security-based swap participant (MSBSP), which in part determine whether a person is required to register as an SBSD or MSBSP. The rules that the SEC released in June 2014 do not state which substantive Title VII requirements will apply to which cross-border security-based swaps; those details are expected in a future rulemaking.

As part of the SEC's cross-border rules, the SEC provided a definition of "U.S. Person" that is in certain respects narrower and less complex than the CFTC's corresponding definition. The CFTC's definition of U.S. Person includes collective investment vehicles that are majority-owned by certain types of U.S. Persons, as well as certain legal entities that are majority-owned by certain types of U.S. Persons who bear unlimited responsibility for the obligations of the legal entity. In contrast, the SEC's U.S. Person definition, while overlapping with the CFTC's definition to a considerable degree, does not include look-through provisions requiring market participants to determine the ownership of their counterparties. In addition, the SEC's rules specifically exempt from the definition of U.S. Person organizations including, among others, the International Monetary Fund and the International Bank for Reconstruction and Development.

The basic SBSD "counting" rules contained in the SEC cross-border rules are as follows:

- a U.S. Person or a "Conduit Affiliate" thereof (as defined by the SEC) must count toward its SBSD registration threshold all of its security-based swap transactions related to dealing activity; and
- a non-U.S. Person must generally count toward its SBSD registration threshold:
  - transactions with U.S. Persons connected with dealing activity (subject to an exception for security-based swaps arranged, negotiated, and executed on behalf of a foreign branch of a U.S. Person SBSD solely by persons located outside the United States); and
  - transactions connected with dealing activity with other non-U.S. Persons that, in relation to the security-based swap, have rights of recourse against a U.S. Person affiliate of their counterparty.

For further information regarding the SEC's and CFTC's cross-border rules, see our Client Alert, available at: ***http://www.mofo.com/~/media/Files/ClientAlert/2014/07/140709CFTCSEC.pdf.***

The CFTC's final rule regarding swaps with utilities relates to the CFTC's swap dealer registration requirement. The CFTC's registration rules provide that, even if a market participant engages in only a very minimal amount of swap dealing activity ($25 million in notional amount) with "special entities" such as municipalities and pension plans, such market participant must register as a swap dealer.

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## FMA Welcomes *More* New Members!

| | |
|---|---|
| Laura McFarland | Farm Credit Administration |
| Elisa Mangual | The Northern Trust Company |
| Robin Maxwell | Linklaters LLP |
| Takeshi Mori | Bank of Japan |
| Robert Pugh | The PNC Financial Services Group, Inc. |
| Kristin Richardson | The Clearing House Association |
| Kevin Rothman | American Express |
| Kelly Schmalhausen | BOK Financial |
| Coryann Stefansson | PricewaterhouseCoopers LLP |
| Kathy Watson | Regions |

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Certain electric and natural gas utilities qualify as special entities because they are owned or operated by state or local governments. The CFTC's new rule, finalized in September 2014 and codifying previous no-action relief, is intended to encourage counterparties to enter into certain swaps with such utilities by permitting them to disregard such swaps for purposes of the $25 million registration threshold.

Proposed rules for margin for uncleared swaps appeared in two separate September 2014 releases by the CFTC and the prudential banking regulators. Both the CFTC and the prudential regulators had previously proposed margin rules in 2011; the re-proposals are intended to conform generally to the international consensus that has appeared to grow around the policy framework for margin stated in a series of papers released by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions.

September 2014 also saw the CFTC's success in litigation, when the United States District Court for the District of Columbia largely ruled in the CFTC's favor in an action brought by industry plaintiffs, including ISDA. The court ruled that the majority of the CFTC's "interpretive guidance" regarding the cross-border application of its substantive rules constitutes a policy statement, with which compliance is optional, rather than a legislative rule, with which compliance would be mandatory. On the basis of this reasoning, the court ruled in favor of the CFTC on the bulk of the plaintiffs' claims. The court did, however, remand certain rules, without vacating them, to enable the CFTC to meet its obligation to provide cost-benefit analyses.

## CFPB UPDATE

### CFPB Action on Consumer Complaints

On July 23, 2014, the CFPB issued a proposed "policy statement" about including narrative information from consumer complaints in its Consumer Complaint Database. The CFPB indicated that it would disclose the narratives only after obtaining informed consent from the consumer and would purge personal information from the narrative.

In a statement about this initiative, CFPB Director Richard Cordray said that publicly disclosing narratives will raise awareness about supervised entities and products while helping the CFPB and other interested groups identify trends and problems in the financial services marketplace. Industry representatives have expressed concern about the potential for reputational damage that may result from publishing raw consumer complaint information, particularly because it appears that the CFPB will not verify information included in the complaints.

### CFPB Credit Card Add-on Product Enforcement Action

On June 19, 2014, the CFPB announced a $225 million settlement with Synchrony Bank, formerly known as GE Capital Retail Bank, for alleged unfair, deceptive or abusive acts or practices violations in connection with credit card add-on products. The consent order claims that Synchrony engaged in deceptive marketing of debt cancellation add-on products. According to the consent order, Synchrony telemarketers misrepresented to consumers details regarding the cost and terms of the debt cancellation products. The CFPB also alleged that Synchrony failed to manage its service providers adequately. The consent order, with is the latest in a number of recent credit card add-on product enforcement actions, requires Synchrony to implement a vendor management policy that includes a heightened focus on due diligence in third-party vendor selection and on contract negotiation.

### CFPB Report on Bank Account Overdraft Features and Services

Federal rules prohibit banks from imposing a fee on a consumer for overdrawing his or her account as the result of a debit card or ATM transaction, unless the consumer has opted in to such overdraft protection. On July 31, 2014, the CFPB released a report on overdraft protection, concluding that a relatively small number of consumers pay large amounts for overdraft advances that are paid back within a short period of time. The CFPB said in the report that the majority of checking account fees incurred by consumers are overdraft and non-sufficient funds fees that result from transactions with a median amount of $24 or less. The report found that consumers who opt in to overdraft services have about seven

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times the number of overdrafts resulting in fees than consumers who do not opt in. In a related press release, CFPB Director Cordray expressed concern about the impact overdrafts have on consumers with low account balances.

### CFPB Issues Bulletin on Payroll Cards

On September 12, 2013, the CFPB issued a bulletin highlighting the federal consumer protections applicable to payroll cards under Regulation E, and making clear that it has the supervisory authority and ability to examine the use of third-party service providers to assess compliance with Regulation E. The CFPB also states in the bulletin that it can bring enforcement actions against any person subject to Regulation E, including financial institutions and employers.

### CFPB Guidance on Credit Card Promotional Interest Offers

On September 3, 2014, the CFPB issued a bulletin to warn credit card issuers about marketing practices related to credit card promotional interest offers. The bulletin discusses circumstances in which the acceptance of a promotional offer causes a consumer to lose a grace period on new purchases if the consumer does not pay the entire statement balance, including the amount subject to the promotional interest offer, by the payment due date. The bulletin warns that credit card issuers who fail to "adequately alert consumers" in marketing materials about the relationship between promotional APR offers, payments on promotional APR balances, and how such payments may impact the availability of a grace period, may be at risk of engaging in "abusive conduct." Along with the bulletin, the CFPB published a set of "consumer tips" to offer advice to consumers about how to avoid interest charges when accepting a promotional interest offer in situations where a consumer either carries a balance or does not carry a balance on the consumer's credit card. For our client alert on this topic, please visit ***http://www.mofo.com/~/media/Files/ClientAlert/2014/09/140904CFPBIssuesWarningtoCreditCardIssuers.pdf.*** ■

## *Who's News*

**George Alexakos**, formerly a Director at Crowe Horwath, has joined the Risk Management team at Santander US.

**John Bagley**, an experienced fixed-income professional with extensive knowledge of trading, underwriting and sales, has joined the MSRB as Chief Market Structure Officer. He will lead a newly created department dedicated to ensuring the MSRB's activities are informed by economic analysis and understanding of current market practices, and reflect market activity based on data.

**Brian Baum**, formerly a Senior Attorney at Goodwin Procter LLP, has joined the Commodity Futures Trading Commission as a Special Counsel.

**Jametriss Roulhac Boone**, formerly Financial Administrator/South Florida Securities Enforcement at the Florida Office of Financial Regulation, is now an AVP at Deutsche Bank.

**Joe Carapiet**, formerly an Associate at Sullivan & Cromwell LLP, is now a Senior Attorney in the Banking Regulation and Policy Group at the Federal Reserve Board.

**James Catano**, formerly an Associate in the Investment Management Practice Group at Goodwin Procter LLP, has joined Dechert LLP as an Associate in the firm's Financial Services and Investment Management Practice Group. Mr. Catano is resident in the Washington, DC office of Dechert LLP.

**Louis Dempsey**, President of Renaissance Regulatory Services, has been selected by the Florida Securities Dealers Association to succeed fellow FMA member Steven Greenbaum as President of the Association for Calendar Year 2015.

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