

# HENDERSON & LYMAN

## DERIVATIVES & SECURITIES REGULATORY UPDATE

APRIL 2011

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**W**e are pleased to provide our clients and friends with a quarterly update of the many regulatory issues that may impact your business.

Since our last regulatory update, many provisions stemming from the comprehensive financial regulatory reform known as the Dodd-Frank Act have been proposed and enacted. The scope of the new or revised financial regulation has drawn criticism and produced confusion for many persons involved in the financial industry. Our goal in this newsletter is to provide you with some information intended to help you stay abreast of these changes and identify potential implications on your business.

At Henderson & Lyman, we understand that these developments are significant and complex, and we welcome the opportunity to assist you in working through them.

If you would like to discuss any of the topics mentioned in this newsletter, please call your Henderson & Lyman attorney or (312) 986-6960.

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## *Derivatives Developments*

### **FINANCIAL MARKET REFORM**

#### **Illinois House May Consider Tax on Stock and Derivatives Trades**

An Illinois state representative has introduced a bill that would tax traders doing business in Chicago's futures, options, and stock markets.

The Financial Transaction Tax Act (the "Act"), introduced at the end of February by Rep. Mary Flowers, would charge one-hundredth of one percent of the value of all financial transactions carried out on markets run by CME and CBOE. If enacted, the Act would add to the already heavy tax burdens currently borne by exchanges, brokers, and traders in Chicago.

The bill has yet to be assigned to a committee, where it will be evaluated before the entire Illinois House of Representatives would hear it. If passed, the proposed tax would go into effect September 1, 2011.

#### **New Securities Exam for Traders**

The nation's exchanges are developing a new test for proprietary traders and market makers that will focus on trading-specific topics. The new Series 56 Examination - known as the Proprietary Traders Exam - is expected to contrast sharply with the Series 7 exam, which is primarily geared towards retail stock brokers. Specifically, the new test will cover such topics as: concentration monitoring; closing out errors; Regulation SHO; expiring exercise declarations; and exercise limits. Currently, there is no counterpart examination required for proprietary firms trading futures or options.

Typically, market makers and prop traders are required to take either the Series 7 exam

and/or one of the house exams designed by the exchanges, such as Nasdaq's Series 55 exam. The new test will likely supersede the house exams. Some exchanges, however, may continue to require new traders to take orientation tests to ensure they understand the exchange's rules. Additionally, waivers from the new exam are expected to be granted to those traders and market makers who already hold Series 7 accreditation.

The Series 56 Examination is expected to be available in September 2011 and will be administered by FINRA.

#### **FINRA Files Registration Rule Proposal**

On March 4, 2011, FINRA filed with the SEC a rule proposal seeking to adopt a controversial rule which would require registration of a large number of broker-dealer back-office personnel.

The proposal was highly criticized by industry participants when FINRA first introduced the plan last summer. In response, FINRA made some minor changes—offering clarity on exactly who would be required to register—but overall, the proposal remains the same. Specifically, the proposed rule would create an "Operations Professional" license, with its own qualification exam and continuing education requirements. As such, the proposal marks a substantial and potentially burdensome expansion of registration requirements, and may force many lower-level employees to register.

Individuals already holding a Series 6 or 7 license, or have a supervisory license, would be exempt from taking the exam but would have to register separately as Operations Professionals if their job functions were covered under the new requirement. FINRA would not assess a separate registration fee, but would subject such individuals to continuing education requirements. Individuals not

holding a Series 6 or 7 license will be allowed 12 months from the rule's effective date to pass the qualifying examination.

In its filing, FINRA noted that the Operations Professional registration would be restricted to senior managers, supervisors or anyone with significant control over a broker-dealer's finances and engaged in a variety of back-office functions. Lisa Roth, a member of FINRA's Small Firm Advisory Board, stated she expects "that a receptionist [at a small firm]...would be covered" by the registration requirement. As a result, some industry participants fear confusion regarding which employees would be covered under the proposed rule.

### *Fast Fact*

#### **2010 Derivatives Trading Figures:**

Commodity derivatives trading: +34%  
Futures trading: +35%  
Options trading: +16%  
Equity derivatives: +14%  
Interest rate derivatives: +29%  
Currency derivatives: +144%

#### **Tools to Assist Advisers with ADV Part 2**

Registered investment advisers required to submit the new ADV Part 2 can take advantage of some free and low-cost software designed to assist advisers in satisfying the new SEC requirement.

Ascendant Compliance Management, Inc. ("ACM") provides a free template, and ProTracker Software Inc.'s Narrative Form ADV Part 2 Template can be downloaded for \$99. Both templates are documents containing dozens of pages of basic verbiage in the new format through which advisers can scroll and customize specifically to their firm in order to assist in the preparation of the new plain-

English ADV forms now required by the SEC.

ACM's template can be downloaded after registering [here](#). ProTracker Software Inc.'s template can be found by clicking [here](#).

### ***DODD-FRANK ACT***

#### **Geithner to Decide on Regulation of Forex Swaps**

The Dodd-Frank Act (the "Act") signed into law last July allows Treasury Secretary Timothy Geithner to decide whether forex swaps should be exempt from key provisions of the Act. Geithner's decision, which is expected within days, could have significant implications for the multitrillion-dollar forex market, and has sparked debate between banks, lobbying against the oversight, and regulators proposing the oversight.

In order to provide greater transparency, the Act requires that most swaps be traded on exchanges and cleared through regulated clearinghouses. Many financial firms argue that forex swaps are less risky than other types of derivatives and would still be subject to certain reporting and business-conduct standards even if exempt from exchange requirements. On the other hand, regulators have urged the Treasury to include forex swaps in the new rules, noting the concern that a broad exclusion could enable swap dealers and participants to structure swap transactions to come within the forex exclusions and thereby avoid regulation. In addition, regulators point to the recent reports of alleged new abuses by major banks accused of overcharging their customers in forex transactions.

In the past, Secretary Geithner has shown an inclination toward exempting forex transactions from regulation; however, it is not clear whether his past views will prevail. The

Treasury has declined to comment while Geithner's decision is pending. Henderson & Lyman will keep you updated on this developing story.

### **SEC to Consider Extending the Private Fund Adviser Registration Deadline**

Robert Plaze, Associate director of the SEC's division of Investment Management, stated in his letter, dated April 8, to the North American Securities Administrators Association that the SEC is expected to consider extending the deadline for investment advisers relying on the private adviser exemption under Section 203(b)(3) of the Investment Advisers Act of 1940.

The April 8<sup>th</sup> letter indicated that while the SEC intends to issue its final rules required by Title IV of Dodd-Frank prior to the July 21, 2011 deadline, the SEC is expected to consider extending the date by which private fund advisers must register with the SEC and come into compliance with the obligations of a registered investment adviser until the first quarter of 2012.

Similarly, the SEC is expected to consider extending the deadline for investment advisers having between \$25 million and \$100 million of assets under management ("Mid-sized advisers") that must transition from registration with the SEC to state registration. Mid-sized advisers are expected to receive a grace period to allow time for state registration and to come into compliance with applicable state regulations prior to withdrawing their registration with the SEC.

To view a copy of the letter, please click [here](#).

### **CFTC Sets Proposed Disclosure Rules for Private Funds**

On January 26, 2011, the CFTC released two proposals that would require funds, commodity pools and commodity trading advisers to file reports with regulators regarding their operations. The proposal is similar to the plan released by the SEC on January 25, 2011, but goes further by seeking to gather data from certain members who had previ-

ously been exempt from filing reports with regulators. Specifically, the CFTC's proposed rules would rescind certain exemptions from reporting and registration requirements that had previously been claimed by commodity fund managers and other fund advisers.

If enacted, the new rules would require a range of commodity pools and commodity trading advisers to open up their books to regulators. The reporting requirements, however, would only apply to funds that manage more than \$150 million in assets. Funds that manage less than \$1 billion would be required to annually provide only basic information about the performance and strategy of their fund and their use of loans for leverage. Funds that manage more than \$1 billion would have to report more detailed information on a quarterly basis. Because the information is proprietary, the CFTC and SEC cannot publicize it, but they must make it available to the Financial Stability Oversight Council.

The SEC Press Release can be found by clicking [here](#), and the CFTC Statement and can be found [here](#).

#### ***Fast Fact***

President Obama proposes to implement user fees in order to increase CFTC funding. Click [here](#) for summary.

### **Dodd-Frank Revises "Accredited Investor" Standards**

The Act changed certain legal requirements governing unregistered private and other limited offers and sales of securities.

Section 413(a) of the Act revised the net

worth threshold for accredited investors, excluding the equity value of the investor's primary residence. Where the amount of debt secured by the primary residence exceeds the estimated fair market value of the property, the excess debt must be considered a liability and deducted from the net worth of the investor.

### **SEC Proposes Compensation and Credit Rating Rules**

On March, 2, 2011, the SEC proposed executive compensation rules ("Compensation Rules"), primarily affecting broker-dealers and investment advisers, and credit rating rules, primarily affecting money market funds and companies registered under the Investment Company Act of 1940.

Specifically, the proposed Compensation Rules would require registered broker-dealers and investment advisers with assets of at least \$1 billion to file annual reports with the SEC on their incentive-based compensation arrangements and would prohibit such firms from providing incentive-based compensation that could encourage inappropriate risk taking.

Such firms would be required to submit an annual report to the SEC that describes the structure of the entity's incentive-based compensation for directors, officers, employees or principal shareholders. The report would need to be sufficient to allow an assessment of whether the structure or features of such compensation arrangements provide or are likely to provide excessive compensation or could lead to material financial loss for such entity. Although the report need not include the actual compensation of directors, officers or employees, it would be required to include the following information:

- A clear narrative description of the components of the compensation arrange-

ments and to which individuals they apply;

- A succinct description of the policies and procedures regarding such compensation;
- Any material changes to the incentive-based compensation arrangements or policies and procedures since the last report; and
- The specific reasons why the entity believes the structure of its incentive-based compensation does not encourage inappropriate risks.

Entities with over \$50 billion in assets would be subject to additional reporting requirements.

The proposed credit rules would eliminate the requirement that money market funds only invest in securities receiving certain credit ratings.

Public comments on the proposed Compensation Rules are due 45 days after the rules are published in the Federal Register. The SEC's statement regarding the proposed rules can be found by clicking [here](#).

### **MARKET STRUCTURE**

#### **CME Group Placed on Credit Watch Negative Status by S&P analysts**

Following the CME Group's ("CME") announcement regarding its new class of securities clearing membership, Standard & Poor's Ratings Service has placed CME's debt ratings under review. Specifically, S&P analysts placed CME's counterparty credit ratings, which remain at investment grade AA for long-term credit and A-1+ for short-term credit, on "Credit Watch Negative" status and noted the new clearing membership could increase risk for CME.

The CME's plan, designed to cut trading

costs, would create a clearing membership class and offer margin discounts to traders of both Treasury securities and Treasury futures. The new class – called Financial Instruments Clearing Membership – would provide margin benefits of up to 65%.

S&P analysts are concerned that there could be operational risk with CME’s plan because CME Clearing would not have direct control of the cash securities for which it is granting margin relief. Rather, the plan shifts this responsibility to the facilities manager, and consequently, any default could fall upon the facilities manager. To cover this possibility, CME is contributing an additional \$100 million of surplus funds to its financial safeguard package.

S&P analysts plan to gather additional information on CME processes and how CME will monitor securities holdings. The analysts will also assess the competitive threat actually posed by NYSE Euronext’s joint-venture offering, called New York Portfolio Clearing.

### **SEC and CFTC Propose Rules for Swap Execution Facilities**

The Dodd-Frank Act granted the SEC and CFTC the power to define new swap-execution facilities as an alternative to exchanges for trading in interest rate, credit and other swaps. Pursuant to this power, on February 2, 2011, SEC commissioners unanimously agreed to seek public comment on a proposal that would move many privately-negotiated swaps onto regulated trading platforms.

Compared to the CFTC proposal, which was released on December 16, 2010, the SEC proposal would allow several types of trading systems, including limit order books or request-for-quote systems (“RFQ” systems). It would also allow customers to choose whether to submit a bid or offer to several

swap dealers or just one participant. Under the CFTC proposal, by contrast, traders would be required to submit a bid or offer to at least five dealers and would have access to fewer types of trading systems.

Public comments on the SEC proposal can be found by clicking [here](#). The CFTC proposal can be found by clicking [here](#).

## **TRIVIA**

Predict the total number of goals that the Blackhawks will score in the 2011 playoffs.

*The first person to email [aclaudio@henderson-lyman.com](mailto:aclaudio@henderson-lyman.com) with the correct answer will win a \$50 Starbucks Giftcard.*

### **CFTC Proposes End-User Exemption from the Swap Margin Rule**

On December 9, 2010, the CFTC unveiled a long-awaited rule outlining exemptions for firms using swaps to hedge business risk. Under the CFTC proposal, end users, or those that use derivatives to manage commercial risk, would be exempt from the rules if one party to the swap is a non-financial entity. Such an exemption is significant because it frees firms from posting the required margin associated with clearing the swap.

Specifically, end users would be exempt if: (1) at least one party to the swap transaction is not a financial entity; (2) information is provided regarding how the firm meets its financial obligations associated with entering into non-clearing swaps; and (3) the swap is being used to hedge or mitigate commercial risk. Hedging or mitigating commercial risk would be determined by analyzing the facts and circumstances at the time the swap is entered into, and taking into account the en-

tity's overall risk mitigation strategies. Swap positions held for speculation, investing, or trading would not be included in the exemption.

The CFTC's notice of proposed rulemaking can be found [here](#).

### **CFTC NEWS**

#### **CFTC Proposes Amendments to CPO and CTA Compliance Obligations**

On January 26, 2011, the CFTC proposed rules that would eliminate or narrow exemptions relied upon by CPOs and CTAs to privately offered funds and investment companies registered ("RICs") under the Investment Company Act of 1940. The proposals would rescind the exemptions from CPO registration under Rules 4.13(a)(3) and 4.13(a)(4) and add conditions for RICs claiming relief from CPO regulation under Rule 4.5. The CFTC's decision to rescind these exemptions is notable because the elimination or narrowing of current CPO or CTA exemptions is not required by the Dodd-Frank Act.

In addition, the CFTC rule would require:

- Annual filing of notices claiming exemptive relief from registration as a CPO or CTA;
- CPOs to certify annual reports of pools offered under Rule 4.7 to qualified eligible persons ("QEPs");
- CPOs and CTAs to make new boilerplate disclosures on the risks of swaps transactions; and
- Additional filings by CPOs and CTAs, with certain information in those filings considered confidential by the CFTC.

For a detailed summary of the proposed amendments to CFTC Regulations, click [here](#) for H&L's Client Update.

### **NFA**

#### **NFA to Examine Forex Brokers**

NFA is preparing a probe into whether forex firms are using unfair trading practices to take advantage of retail investors. Specifically, NFA plans to investigate all of its 16 member forex firms for any signs they are designing computer systems to take advantage of slippage, or small price movements that occur between the time a customer enters a trade and when that trade is actually executed. While some slippage is normal, the NFA sweep is designed to determine whether the trades are being executed only when the currency price moves in the firm's favor. An affirmative answer would suggest that the firm is violating NFA rules mandating fair business practices. In such cases, NFA may assess fines and may suspend or expel a firm from NFA membership. NFA has already indicated that it will review all of the trades each member firm executes on a daily basis.

In October, NFA issued complaints against Ikon Global Markets and GAIN, accusing the firms of taking advantage of slippage at their clients' expense. Both firms settled without admitting or denying the allegations. Ikon paid a \$320,000 fine and has ceased offering retail currency trading to U.S. citizens; GAIN paid a \$459,000 penalty.

### **ENFORCEMENT**

#### **State Prosecutors Allege Public Pension Funds Overcharged for Forex Transactions**

Allegations in recently unsealed Virginia court documents accuse Bank of New York Mellon Corporation's ("Mellon") currency traders of using a forex system called "Charlie" to create fake trades and overcharge Virginia pension funds by at least \$20 million. Separately, Florida intervened in a

2009 whistleblower lawsuit against Mellon alleging the bank overcharged Florida pension funds for forex transactions. Likewise, California has intervened in a similar whistleblower claim against State Street Corp. The cases were prompted by suits by several current and former bank employees who turned whistleblower (which potentially entitles them to a portion of any money the states recover).

The allegations are part of a widening probe by state prosecutors into whether custody banks, such as Mellon and State Street, short-changed public pension funds in executing currency trades used to complete financial transactions abroad. Similar to NFA's current forex probe reported above, the states are investigating claims that the banks did not charge the pension funds the currency rates that the banks paid. Rather the banks consistently charged the funds the highest currency-conversion rates of the day and pocketed the difference. These suits allege the banks similarly overcharged when the pension funds exited the trades.

In one trade, cited in the Virginia lawsuit, the whistleblower alleges that Mellon profited after transacting a foreign exchange of Canadian dollars for a client at the worst U.S. dollar-Canadian rate of the day. According to the complaint, the fund needed to convert \$12.5 million into Canadian dollars, and although Mellon sold the U.S. dollars at a rate of C\$1.0795 (totaling C\$13.5 million), the fund only received C\$13.35 million, based on the lowest rate of the day of C\$1.0682. The trade allegedly enabled Mellon to pocket approximately C\$141,250.

Relatedly, several large investment firms have become concerned with the rates charged by custody banks for forex trades. Because custody banks do not have to provide transaction-time records, it is hard for firms to know exactly when a currency ex-

change took place or whether they received the prevailing market prices. As a result, some firms have begun altering the way they trade currencies, either by executing the trades themselves, or by demanding evidence that they are receiving the prevailing rates.

## TRIVIA

Predict the total number of games that the Bulls will win during the 2011 NBA playoffs.

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## Securities Developments

### SEC NEWS

#### SEC Seeks More Input on Clearing Voting Rules

On March 2, 2011, the SEC elected to reopen the comment period on an October rule proposal designed to restrict the voting power financial firms control in derivatives clearing and trading venues. The proposal, which created a substantial debate, was reopened for further consideration and marks the first major delay in the SEC's rule-writing agenda for OTC derivatives under the Dodd-Frank Act.

Additionally, a separate proposal was unanimously approved establishing governance and operational requirements for clearinghouses. That plan includes a large list of requirements for clearing agencies, including a rule ensuring that clearing agencies have the financial resources in place to cover a default by its largest member and requirements that aim to prevent clearinghouses from shutting

out smaller firms that wish to join.

### **Regulators Consider New Stock Rules**

The SEC is considering whether to ease decades-old constraints on share issues by private companies, in a sweeping review that could restructure the way start-up companies raise capital.

The current rules, designed to stop insiders from trading shares using information that is not publicly available, have been criticized for discouraging investment and limiting economic growth. The steps under consideration would allow privately held companies to raise money without incurring the increased reporting and other requirements of becoming a private company. The likely changes would include raising from 499 the number of shareholders private companies can have without being required to open their books, and also making it easier for such companies to publicize share offerings. Notably, the SEC can increase the limit without approval from Congress.

The possible changes could potentially delay or derail IPOs by tech companies that want to grow without disclosing vast amounts of information. It could also shut out many ordinary investors, as shares in private companies are generally available only to accredited investors.

## ***FINRA***

### **New FINRA Rules on Know Your Customer and Suitability**

On October 7, 2011, two new consolidated FINRA rules governing know-your-customer and suitability requirements of broker-dealers will take effect. Rule 2090 (Know Your Customer) and Rule 2111 (Suitability) will replace NYSE Rule 405 and NASD Rule 2310 as part of FINRA's ongoing effort to cre-

ate a consolidated rulebook harmonizing former NASD and NYSE rules. For a detailed summary of the new rules, click [here](#) for H&L's Client Update.

### **FINRA Sanctions Broker-Dealers in Private Placement Crackdown**

FINRA has made broker-dealers' sale of private placements that failed during the market collapse an enforcement priority this year. As a result, FINRA has begun imposing sanctions and fines against both broker-dealers and executives from firms responsible for selling the now defunct private placements. In doing so, the regulator cited a lack of due diligence in selling the high-risk products.

FINRA named two series of private placements—notes issued by Medical Capital Holdings, Inc. and preferred stock from Provident Royalties, LLC—as problematic. FINRA has asserted that its investigation into broker-dealers that sold these and other problematic private placements will continue. While FINRA's actions are not groundbreaking, the imposition of sanctions against firms and executives for failing to conduct a reasonable investigation of the sale of such products suggests that FINRA may be imposing a higher threshold of care than in the past, and firms should ensure that their due diligence investigations are adequate.

## ABOUT THE FINANCIAL SERVICES PRACTICE GROUP

Henderson & Lyman has represented leaders in the financial services industry for over twenty-five years. Our clients range from publicly-traded brokerage firms to small introducing brokers and individual traders. We represent Broker-Dealers, Futures Commission Merchants, Forex Dealer Members, Introducing Brokers, Commodity Pool Operators, Commodity Trading Advisors, Investment Advisers, and proprietary trading groups. The firm also has a sophisticated practice representing hedge funds, private equity funds, offshore funds and their managers.

The Financial Services Practice Group provides counsel regarding numerous formation, compliance, regulatory, trading-related, and litigation matters. In counseling its clients, the Financial Services Practice Group draws upon its significant industry experience.

Henderson & Lyman is located in the heart of Chicago's financial district and provides goal-oriented legal services to a wide array of companies and individuals. The firm also represents clients in a wide variety of business, regulatory and commercial litigation matters.

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