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Chancery Court Grants in Part and Denies in Part Motion to Dismiss Brought by Defendant FXCM, Inc. in Derivative Suit Alleging That FXCM Knowingly Violated Regulation 5.16

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In *Brett Kandell v. Dror Niv et al.*, the Delaware Chancery Court denied in part and granted in part a motion to dismiss a derivative action brought by a stockholder ("Plaintiff") against nominal defendant FXCM, Inc. ("FXCM" or "the Company"), a foreign exchange ("FX") broker. The claim was brought against FXCM directors ("Defendants") for losses associated with the "Flash Crash" in the value of the euro relative to the Swiss franc, which happened when the Swiss decoupled the two currencies. As a result of these huge losses, FXCM had to obtain a loan under onerous conditions. Two main causes of action were asserted: (1) that the directors' ability to exercise business judgment with respect to the Flash Crash was impaired, and (2) that the directors knowingly violated 17 C.F.R. § 5.16 ("Regulation 5.16") which prohibits foreign exchange traders from representing that they will limit clients' trading losses. Plaintiff did not make a demand on the company prior to bringing suit.

The Court concluded that, with respect to the actions taken after the Flash Crash, a majority of the directors were independent and disinterested, and Plaintiff failed to demonstrate that the directors' ability to exercise business judgment was impaired. Therefore, demand was not excused with respect to this cause of action. However, with respect to the loan transaction itself, a majority of the directors were not independent and disinterested, and therefore demand was excused with respect to that transaction. The more difficult question, and the one the Court focused on, was whether demand was excused on the Regulation 5.16 claim. The Court found that the substantial likelihood of liability faced by the Defendants with regard to Regulation 5.16 prevented an exercise of business judgment, and therefore demand was excused with respect to this cause of action.

FXCM is an online provider of foreign exchange trading and related services. It is the largest FX broker for retail customers in the United States. FXCM's trading platform employs an "agency model" to carry out trades. In their 2013 Form 10-K, FXCM described their agency model as follows: "In the agency model, when our customers execute a trade on the best price quotation offered by our FX market makers, we act as a credit intermediary, or riskless principal, simultaneously entering into offsetting trades with both the customer and the FX market maker." FXCM maintains several policies intended to reduce its customers' risk of loss. These policies are provided in FXCM's Client Agreement, which customers must sign before they open an account, as well as on FXCM's U.S. website and various social media pages.

FXCM is regulated by the Commodity Futures Trading Commission ("CFTC"). The CFTC adopted Regulation 5.16 in September 2010 as part of the Dodd-Frank Act. Under Regulation 5.16, "No retail foreign exchange dealer, futures commission merchant or introducing broker may in any way represent that it will, with respect to any retail foreign exchange transaction in any account carried by a retail foreign exchange dealer or futures commission merchant for or on behalf of any person: (1) guarantee such person against loss; (2) limit the loss of such person; or (3) not call for or attempt to collect security deposits, margin, or other deposits as established for retail forex customers." The purpose of Regulation 5.16 is to provide protection for FX companies in the event of extreme volatility in the currency market. Additionally, the Regulation seeks to ensure that FX companies remain financially viable, because a company that agrees to cover its customers' losses is at risk of undercapitalization which may necessitate bankruptcy. According to the Complaint, "the individual Defendants ignored Regulation 5.16 in order to attract customers lured by the guarantee that they would never be financially responsible for a negative balance incurred on their account."

The central question is whether the Defendants knew that they were violating Regulation 5.16. The Complaint alleges that the Company's board of directors (the "Board") knew or should have known that the Company's zero debit policy was a violation of Regulation 5.16 because the Regulation was part of the substantial restructuring of CFTC regulations that accompanied the highly-publicized Dodd-Frank Act. The Complaint also points to the Company's marketing materials, client agreements, and SEC filings as evidence that the Board was aware of FXCM's violations of Regulation 5.16. On August 18, 2016, the CFTC brought a complaint against FXCM, alleging that it had improperly guaranteed its customers against loss, limited the loss of customers, or not called for or attempted to collect security deposits, margin, or other deposits of customers. The CFTC sought damages in the billions of dollars. In February 2017, FXCM entered into a consent order with the CFTC in which it agreed to pay a $650,000 fine for, among other things, violations of Regulation 5.16.

This derivative suit was brought in response to the "Flash Crash" that occurred in 2015. From September 2011 to January 2015, the Swiss National Bank ("SNB") maintained a policy of pegging the Swiss franc (CHF) to the euro (EUR). The SNB adopted this policy during the Eurozone debt crisis due to an influx of money flowing into Switzerland, which put pressure on the Swiss franc. As a result of SNB's effort, the EUR/CHF currency pair remained stable for several years, and FX traders took large positions on the pair. In response to concerns that the European Central Bank was going to put downward pressure on the euro by pumping in money through bond purchases, the SNB announced on January 15, 2015 that it would allow its currency to "float freely against the euro." As a result, the Swiss franc rose more than 41% against the euro, eventually settling at an 18% rise over the course of the day.

Because of this volatility, FX markets were drained of liquidity, which prevented FXCM from executing stop orders or margin calls until approximately forty-five minutes after the announcement. However, by that time, customers on the wrong side of the EUR/CHF pair had taken significant losses. On the evening of January 15, 2015, FXCM put out a press release announcing that FXCM's customers had suffered losses leading to "negative equity balances owed to FXCM of approximately $225 million," a figure that was later revised to upward of $276 million. FXCM could not collect on these accounts because of its policy regarding customer losses, which put the Company on the hook for the losses.

FXCM's Board met several times over the next few days to determine what to do next. At the first meeting on January 15, CEO and Chairman Dror Niv announced that FXCM's regulators had threatened a temporary suspension of the Company's operations if sufficient funds were not raised immediately. When the Board met the following day, the directors learned that the Company would

be forced into liquidation if it did not obtain enough capital to bring it into regulatory compliance by noon. There was a loan offer on the table from Jeffries Group LLC, an investment banking subsidiary of the holding company Leucadia. Niv told the Board that the Leucadia loan was the Company's only option if it was to continue to operate. Leucadia would extend a $300 million loan to FXCM, set to mature in two years, and in exchange Leucadia would receive 10% interest per annum, increasing by 1.5% every quarter. Plaintiff alleged that, despite the fact that the Board received updates and information from Niv about the situation and potential next steps, the Board did not engage a financial advisor to counsel them on issues that were essential to the Company's continued existence. All of the directors voted in favor of the Leucadia loan, except for one who abstained.

On January 19, 2015, FXCM issued a press release announcing the Leucadia loan. According to the Complaint, market reaction to the Leucadia deal was negative; Plaintiff points to the fact that on January 15, FXCM closed at $12.63, and when trading of the stock began again on January 20, FXCM stock opened at $1.58 and closed at $1.60. Because FXCM was unable to pay down the Leucadia loan with revenue from its businesses, the Company had to sell several of its subsidiaries.

Defendants moved to dismiss Plaintiff's Complaint for failure to make a demand. When a Plaintiff fails to make a pre-suit demand on the board, the Court must dismiss the complaint unless it alleges particularized facts showing that demand would have been futile. The test for demand futility requires a derivative plaintiff to allege particularized facts which raise a reasonable doubt that, if a demand had been made the board of directors could have properly exercised its independent and disinterested business judgment in responding to it. *Aronson v. Lewis* applies when the plaintiff is challenging a business decision by the board of directors that would be considering the demand, which is the case here. To establish demand futility under *Aronson*, the plaintiff must allege particularized facts which create a reasonable doubt that the directors are disinterested and independent or the challenged transaction was otherwise the product of a valid exercise of business judgment. The question of demand futility ultimately turns on whether the board is capable of exercising its business judgment in considering a demand.

In regard to the Leucadia Loan, the Court found that, under *Aronson*, demand was excused. At the time, eleven directors sat on FXCM's Board. Of those eleven, five were corporate directors, and Defendants did not argue that these Company employees were disinterested with respect to the Leucadia deal. Six members of the Board were outside directors. When presented with the Leucadia proposal, one of the outside directors expressed his interest in becoming involved in the transaction from the lender's side; as a result, that outside director abstained from the vote. This effectively left a ten-member board, with five interested members and five disinterested members. Thus, since the transaction was not approved by a board with a majority of disinterested and independent directors, the Board could not effectively exercise its independent judgment on a litigation demand, and the demand was excused.

Plaintiff's Regulation 5.16 claim alleged that Defendants breached their fiduciary duties by patterning FXCM on a business model that blatantly violates Regulation 5.16, and ignored red flags related to this violation. The Court stated that the fundamental question is whether the Board, as it was constituted when the Plaintiff filed his Complaint, was capable of exercising its business judgment in evaluating a demand involving these allegations. Plaintiff did not allege that Defendants were interested or lacked independence with respect to the alleged violations of Regulation 5.16. Thus, in order to establish demand futility, Plaintiff had to successfully allege that Defendants faced a substantial likelihood of liability because they violated the duty of loyalty by breaking the law.

Defendants argued that they were not aware that the no-debit policy violated the Regulation until the

CFTC brought its action alleging such a violation in August 2016. However, the Court did not accept this argument. Considering that the primary pursuit of the Company was retail FX trading, and that the Company pursued clients explicitly on the ground that FXCM would not hold them responsible for loss beyond investment (in contrast to competing FX brokers), the Court inferred that the directors understood that FXCM was engaged in a no-debit policy. The Court also found that it could be inferred, based on the Form 10-Ks, that the directors were aware of Regulation 5.16 and its prohibition on advising clients that the Company would limit trading losses.

The remaining question was whether, under the facts alleged, the Court could infer that the directors knew the no-debit policy violated Regulation 5.16. Defendants argued that there was no enforcement by the CFTC itself of Regulation 5.16 against FXCM, despite the fact that the Company openly advertised this policy for several years following the adoption of the Regulation. According to Defendants, such behavior suggests that the necessary scienter did not exist on the part of the directors, as they were clearly not trying to hide their practices, which they likely would have done had they thought they were breaking the law.

The Court acknowledged that this case presented “a highly unusual set of facts: a Delaware corporation with a business model allegedly reliant on a clear violation of a federal regulation.” However, the Court found that given the strong inference that the directors were aware of Regulation 5.16 and were also aware of the Company’s no-debit policy, the facts were sufficient at the pleadings stage to infer scienter. Therefore, the Court found that a substantial threat of personal liability rendered the Board incapable of independently evaluating a litigation demand, and demand was excused.

Brett Kandell v. Dror Niv et al., C.A. No. 11812-VCG (Del. Ch. September 29, 2017)

Daisy Sexton contributed to this article.

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