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Inside

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HeadNotes

Under the leadership of Section Chair David Oppenheim, since the summer the Business Law Section has been engaged in medium and long-range strategic planning, aimed at defining the Section's mission and enhancing its ability to serve the needs of its nearly 3,800 members going forward. As detailed in the Report of the Chair herein, four primary objectives emerged from the planning effort: 1) advocacy, aimed at promoting New York as a "business friendly" state; 2) assisting our members to be more efficient and effective providers of legal services to their clients; 3) continuing to provide quality and timely information on business law issues; and 4) enhancing the governance of the Section to achieve these objectives. With regard to items 2) and 3), it is gratifying to the editors that our members have identified the *Journal* as one of the prime benefits of Section membership. We welcome your ongoing feedback regarding ways we can make the *Journal* more responsive to your needs. We also encourage our readers to participate in the newly established Section "Community"—an online forum for timely business law information, discussed in more detail in the Report of the Chair.

Advocacy has come to the fore as a prime objective of the Section also, in response to initiatives at the State and local level that have the effect, intended or not, of discouraging business formation in the State. As discussed in the Summer issue, the Section voted to actively oppose extending the reach of Section 630 of the Business Corporations Law, which makes the ten largest shareholders of a New York close corporation personally liable to pay wages of the corporation's employees, to foreign corporations doing business in the State. The legislature had earlier extended the law to LLCs as well as corporations. Now the Section's Legislative Affairs Committee is working actively with the International Law Section of the NYSBA to repeal these provisions outright. As discussed in the Legislative Affairs Committee Report herein, whatever the merits of Section 630 when it was enacted, it is an anachronism today and has the effect of driving business out of New York.

Apropos: the simmering hostility to banks, ironically in the world's banking capital, had its latest manifestation earlier this year as New York City Mayor Bill de Blasio took steps to implement the City's "Responsible Banking Act" ("RBA"). The RBA was enacted by the City Council in 2012, notwithstanding the vociferous opposition of then-Mayor Michael Bloomberg and his administration, and over the Mayor's veto. The RBA ostensibly aimed at using the City's power to determine in which banks it deposits its funds to compel banks to be more "responsible" at the local level, by such measures as increasing small business loans and restructuring mortgages. In a suit brought by the New York Bankers Association ("NYBA"), in July a federal judge overturned the RBA, agreeing with the NYBA—and the position taken earlier by the Bloomberg Administration—that the RBA exceeds the City's authority by attempting to regulate the banking business, and is preempted by both federal and State law. In "'Responsible Banking'—Or Irresponsible Legislating?" the *Journal*'s Editor-in-Chief David Glass discusses the preemption and other legal issues raised by the RBA. Mr. Glass, a former general counsel of the NYBA, also relates this legislation to earlier misguided attempts by the City to regulate the banking business.

When not attempting to regulate banks, the City Council has been keeping itself busy enacting new laws that affect the rights of workers, and the responsibilities of employers, in the City. In "Recent Employment Laws Impacting Private Employers in New York City," attorney Sharon Parella discusses two such laws: first, the much-anticipated "ban the box" law, which further restricts the ability of employers to inquire into an applicant's past criminal conduct during the hiring process; and second, the Stop Credit Discrimination in Employment Act, which generally prohibits employers from requesting or using a "consumer credit history" in connection with making hiring decisions, or making employment decisions about an existing employee. Both laws apply to private employers with as few as four employees. Ms. Parella, founder of the Parella Firm LLP, focuses on advising businesses on employment law matters. She is a regular contributor to the *Journal* and a member of the *Journal*'s Editorial Advisory Board. Her timely updates on employment issues have been highly valued by our readers.

Another regular feature of the *Journal* that has proven invaluable to practitioners is "Inside the Courts," a comprehensive survey by the attorneys of Skadden Arps LLP of current litigation pertaining to securities and corporate matters in the federal courts. The current issue contains the usual clear and concise summaries of a wide range of current matters, ranging from shareholder derivative suits, to fiduciary duties, to current developments in Madoff-related litigation. We remain indebted to the attorneys of Skadden for continuing to generously share this exceptionally valuable summary with the readers of the *Journal.*

Our next two articles focus on different aspects of the attorney-client privilege. In "The D.C. Circuit: Wrong and Wronger!" the *Journal*'s ethics guru Evan Stewart, in his usual pull-no-punches style, takes the D.C. Circuit Court to task for two recent decisions related to the application of the privilege in the internal investigation context. In Mr. Stewart's view, among the Court's failings were the conflating of the attorney work product doctrine with the privilege—a topic he has explored in earlier issues of the *Journal*—and misapplying the Supreme Court's seminal 1981 ruling in *U.S. v. Upjohn Co.*, which dealt with internal investigations led by company in-house lawyers. But of perhaps greatest practical significance for practitioners, Mr. Stewart, a partner at Cohen & Gresser LLP, notes the many procedural flaws in how the internal investigation was conducted, which contributed in no small part to the court's ostensible confusion. Counsel involved in an internal corporate investigation would do well to heed Mr. Stewart's always timely insights.

Another ongoing problem with the attorney-client privilege is its application to regulatory examinations in the financial institutions context. In "Can Regulators Compel Banks to Disclose Privileged Documents?" Clifford Weber reviews the situation where a bank is undergoing a regulatory examination. In its files are memoranda from counsel suggesting that certain practices are not (yet) in compliance with law. Should the bank turn over such memoranda to the bank examiners? Must it do so? Mr. Weber, a partner in the White Plains office of Hinman, Howard & Kattell, notes that regulators—including, most recently, the General Counsel of the Federal Reserve—have taken the position that a regulator has unfettered access to a bank's records, even those that might otherwise be privileged. The saving grace is that federal law allows for selective waiver—i.e., provision of privileged matter to the regulators does not constitute waiver of the privilege as to third parties. Still, as Mr. Weber notes, there may be circumstances in which the bank should resist disclosure.

Since the enactment of the Sarbanes-Oxley Act in 2002, the role of the Board Audit Committee has taken on increasing importance for public corporations. In "Considerations for Audit Committee Members," Samuel Gunther, an attorney and accountant who has written previously for the *Journal*, lays out some practical guidance for individual members of the Audit Committee. Of paramount importance, the member must assume an active role in critically reading and reviewing the company's financial material—it is not sufficient to simply show up and participate in Committee meetings. Though aimed primarily at Audit Committee members, Mr. Gunther's article also provides an invaluable checklist for attorneys who may be called upon to advise the members on their duties, or to advise the company on what to expect and demand from its Audit Committee.

The Commodity Futures Trading Commission ("CFTC") continues to flex its muscles, in the wake of the dramatic expansion of its mandate under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. A recent case in point: the CFTC has recently determined that "bitcoin" and other so-called virtual currencies are in effect "commodities" like gold or silver under the Commodity Exchange Act (CEA). As such, the CFTC has asserted jurisdiction over transactions in swaps and futures over bitcoin. In "Enforcement Risk: The Long Length of the CFTC's Reach," six attorneys at Sidley Austin LLP go beyond the recent bitcoin ruling to outline the scope of the CFTC's jurisdiction more generally. While the CEA ostensibly does not give the CFTC jurisdiction over trading in physical commodities, but only over trading in derivatives such as swaps and futures against commodities, the authors note that Dodd-Frank allows the CFTC to assert jurisdiction over any commodity transaction that involves manipulation or fraud in interstate commerce, and any transaction, wherever it may occur, that may have a "direct and significant" connection with U.S. activities. The authors provide a concise and useful outline of the key areas of regulatory and enforcement risk for entities that trade products subject to CFTC jurisdiction.

In "The Flash Crash Case Against Sarao—Will the CFTC Prevail?" Professors Ronald Filler of New York Law School, a member of the *Journal*'s Advisory Board, and Jerry Markham of Florida International University at Miami, provide a graphic example of the CFTC's ability to reach beyond U.S. borders in a case involving manipulation that affects U.S. markets. Earlier this year, the agency filed a lawsuit against a trader who allegedly contributed to the so-called "flash crash" of May 6, 2010, in which the Dow Jones average dropped nearly 1,000 points in a matter of minutes, by "spoofing" orders that he entered from a home computer in his parents' home outside London. In essence, the CFTC asserts that the defendant engaged in a massive effort, using complex computer algorithms, to manipulate trading in a particular futures contract against the Standard & Poor's 500 stock index. Professors Filler and Markham provide a cogent and detailed analysis of what the CFTC will need to demonstrate in order to prove its charges against the defendant. They conclude that the suit is, ultimately, an ad hoc approach to regulation that provides little guidance to traders going forward. Along the way, the article provides a thorough and useful analysis of the historical development of manipulation theories under the CEA since its enactment in 1936.

David L. Glass

"Responsible Banking"—Or Irresponsible Legislating?

By David L. Glass

Introduction

In a strongly worded 71 page opinion, on August 7, 2015 Judge Katherine Polk Failla of the United States District Court for the Southern District of New York struck down New York City Local Law 38 of 2012, the so-called "Responsible Banking Act" ("RBA"), holding that it was preempted by both federal and New York State law regulating the business of banking.[1] The RBA sought to compel those banks that serve as depositaries of City funds to provide granular and confidential financial information, literally on a neighborhood by neighborhood basis, aimed at determining whether they were meeting certain specified political objectives in areas such as lending to small business and modifying mortgages in lieu of foreclosure. The law called for, among other things, an annual report that would identify banks by name, presumably with the intent to "shame" the miscreants whose definition of "responsible banking"—driven by pervasive federal and State regulation—differed from that of local politicians. And it encouraged, but ostensibly did not require, the City to take this information into account in selecting the banks in which it would deposit its funds ("Deposit Banks").

In enacting the law, the New York City Council (the "City Council") contended that the RBA was no more than an exercise of the City's "proprietary" authority to set the terms for contracts with private parties. Then-Mayor Michael Bloomberg and his administration strongly disagreed. The Mayor saw the law as being regulatory rather than proprietary in intent, and opposed it both because the City lacked the resources and expertise to be a bank regulator, and because the legislation likely was preempted under both federal and state law—not to mention that the City's power to direct in which banks it deposits its funds has always been aimed at ensuring that the City's funds are safe and that it gets the best terms from its banks, not at furthering local political objectives. The New York State Department of Financial Services ("DFS") also opposed the legislation, on the grounds that it interfered and conflicted with the DFS's authority to regulate the State's banks. But the City Council went forward, overwhelmingly enacting the RBA and then reenacting it over the Mayor's veto.[2]

The New York Bankers Association ("NYBA"), the primary trade group for banking institutions in the State of New York, initially brought suit in federal district court for the Southern District of New York in October of 2013; however, at the time the Bloomberg administration was refusing to implement the law, by the simple expedient of declining to appoint members of the Community Investment Advisory Board ("CIAB") created thereunder.[3] The court held, therefore, that the NYBA lacked standing to sue since none of its members had, in fact, sustained injury.[4] But the election of new Mayor Bill de Blasio in November 2013 jump-started the law, as the new Mayor quickly moved to implement it. In May of 2015, with the deadline looming for Deposit Banks, and would-be Deposit Banks, to comply, the NYBA again sued, and the parties cross-moved for summary judgment. Judge Failla's decision, rendered with remarkable rapidity,[5] makes clear that the RBA is void in its entirety, because it is preempted by both federal and State law as an impermissible attempt to regulate the banking business. The City was granted 30 days to file an appeal, but made no attempt to do so.

Thus came to a close the latest attempt by the City Council to intrude itself into the bank regulation field, notwithstanding the already pervasive regulation of banks by four different federal regulators—the Federal Deposit Insurance Corporation ("FDIC"), the Board of Governors of the Federal Reserve System (the "Fed"), the Office of the Comptroller of the Currency ("OCC"), and the Consumer Financial Protection Bureau ("CFPB"), created in 2010 under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[6]—as well as the DFS, which has plenary authority under State law to regulate State-chartered banking institutions. The intent of the laws creating these agencies is clear and unambiguous: they are charged with regulating the business of banking, and to do so in a way that balances safety and soundness considerations with the needs of individual customers and the national economy as a whole, free of interference by localities and their parochial concerns.

This article begins by reviewing the provisions of the RBA, why they were enacted and what they were intended to achieve, and how they were ostensibly crafted to avoid the very preemption issues that ultimately defeated the law. The article next reviews the relevant provisions of federal and State law and shows why, despite the City Council's efforts to cast the banks' compliance with the RBA as "voluntary," its provisions inevitably and fundamentally clash with the structure and intent of both federal and State regulation of the banking industry. Finally, the author shares his thoughts as to why, beyond the legal issues it presents, local legislation of this type is fundamentally a bad idea, one that can only redound to the detriment of the very people it purports to help.

Enactment of the RBA

The RBA was enacted against the backdrop of the global financial crisis of 2008-2009. A principal cause of the crisis, as has been well documented, was the indiscriminate making of subprime residential mortgage loans, which were then packaged into securitization pools and sold to institutional investors, thereby separating risk from reward and giving lenders no incentive to exercise traditional credit judgment.[7] A predictable result was to create a "bubble" in housing, financed by cheap and plentiful credit, and to saddle some lower and middle income consumers with levels of debt that proved unmanageable. In turn, this led to calls for lenders to undertake to modify or restructure loans to help borrowers avoid forfeiting their homes in foreclosure.

Thus, a prime focus of the early discussions leading to the RBA was to determine which banks were, and were not, achieving the objective of modifying residential mortgage loans to assist distressed borrowers.[8] Additional objectives were to promote further lending to small business, and investment in local community development projects.[9] Another objective—not expressly stated in the legislation, but clearly apparent in the debate leading up to it—was to extract tit-for-tat from the banking industry, which was perceived (incorrectly) as having been "bailed out" by ordinary people during the crisis.

As one of the law's two principal sponsors put it, "[j]ust as we bailed out the banks through public dollars and now we can't even find out from these banks what they're doing in our communities, when they used our tax dollars to become whole."[10] In reality, the funds invested in a handful of the largest banks and some community banks scattered across the country—all but a few of which were not Deposit Banks—under the Troubled Asset Relief Program (TARP) enacted by the Congress during the financial crisis were repaid in full, at a substantial profit to the Treasury.[11]

The RBA was not the City Council's first foray into designating itself a bank regulator. In 2002 the Council enacted Local Law 36, a "predatory lending" law, again over the objections, and ultimately the veto, of Mayor Bloomberg. The law purported to prohibit the City from doing business with, including making deposits in, banks engaged in "predatory lending," defined to mean residential mortgage loans priced at an interest rate of more than 6 percent over the prime rate, or with fees totaling more than four percent of the loan amount. These standards were stricter than—and thus inconsistent with—those contained in the New York State predatory lending law that was enacted the same year.[12]

In 2003 Mayor Bloomberg took the extraordinary step of suing the City Council in State Supreme Court, seeking to overturn Local Law 36. The Mayor's suit contended that the law's requirements would drive banks to refuse to do business with the City, causing "irreparable harm from the loss of potential low bidders" and more generally "cause chaos and confusion in the area of municipal contracts, bond issues, and deposits of city funds."[13] In 2004 the Mayor prevailed, as Judge Michael Stallman ruled that Local Law 36 conflicted with both federal and state law and was preempted in its entirety.[14] In so ruling, Judge Stallman noted among other things that, by specifying matters such as permissible interest rates and fees, the law amounted to an attempt to regulate the banking business, in violation of the plenary authority of federal and State regulators to regulate such matters.

Though bloodied, the City Council remained unbowed. In crafting the RBA, the one lesson it apparently took away from the Local Law 36 debacle was to attempt to structure the new legislation in such a way as to make compliance with its requirements appear voluntary in nature, thereby presumably negating the inference that the law was regulatory. Thus, the law provided that banks were not obligated to furnish the required information (albeit that banks that chose not to comply would be barred from serving as Deposit Banks), but also that the City Banking Commission (consisting of the Mayor, the City Comptroller, and the City Commissioner of Finance), which under the City Charter has the sole authority to decide in which banks to deposit the City's funds, was not obligated to take this information into account in so deciding. As Judge Failla was to recognize in her decision, these attempts to make the RBA appear to be something other than regulatory were disingenuous at best.

What the Law Provided

The RBA established an eight-member Community Investment Advisory Board ("CIAB"), whose primary function was to collect data, at the census-tract level, from the 21 Deposit Banks currently eligible to receive some of the City's approximately $150 billion in annual deposits. As noted, the three-person Banking Commission, established in the nineteenth century, has the sole authority to direct the deposits of City funds, by approving banks as NYC Designated Banks, which then are the only banks authorized to receive City deposits.[15] The CIAB, by contrast, would have eight members—the three members of the Banking Commission (the Mayor and Comptroller could each appoint a designee in their stead), along with the Council Speaker or her designee; the Commissioner of the Department of Housing Preservation and Development; a member of a community-based organization, designated by the Speaker, whose "principal purpose is community and/or economic development, or consumer protection"; a representative, also designated by the Speaker, of an organization or association that represents small business; and finally, a lone representative of the City banking industry designated by the Mayor.[16]

Apparently mindful that the "predatory lending" law had been struck down as an impermissible attempt to regulate the banking industry, the legislation was careful to couch the function of the CIAB as being "advisory," since under the City charter only the Banking Commission can actually decide where to deposit the City's funds. In exercising this authority, the Banking Commission's "fundamental purpose…is to limit City deposits to institutions that are best equipped to secure taxpayer money while offering competitive pricing and services."[17] But the structure and language of the RBA made clear that, in "advising" the Commission (all three of whose members, of course, also were to sit on the CIAB) on the discharge of its duties, the CIAB was intended to entirely disregard what has always been the Commission's "fundamental purpose"—to assure the City's funds are safe, and to obtain the most favorable terms for depositing its funds—in favor of pressuring the Commission to make decisions based upon completely unrelated criteria.

Thus, the CIAB was assigned three primary functions. First, it was to complete a written assessment of the "credit, financial and banking services needs throughout the City with a particular emphasis on low and moderate income individuals and communities" (the "Needs Assessment"); second, it was to use the information gathered for the Needs Assessment to "establish benchmarks, best practices, and recommendations for meeting the identified needs"; and third, it was mandated to compile and publish an annual report of its findings, which among other things would specifically identify the banks that submitted information and how well they ostensibly measured up to the law's criteria.[18]

In developing the Needs Assessment, the CIAB was to hold hearings in each borough of the City and obtain comments from the public. Most important, it was to collect, from each Deposit Bank, information—at the census tract level—relating to the bank's efforts to i) address the "key credit and financial services needs of small businesses"; ii) develop and offer financial products and services "most needed by low and moderate income individuals and communities" as well as to provide physical branch locations in these communities; iii) provide funding for "affordable housing and economic development" in these communities; iv) address "serious material and health and safety deficiencies" in foreclosed and bank-owned properties; v) "conduct consumer outreach, settlement conferences, and similar actions related to mortgage assistance and foreclosure prevention"; vi) "partner in the community development efforts of the city"; vii) "positively impact" the City through, among other things, "philanthropic work and charitable giving"; and viii) "plan for and articulate how the bank will respond to the credit, financial and banking service needs" identified in the Needs Assessment. This information was to be published on the Department of Finance's website, and the RBA mandated that such publication "specifically identify any Deposit Bank's failure to provide information.…"[19]

The Annual Report required by the RBA was to evaluate and report on the performance of each Deposit Bank relative to the "benchmarks and best practices" developed by the CIAB; identify areas of improvement from past evaluations; specifically identify Deposit Banks that failed to provide the information demanded; summarize written comments received; and summarize in tabular form the data collected from the Deposit Banks.[20] Perhaps recognizing its own overreach in demanding information from the banks that exceeds what they are required by law to furnish to their federal and state regulators, the RBA grudgingly allowed that information deemed confidential or proprietary by the bank need not be disclosed. And finally, in a manifest effort to avoid the pitfall that doomed the "predatory lending" law eight years earlier, the RBA provided that the Banking Commission "may"—not "must" or "shall"—consider the CIAB report in determining in which Deposit Banks to place City funds.

Preemption Under Federal Law

The doctrine of preemption derives from the Supremacy Clause of the United States Constitution, which provides that federal law shall be supreme over that of the states (and, by extension, local governments within states).[21] In general, preemption will be found where i) Congress expressly preempts state law; ii) federal law conflicts with the state law in question; or iii) Congress has legislated so comprehensively on a subject as to occupy an entire field of regulation, leaving no room for state law.[22]

The United States has a "dual" banking system, whereby a bank can be chartered by either the federal government or the state in which it is located. The OCC charters national banks—which today include the great majority of the large banks that operate interstate—and federal thrift institutions, including federal savings and loan associations and federal savings banks (collectively "federal thrifts"), and is the exclusive regulator of the institutions it charters. In addition to being chartered under and subject to state law, because they take deposits from the public and are insured by the FDIC, state banks and thrifts are pervasively regulated at the federal level as well.

Thus, federal law does not "occupy the field" to the extent of preempting state laws regulating banking. To the contrary, for much of the nation's history, banking was a state-regulated function; while establishing the national bank system, the NBA did not purport to interfere with the parallel authority of the states to charter and regulate banks.

Nonetheless, the RBA raised significant federal preemption issues in two specific areas: first, with respect to national banks and federal thrifts, whether it intruded on the exclusive "visitorial" authority of the OCC under the National Bank Act ("NBA")[23] and the Home Owners Loan Act ("HOLA"),[24] respectively, which encompasses obtaining information from them as well as on-premises inspection; and second, with respect to all FDIC-insured banks and thrifts, whether federal or state-chartered, whether it conflicted with the federal Community Reinvestment Act ("CRA"), under which all FDIC-insured institutions are mandated to serve their local communities according to criteria specified by their federal regulators.

Preemption Under the NBA and HOLA

The NBA[25] was the brainchild of President Lincoln's Treasury Secretary, Salmon P. Chase, and was enacted at the height of the Civil War. At the time, circulating currency consisted of notes issued by state-chartered banks, which varied widely in their value and the degree of acceptance they enjoyed as money. By creating nationally chartered banks subject to more stringent standards and regulation, Chase and Lincoln sought to establish a more stable currency and to give the federal government a means to finance the war effort.[26] The NBA empowered the OCC to charter national banks within states regardless of whether the states consented. Accordingly, Lincoln and Chase recognized the importance of using the power of Congress to preempt state laws, under the Constitution's Supremacy Clause, to prevent the states (and by extension, local governments) from interfering in any way with the operation of the new national banks or the way they were regulated by the OCC.

Thus, the NBA expressly provides that "no national bank shall be subject to any visitorial powers except as authorized by Federal law.…"[27] As the agency charged with interpreting and enforcing the NBA, the OCC has defined "visitorial powers" to include "inspecting or requiring the production of books or records of national banks…examination of a bank…regulation and supervision of activities authorized or permitted pursuant to federal banking law…[and] enforcing compliance with any applicable federal or state laws concerning those activities."[28] The Dodd-Frank Act of 2010, in transferring authority to regulate federal thrifts to the OCC from the Office of Thrift Supervision (which was abolished under Dodd-Frank), expressly provided that the NBA provisions regarding visitorial authority would apply to federal thrifts to the same extent as if they were national banks.[29]

Against this backdrop, the NYBA argued that "the direct conflict between [the RBA] and the NBA could not be clearer."[30] The Needs Assessment and the Annual Report both specifically provide for an "examination" of the Deposit Banks, which include national banks. More generally, the RBA calls for the CIAB to "require the production of books and records," and mandates that Deposit Banks "plan for and articulate how they will respond to the credit, banking and financial services needs" of City residents as determined by the CIAB.[31] Thus, in the NYBA's view the power of the CIAB to require national banks and federal thrifts to offer certain services, and to subjectively evaluate how they do so, amounts to impermissible "regulation and supervision of activities authorized or permitted pursuant to federal banking law."[32]

Two recent Supreme Court cases have dealt with state intrusion into the OCC's exclusive "visitorial" and regulatory powers. In the first case, the Court held that a state could not inspect a mortgage lending subsidiary of a national bank, notwithstanding that the subsidiary was a corporation organized under state law, since it was engaged in activities authorized for the national bank by the OCC.[33] The Court's decision was legislatively overruled by Congress in the Dodd-Frank Act—i.e., Congress clarified that the OCC's exclusive "visitorial" powers over a bank do not extend to its non-bank subsidiary. But Congress left intact the OCC's exclusive authority as applied to the bank itself. The RBA, of course, sought information directly from the bank.

In the second case, New York's Attorney General sought to subpoena the records of a national bank to determine its compliance with state "fair lending" laws. The Court held, 5-4, that the subpoena was enforceable, notwithstanding the OCC's exclusive "visitorial" powers. Writing for the majority Justice Scalia reasoned, in effect, that the buffer of requiring a judicial subpoena protected against the State's unwarranted intrusion into the affairs of a national bank.[34] The RBA, of course, purports to authorize the CIAB to demand this information directly, not through a judicial subpoena.

More generally, as the NYBA argued, it is not possible to interpret the RBA in a way that avoids conflict with the NBA and implementing OCC regulations.[35] The NBA and the OCC regulations expressly authorize, and govern, powers such as branching, deposit-taking, residential mortgage lending, and others directly implicated by the RBA. Furthermore, many of these powers are expressly authorized without regard to state (and by extension, local) law. Thus, in mandating that banks "develop and offer financial services and products that are most needed by low and moderate income individuals and communities throughout the city and provide physical branches," the RBA intrudes directly on the exclusive power of the OCC to determine how national banks and federal thrifts offer their services.[36]

Preemption Under the Community Reinvestment Act

Enacted in 1977, the CRA[37] was aimed at combatting "redlining"—the process by which banks allegedly discriminate against minority and lower income areas by drawing a "red line" around such areas on a map and not making loans within the redlined areas.[38] Toward this end, the law generally mandates that a bank serve the entire community from which it derives its deposits. CRA is thus tied to deposit-taking; lenders that are not insured by the FDIC and do not take deposits from the public, such as mortgage bankers, are not subject to the CRA. While aimed at encouraging banks to serve their communities, CRA does not require them to make any particular type of loan, or to make loans that might jeopardize their financial stability. To the contrary, the CRA specifically provides that all CRA-related activities must be conducted in a way that is consistent with the safe and sound operation of the bank.

Each bank is subject to being examined for CRA compliance by its federal regulator—the OCC for national banks and federal thrifts, the Fed for State-chartered banks that are Fed members, and the FDIC for all other depository institutions insured by the FDIC. The exam results in one of four ratings—Outstanding, Satisfactory, Needs Improvement, or Substantial Noncompliance. In conducting the CRA examination, the regulator is instructed to "assess the institution's record of meeting the credit needs of its entire community, including low and moderate-income neighborhoods, consistent with [its] safe and sound operation."[39] Unlike traditional bank examinations, which are focused on safety and soundness and by law may not be publicly disclosed (in order to guard against triggering a run on a bank that has an adverse rating),[40] the results of CRA examinations are made public.[41]

CRA mandates that the regulators take the exam ratings into account "in [their] evaluation of an application for a deposit facility."[42] In practice, banks that are not rated Outstanding or Satisfactory generally will be barred from opening branches or engaging in other expansionary activities such as mergers. Furthermore, their parent holding company (if any) will be barred from engaging in a broad range of financial activities that would otherwise be allowed for qualifying holding companies under the Gramm-Leach-Bliley Act of 1999.[43]

The CRA imposes a "continuing and affirmative obligation" on every bank to "help meet the credit needs of the local communities."[44] It thus has an "inherently local focus" that regulators must consider in assessing a bank's CRA performance. Members of local communities, including local public officials, can and do submit their views regarding a bank's CRA performance.[45]

Thus, NYBA argued in effect that the RBA conflicts, and thus is preempted by, the CRA in three basic ways.[46] First, while CRA requires banks to develop information for their assessment area as a whole, RBA purports to require information at the census tract level. That this imposes a substantial burden well beyond the data banks are required to provide under CRA is apparent; New York City has some 2,168 census tracts, each of which covers a mere 90 acres and has about 3,000-4,000 people on average.[47] Second, by threatening to withhold business from banks deemed non-compliant, RBA introduces a penalty beyond those authorized by the Congress.[48] And third, by mandating disclosure of certain community investment activities beyond those required by CRA, the RBA violates the limitations imposed by Congress as to which activities of an FDIC-insured bank should be disclosed to the public. In sum, therefore, the NYBA argued that RBA conflicts with Congress' purpose under CRA, to achieve a "careful balance of disclosures and incentives" in promoting community investment activities by FDIC-insured banks.[49]

Preemption Under State Law

In addition to being subject to federal regulation such as the CRA, banks and thrifts that are chartered under New York State law are subject to a comprehensive scheme of regulation by the DFS. The DFS has exclusive authority to issue State charters to those banks and thrifts located in New York that choose to operate under a State, rather than federal, charter. Because the statutory scheme for chartering and regulating banks is plenary, banks cannot be established under, and are not subject to, general state corporation laws such as the New York Business Corporation Law.[50] Similarly to the doctrine of federal preemption, New York courts have held local laws to be preempted where there is a direct conflict with State law, or where "the State has evidenced its intention to occupy the field."[51]

Thus, the NYBA argued that the RBA was preempted under State law in two ways: first, because it directly conflicts with New York's own CRA law, which largely mirrors the federal CRA (while applying, of course, only to State-chartered institutions)[52]; and second, because New York Banking Law manifestly occupies the field of banking regulation as applied to State banks, in areas including branching, deposit-taking, mortgage lending, and others implicated by the RBA.[53]

The Court Decides

Confronted by NYBA's preemption arguments, the court recognized that the threshold issue was whether the RBA was in fact regulatory in nature, as NYBA argued, or rather, whether it was merely "proprietary," as the City asserted. The court had little difficulty in concluding that it was regulatory.

The court began by noting that there are two key questions in determining whether any particular enactment is proprietary or regulatory:

> First, does the challenged action essentially reflect the [City's] own interest in its efficient procurement of needed goods and services, as measured by comparison with the typical behavior of private parties in similar circumstances? Second, does the narrow scope of the challenged action defeat an inference that its primary goal was to encourage a general policy rather than address a specific proprietary problem?[54]

Essentially the same analysis applies to state preemption of a local ordinance. Thus, in a recent case in which Mayor Bloomberg challenged yet another City Council ordinance (unrelated to banking), the New York Court of Appeals held that the ordinance was regulatory, rather than proprietary, given that the Council "[did] not seriously assert that the purpose and likely effect of the law was to make the City's contracts cheaper or their performance more efficient."[55]

Still, the City asserted that the RBA nonetheless was not regulatory, in that it was intended to serve a "purely informational" purpose; the decision whether or not to award deposit business to a particular bank still resided with the independent Banking Commission; and none of its requirements were compulsory.[56] The court had no trouble making short shrift of these points.

First, on its face the RBA says its purpose is to assess "the credit, financial and banking services throughout the City with a particular emphasis on low and moderate income individuals and communities," and the law sets forth only one purpose for this assessment: "it may be considered by the Banking Commission" in determining which banks to designate as Deposit Banks. "These aims," said the court, "however commendable, evince a regulatory purpose."[57]

Second, the court dismissed the City's "incantation of 'transparency' as an end in and of itself." By applying its information requirement only to Deposit Banks, and not to all banks, it was evident that the "RBA places its premium on leverage to advance policy objectives rather than on information *qua* information. It is not lost on the Court that the RFIs [requests for information] were addressed to individuals responsible for maintaining each Deposit Bank's depository status with the City, rather than individuals charged with gathering Federal CRA information."[58]

Third, the court found that the purpose of the RBA manifestly was not "proprietary": "nowhere in the text of the RBA or the legislative history cited by the parties is there even a suggestion that the City's role as proprietor drove this law."[59] The Banking Commission's function is to place the City's funds with consideration to safety and to maximizing the City's economic benefit. But the RBA says nothing about protecting the City's money; and contrary to promoting the City's economic benefit as proprietor, "the RBA will cost the City more than $500,000 per year, but will yield the City—as banking customer—no discernable financial benefits."[60]

Finally, the court disposed of the City's argument that the RBA was not regulatory because it did not compel the Banking Commission to choose Deposit Banks based on the CIAB's findings, noting that "a legislature's grant of discretion in the enforcement of laws is unremarkable; it is, in most circumstances, presumed." Thus, if enforcement was required before a law could be deemed "regulatory" in nature, "even the Federal CRA would not qualify, because it does not *require* federal regulators to penalize banks for poor ratings…under [the City's] theory local legislatures could immunize legislation that otherwise would be preempted simply by changing the words 'shall' and 'must' to 'may' (emphasis in original)."[61]

Why Localized Bank Regulation Is a Bad Idea

The bank robber Willie Sutton, when asked why he robbed banks, famously said "because that's where the money is." The RBA is just the latest example of "creeping Willie Sutton-ism" at the local legislature level. In 1993, as general counsel of the NYBA, the author was called upon to testify before the Suffolk County Legislature regarding a proposed local ATM safety ordinance, modeled on one recently adopted by New York City. The NYBA's position was to support the legislation, but to request modification of a provision the NYBA's members—most of which were, and are, smaller community banks—had determined would be costly to implement and would not enhance safety. The same modification had already been agreed to by the legislatures of Nassau and Westchester Counties in enacting similar ordinances. The author was asked by a member of the Suffolk legislature what the provision would cost. He replied that it would cost an estimated $15,000 per branch location to install, apart from ongoing maintenance costs. The legislator replied, "Well, that doesn't sound like much to me. Those banks have all the money in the world."

The money banks "have," of course, is not theirs. It is money entrusted to them by their depositors, and which the FDIC, backed as necessary by the American taxpayer, is obligated to repay if it is lost. This, of course, is why banks are so pervasively regulated at the federal and state level, and why local legislation that conflicts with that regulation in favor of pursuing a parochial political agenda is antithetical to the objectives of such regulation. It is astonishing that some legislators apparently do not, or choose not to, understand this. But it is evident that "creeping Willie Sutton-ism" was the motivation of at least some of the RBA's proponents.

Thus, one Councilwoman spoke about making banks "give back to the community in regards to maybe home equity lines of credit, credit cards…you've got to start thinking about people coming back from incarceration… let's get them credit cards of $200 [and] make sure everyone gets their fair share"[62]—as if responsible banking entails the giving of credit on the basis of someone's sense of fairness, rather than on the basis of whether it can be repaid. Another Council member demanded that "we must address the locations of banks in my district."[63] It is precisely because such parochial concerns come to the fore that banking regulation should not be conducted at the local level.

The Bloomberg administration, in opposing the RBA, nonetheless took pains to acknowledge that it was well intentioned.[64] While this no doubt was an effort at diplomacy, the author would respectfully disagree. It is too easy for politicians to hide behind their own purportedly good intentions in passing bad laws; as the saying goes, "The road to Hell is paved with good intentions." The author does not believe it is "well-intentioned" for a local legislature to pass a law aimed at furthering parochial objectives that is manifestly in conflict with longstanding, and carefully thought out, federal and state legislation on the same subject. As Mayor Bloomberg's Commissioner of Finance aptly noted in testifying against the RBA,

> neither the Department of Finance nor any other City entity has the expertise, resources or legal authority to step into [a bank regulatory role]. This is not surprising since bank regulation should be and currently is a matter of primarily national interest and secondarily state interest. Interposing yet another level of regulation at a municipal level threatens not only the overarching federal scheme but practically places the City at a competitive disadvantage to retain private banking functions and the tax revenues and jobs that come with them.[65]

Indeed, as the court observed, "a certain regulatory braggadocio permeates the legislative history of the RBA."[66] The record is replete with examples of this. For instance, the court noted that City Council members expressed concern that federal and State regulatory regimes "did not go far enough in obtaining information or influencing bank conduct, thereby necessitating action by the City."[67]—in effect, arrogating to the City Council a presumptively greater knowledge of appropriate bank conduct than that of the federal and State agencies whose full-time job it is to regulate bank conduct.

Similarly, several Council members and their allies purported to have perfect knowledge of what constitutes "irresponsible" banking and how it should be remedied. Thus, the bill's chief sponsor stated that "[t]o do nothing is [to] support irresponsible banking and we've seen too many examples of that in the past few years."[68] A consultant hired by the CIAB to help implement the law stated that he would be gathering information from the Deposit Banks to establish "how they could do things differently *and better* (emphasis supplied)."[69] And a lobbyist for a community investment group testified that "it's really important that banks are acting responsibly. We know what happens when they don't."[70]

Again, the underlying assumption is that the federal and State regulators charged with enforcing the CRA cannot be trusted to ensure that banks live up to their community reinvestment responsibilities, so this function must be taken over by the City Council. Actually, however, they have it backwards: recent history makes clear that the primary "irresponsibility" of the banking industry that led to the crisis was the indiscriminate making of loans to people who could ill afford them.

Conclusion

In the *NYBA* case, Judge Failla clearly and emphatically rejected the latest attempt by the City Council to regulate the banking business. In rejecting the Council's flimsy attempt to preserve the law by claiming it was nothing more than an exercise of the City's "proprietary" right to set the terms for its contracts with third parties, she held that the RBA is preempted in its entirety by both federal and State law as an unwarranted intrusion by a local government into banking regulation. As such, the decision serves notice on those municipalities that may be contemplating similar legislation that, at the least, it will have to be carefully and narrowly drawn to avoid having the effect of regulating how banks conduct their business, in order to withstand judicial scrutiny.

In this regard, it should be noted that New York City is not the first, or only, municipality to enact a "responsible banking" ordinance. Cleveland, Ohio has had one in place since 1991, and in more recent years has been followed by Philadelphia, San Jose, Seattle, Pittsburgh, Los Angeles, Portland (Oregon) and San Diego.[71] It does not appear that any of these ordinances has been subject to legal challenge to date. The author has not reviewed these ordinances in depth and expresses no view as to whether any of them would withstand an attack based on preemption or otherwise. The San Diego ordinance, for example, appears to rely primarily on the bank's federal CRA rating, coupled with some additional local data-gathering, and thus appears less intrusive—and less "regulatory"—than New York's.

While the *NYBA* decision addressed itself primarily, and properly, to the preemption of the RBA under federal and State law, the author has argued that enactments of this type are troubling on a policy level as well. They rest upon the basic, and faulty, assumption that local politicians are better qualified than the banks themselves, their state and federal regulators, and the extensive body of federal and state law that governs them, to determine what constitutes the "responsible" investment by banks of the funds entrusted to them by their depositors and insured by the FDIC. And by seeking to penalize banks that do not toe the line, without regard to whether the desired behavior is consistent with the requirements of federal and state legislation, a law of this type can only undermine the objectives of bank regulation.

Furthermore, the RBA—like other City Council efforts before it—manifested a fundamental hostility to the banking industry and its critical role in meeting the financial needs of society—a hostility that is particularly damaging here, given the historic role of New York City as the financial capital of the world. To cite one example, the NYBA recently fought, but failed to defeat, another City Council enactment that restricts the size of storefronts banks can occupy, in the trendy upper West Side neighborhood of the enactment's chief sponsor, to an unworkable 25 feet—while allowing all other businesses to have more footage.[72] The result, and apparent intent, will be to preclude banks from opening new branches in that area in the future—even as the RBA purported to compel them to open branches in other parts of the City.

The banking industry provides employment to more than 200,000 New Yorkers. But contrary to the assertion of one City Council member that the "banks are not going to run away from New York City,"[73] modern law and technology increasingly make it possible for banks to conduct business, and provide jobs, in locations far from where they are headquartered. The City Council's periodic attempts to meddle in bank regulation can only send the message that it is prudent for banks to locate as many of these jobs as they can far away from the City. In any event, Judge Failla's thorough and well-reasoned decision should serve notice: to the extent that a local ordinance is regulatory in nature, it will not withstand scrutiny under a federal and State preemption analysis. And its pernicious effect cannot be disguised by the simple expedient of using the word "may" rather than "must" with respect to its enforcement.

Endnotes

1. New York Bankers Ass'n, Inc. v. City of New York, __ F. 3d ___, slip op., 2015 WL 4726880 (SDNY Aug. 7, 2015) ("NYBA").
2. The Council is comprised of 51 members representing discrete districts. At present, there are 47 Democrats, 3 Republicans, and one vacancy. See http://council.nyc.gov/html/members/members.shtml (last visited Dec. 1, 2015). There is, thus, little difficulty in marshaling a veto-proof majority. In fact, the vote to override Mayor Bloomberg's veto was 46 to 5. NYBA at 21.
3. This was not mere benign neglect. Then-Speaker Christine Quinn of the Council wrote to the Mayor asking him to make his appointments so the CIAB could get up and running; the Mayor replied that he believed the law was not proprietary in nature and was preempted, and thus that he refused to make the appointments. NYBA at 25-6.
4. New York Bankers Ass'n, Inc. v. City of New York, 2014 WL 4435427 (SDNY Sept. 9, 2014).
5. The parties' reply briefs were due July 29, 2015, and oral argument was scheduled for August 5. *See* The New York Bankers Association, Inc. v. The City of New York, Scheduling Order, June 8, 2015. Nonetheless, Judge Failla rendered her Opinion and Order on August 7.
6. Pub.L. No. 111-203 (July 21, 2010).
7. *See* The Big Short: Inside the Doomsday Machine by Michael Lewis (W.W. Norton 2010) for a particularly readable explanation of how this happened.
8. *See, e.g.*, NYBA at 11, quoting remarks of Albert Vann, Chairman of the City Council Committee on Community Development ("A lot of homeowners are losing their homes because of lack of support from our banks by modifying their loans and so forth.")
9. *Id.* at 19.
10. NYBA at 13 (remarks of Councilman Vann).
11. See "U.S. ends TARP with $15.3 billion profit," CNNMoney, Dec. 19, 2014, available at money.cnn.com/2014/12/19/.../government-bailouts-end/ (last visited Dec. 5, 2015). The article notes that the Treasury lost about $9.6 billion on the auto industry bailout, implying that the profit on the bank bailout was in excess of $25 billion.
12. New York Banking Law §6-I.
13. "City Tries to 86 Local Law 36," p.a. at http://citylimits.org/2003/04/15/city-tries-to-86-local-law-36/ (last visited Dec. 1, 2015).
14. Mayor of City of N.Y. v. Council of City of N.Y., 4 Misc. 3d 151, 780 N.Y. Supp. 2d 266 (Sup. Ct. N.Y. Cty 2004).
15. See http://www1.nyc.gov/site/finance/about/banking-commission.page (last visited Dec. 1, 2015).
16. NYBA at 22-3. No doubt indicative of Mayor de Blasio's mindset, not to mention the one-sided nature of the legislation, the Mayor's appointment to represent the banking industry was an official of a minority-owned savings & loan that was not a designated City Deposit Bank and was not seeking to become one. Thus, those banks directly affected—the Deposit Banks—were not represented at all.
17. NYBA at 19 (quoting testimony of Department of Finance Commissioner Frankel at the hearings for the bill before the City Council).
18. NYBA at 23-5.
19. *Id.* at 23-4.
20. *Id.* at 25.
21. US CONST., ART. VI, cl. 2.
22. *See, e.g.*, Pac. Capital Bank N.A. v. Connecticut, 542 F.3d 341, 351 (2d Cir. 2008).
23. 12 U.S.C. §§1 *et seq.*
24. 12 U.S.C. §§1461 *et seq.*
25. 12 U.S.C. §§1 *et seq.*
26. *See generally* Lowenstein, R., *America's Bank*, Ch. 1 (Penguin Press 2015) for a discussion of the origins and purpose of the NBA.
27. 12 U.S.C. §484(a).
28. 12 C.F.R. 7.4000(a)(2).
29. 12 U.S.C. §1465(c). Accordingly, for simplicity the HOLA will not be referred to further herein as the OCC's authority over federal thrifts thereunder is coextensive with its authority over national banks under the NBA.
30. The New York Bankers Association, Inc. v. The City of New York, Complaint of the New York Bankers Association, May 26, 2015, ¶115 ("Complaint").
31. Complaint at ¶¶117-118.
32. 12 C.F.R. 7.4000(a)(2).
33. Watters v. Wachovia Bank N.A., 550 U.S. 1 (2007).
34. Cuomo v. Clearing House Ass'n, 557 U.S. 519 (2009).
35. Complaint ¶¶118-119.
36. Complaint ¶¶120-121.
37. Codified at 12 U.S.C. §§2901 *et seq.*
38. *See generally* Office of the Comptroller of the Currency, Community Developments Fact Sheet on the Community Reinvestment Act, March 2014 (p.a. at http://www.occ.treas.gov/topics/community-affairs/publications/fact-sheets/fact-sheet-cra-reinvestment-act.pdf (last visited Dec. 1, 2015).
39. 12 U.S.C. §2901.
40. For this reason, under the federal Freedom of Information Act ("FOIA"), bank examination records in the hands of federal

agencies are automatically exempt from disclosure to the public. 5 U.S.C. §552(b)(8).

41. 12 U.S.C. §2908.

42. 12 U.S.C. §2903(a)(2).

43. 12 U.S.C. §1843(l)(1). To engage in the broader range of activities, the holding company must elect to be designated a "financial holding company" by the Fed. However, such election is not effective if any of its subsidiary depository institutions does not have at least a Satisfactory rating under CRA. 12 U.S.C. §2901(c)(3)(A).

44. 12 U.S.C. §2901(c).

45. Complaint ¶¶137, 139.

46. *See* Complaint ¶¶140-143.

47. New York City Census Fact Finder, as cited in NYBA fn. 5.

48. "Congress has plainly spoken on the question of what enforcement tools are available to agencies under the CRA. The CRA provides for enforcement only in the application context.…" Memorandum from Walter Dellinger, Asst. Att'y General, to Eugene Ludwig, Comptroller of the Currency, Dec. 15, 1994, as cited in Complaint ¶141.

49. Complaint ¶143.

50. McKinney's New York Business Corporation Law §103(a).

51. NYBA at 45 and cases cited therein.

52. McKinney's New York Banking Law §28-b.

53. Complaint ¶149.

54. Healthcare Ass'n of New York State v. Pataki, 471 F. 3d 87, 109 (2d Cir. 2006).

55. Matter of Council of City of New York v. Bloomberg, 6 NY 3d 380, 392.

56. NYBA at 47.

57. *Id.* at 48.

58. *Id.* at 49.

59. *Id.* at 52.

60. *Id.* at 54. This cost related both to hiring several full-time staff members and to paying for a consulting study by an outside firm, whose stated purpose was to "narrate…how each [Deposit Bank] is meeting the needs identified" by the CIAB. *Id.* at 28.

61. *Id.* at 58 (emphasis in original).

62. NYBA at 30 (remarks of Council Member Darlene Mealy).

63. *Id.* at 31 (remarks of Council Member Deborah Rose).

64. See NYBA at 3 ("thoughtful but misguided"), 10 ("very good intentions").

65. NYBA at 17 (remarks of Department of Finance Commissioner Frankel).

66. *Id.* at 48.

67. *Id.* at 15.

68. *Id.* at 19 (remarks of Councilman Vann).

69. *Id.* at 28.

70. *Id.* at 31 (remarks of Jamie Weisberg, Association for Neighborhood Housing and Development, Inc.).

71. National Community Reinvestment Coalition, Summary of Local Responsible Banking Ordinances, July 2012 (p.a. at http://www.ncrc.org/images/stories/pdf/research/summary_responsiblebank.pdf (last visited Dec. 2, 2015).

72. See "City Council Changes Zoning to Limit Sprawl of Banks on Upper West Side," NY Times. July 28, 2012, available at http://www.nytimes.com/2012/06/29/nyregion/city-council-limits-size-of-banks-on-upper-west-side.html (last visited Dec. 10, 2015).

73. NYBA at 22 (remarks of Council member Albert Vann).

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Recent Employment Laws Impacting Private Employers in New York City

By Sharon Parella

Introduction

During 2015, the New York City Council enacted two new laws that significantly impact private employers and their hiring practices. First, the City Council enacted a long-anticipated "ban-the-box" law that further restricts an employer's ability to inquire about an applicant's criminal history during the hiring process, and also mandates enhanced procedures when, based on such criminal history, an employer either withdraws a conditional offer of employment or takes adverse action against a current employee. Second, the City Council enacted a law that substantially restricts inquiries about and use of an applicant's or employee's credit history.

A summary of these laws is set forth below.

The Fair Chance Act

Effective October 27, 2015, an amendment to the New York City Human Rights Law, known as the "Fair Chance Act,"[1] prohibits a New York City employer with four or more employees from asking an applicant about his or her criminal record until after the employer has extended a conditional offer of employment to such applicant. Specifically, the Fair Chance Act, which is commonly referred to as a "ban-the-box" law, precludes an employer from inquiring about the applicant's pending arrests and/or prior criminal convictions on its employment application or during interviews until after the applicant has received a conditional offer (i.e., one which is contingent on the applicant's successful completion of the employer's background screening process). This new law also precludes an employer from stating on a solicitation, advertisement or publication that individuals with criminal records may not apply. In addition, as set forth in detail below, the new law requires that an employer who withdraws a conditional offer based on criminal history must provide the applicant with a written analysis of the reasons why such rejection is appropriate, and then wait for at least three days before then filling the position so that the applicant may respond. This procedure also applies when an employer takes adverse action against a current employee based on his or her criminal record, whether related to termination, transfer or promotion decisions.[2]

Historically, the New York State Human Rights Law ("NYSHRL") has protected applicants from discrimination based on their criminal records by strictly prohibiting employers with four or more employees from making inquiries about prior arrests that have been terminated in the applicant's favor, been resolved by a youthful offender adjudication, or resulted in a sealed conviction unless expressly required or permitted to do so by statute. Furthermore, the NYSHRL precludes employers from requiring an applicant to divulge information pertaining to any such arrest, adjudication or sealed conviction.[3]

Moreover, the NYSHRL provides that an employer cannot lawfully reject an applicant based on his or her criminal conviction(s) unless the employer can establish, based on the specific factors set forth in Article 23-A of the New York State Correction Law ("Correction Law"), a direct relationship between the applicant's prior misconduct and the job duties that the prospective employment would entail (or where offering employment would involve an unreasonable risk to property or safety or welfare of others).[4] Such factors include how the criminal offense at issue bears on the specific duties and responsibilities of the potential position, and the amount of time that has elapsed since the criminal offense.[5] Additionally, the NYSHRL requires that upon rejecting an applicant on this basis, the employer must, within 30 days of a request by the applicant, provide a written statement setting forth the reasons for the adverse action.[6] An employer must also provide a copy of the Correction Law to any applicant who is subject to a background check.[7]

Likewise, prior to the enactment of the Fair Chance Act, the New York City Human Rights Law ("NYCHRL") provided applicants with protections only equivalent to those set forth in the NYSHRL.[8] Accordingly, while New York City employers were restricted from investigating prior arrests that did not result in convictions, they were previously at liberty to make inquiries about pending arrests and prior convictions at any stage in the hiring process.

With the Fair Chance Act now in effect, however, a New York City employer must both (i) carefully restrict its inquiries about an applicant's pending arrests and prior criminal convictions until after the applicant has received a conditional offer of employment,[9] and (ii) take precise steps before withdrawing such conditional offer or taking any adverse action against a current employee based on a criminal record.[10] Specifically, an employer who withdraws an offer or takes adverse action against an employee (i.e., termination, transfer or promotion decisions) on this basis must:

(i) provide the applicant or employee with a written copy of the criminal history in a form determined by the New York City Commission on Human Rights ("NYCCHR"). In this connection, the NYCCHR requires that an employer "disclose a complete and accurate copy of every piece of information that it relied on to determine that an applicant [or employee] has a criminal record, along with the date and time the employer accessed the information. The applicant [or employee] must be able to see and challenge the same criminal history information relied on by the employer. Employers who hire consumer reporting agencies to conduct background checks can fulfill this obligation by a copy of the CRA's report on the applicant [or employee].… Employers who search the Internet to obtain criminal histories must print out the pages they relied on, and such printouts must identify their source so that the applicant [or employee] can verify them. Employers who check public records must provide copies of those records. Employers who rely on oral information must identify the interlocutor and provide a written summary of their conversation;[11]

(ii) provide the applicant [or employee] with a written copy of its analysis pursuant to the Correction Law which sets forth the basis and reasons for the adverse action, together with any supporting documents, in a form determined by the NYCCHR (the NYCCHR has prepared a "Fair Chance Notice" for employers or, provided that the material substance does not change, an employer may adapt the Notice to its preferred format);[12] and

(iii) after providing the requisite documentation, wait a reasonable time (at least three business days) before filling the position so that the applicant [or employee] has an opportunity to respond. After receiving a response from an applicant or employee, an employer must examine whether the response changes its Correction Law analysis. In this regard, if an applicant or employee does not demonstrate that any discrepancy between the information that the applicant or employee disclosed and the criminal background check is due to an error, the employer can decline to hire the applicant or take adverse action against the employee without any further Correction Law analysis based on the misrepresentation.[13]

Among its exceptions, the Fair Chance Act is inapplicable in situations where a federal, state or local law requires an employer to undertake a criminal background check as a prerequisite to employment, or bars employment based on an applicant's criminal record. For purposes of this provision, "federal law" includes the rules and regulations of a self-regulatory organization as defined by the Securities Exchange Act of 1934, such as the Financial Industry Regulatory Authority, Inc. ("FINRA").[14]

With respect to available remedies for an employer's violation, the Fair Chance Act provides aggrieved applicants and employees with a private right of action and broad remedies. The NYCCHR will also enforce the Fair Chance Act, and the amount of its civil penalty, which will be in addition to any remedies obtained by those who resolve or prevail in private claims, will be based on factors including (i) the severity of the violation, (ii) the existence of additional previous or contemporaneous violations, (iii) the employer's size, considering the total number of employees and its revenue, and (iv) whether the employer knew or should have known about the Fair Chance Law.[15]

According to the "New York City Commission on Human Rights Legal Enforcement Guidance on the Fair Chance Act, Local Law No. 63 (2015)" ("Guidance"), the new law was motivated, in large part, by the City's assessment that a substantial number of qualified individuals risk being overlooked during the hiring process based on their criminal records. Specifically, the Guidance states that "[e]ven though New York Correction Law Article 23-A ('Article 23-A') has long protected people with criminal records from employment discrimination, the City determined that such discrimination still occurred when applicants were asked about their records before completing the hiring process because many employers were not weighing the factors laid out in Article 23-A."[16]

As a consequence of this new Fair Chance Act, prior to extending a conditional offer of employment to an applicant, an employer must ensure that its (i) employment application does not contain questions about criminal history, (ii) employees who conduct interviews are educated about the provisions of the new law and therefore do not ask questions about criminal history, (iii) job postings and advertisements do not limit applications based on criminal history (including phrases such as "no felonies," "background check required" and "must have clean record"),[17] (iv) Human Resources professionals who conduct internet and public records searches on applicants do not include criminal history in their research and reports, and (v) its third-party vendors, such as consumer reporting agencies, who provide background checking services, comply fully with this law.

Stop Credit Discrimination in Employment Act

Effective September 3, 2015, an amendment to the New York City Human Rights Law, known as the "Stop Credit Discrimination in Employment Act,"[18] prohibits a New York City employer with four or more employees from requesting and/or using the consumer credit history of (i) an applicant in connection with its decision whether to hire such applicant, and (ii) a current employee when making employment decisions pertaining to such employee. In sum, the new law strictly prohibits an employer from discriminating "against any applicant or employee with regard to hiring, compensation, or the terms, conditions or privileges of employment based on the consumer credit history of the applicant or employee."[19]

Under the Stop Credit Discrimination in Employment Act, "consumer credit history" means an individual's credit worthiness, credit standing, credit capacity or payment history as evidenced by items including:

(i) a consumer credit report;

(ii) a credit score; and

(iii) information directly obtained from the applicant or employee regarding details about his or her credit accounts (including the number of credit accounts), any late or missed payments, charged-off debts, items in collection, credit limits, prior credit inquiries, bankruptcies, judgments or liens.[20]

Under the new law, employers are not, however, prohibited from inquiring about and/or considering credit history in connection with:

(i) positions with signatory authority over third party funds or assets valued at $10,000 or more;

(ii) positions that involve fiduciary responsibilities and with authority to enter into financial agreements valued at $10,000 or more on behalf of the employer;

(iii) positions with regular duties that allow an employee to modify digital security systems established to prevent the unauthorized use of the employer's or its client's networks or databases;

(iv) non-clerical positions with regular access to trade secrets, intelligence information or national security information;

(v) police officers, peace officers or those in certain positions at the City of New York Department of Investigation (including those with a law enforcement or investigative function);

(vi) positions requiring bonding under federal, state or city laws, such as positions in the financial services industry; and

(vii) positions requiring security clearance under any federal or state law.[21]

For purposes of the foregoing exemption relating to non-clerical employees with regular access to trade secrets, the new law defines "trade secrets" as information that (i) derives actual or potential independent economic value from not being generally known to (and not being readily ascertainable by proper means by) other persons who can obtain economic value from its disclosure or use, (ii) is the subject of reasonable efforts (under the circumstances) to maintain its secrecy, and (iii) can reasonably be said to be the end product of significant innovation. Furthermore, the law provides that "trade secrets" definitively are not general proprietary company information such as handbooks and policies.[22]

In addition, the law also will not apply to employers that are required to consider credit history for employment purposes under any federal or state law or regulations, including those of a self-regulatory organization as defined by the Securities Exchange Act of 1934.[23]

The Stop Credit Discrimination in Employment Act provides aggrieved applicants and employees with a private right of action and broad remedies. In addition, the New York City Commission on Human Rights will also enforce the law and will impose civil penalties up to $125,000 for violations, and up to $250,000 for violations that are the result of willful, wanton or malicious conduct.[24] Accordingly, New York City employers must carefully evaluate which, if any, of their positions are exempt under this law, and ensure that their background screening processes are in strict compliance with its provisions.

Endnotes

1. N.Y.C. Admin. Code § 8-107(11-a).
2. New York City Commission on Human Rights Legal Enforcement Guidance on the Fair Chance Act, Local Law No. 63 (2015), available on the NYCCHR's website, http://www.nyc.gov/cchr.
3. N.Y. Exec. Law § 296(16).
4. N.Y. Exec. Law § 296(15); N.Y. Correct. L. § 752.
5. N.Y. Correct L. § 753.
6. N.Y. Correct L. § 754.
7. N.Y. Gen. Bus. Law § 380-c.
8. N.Y.C. Admin. Code §§ 8-107(10) & (11).
9. N.Y.C. Admin. Code § 8-107(11-a)(2)(a).
10. N.Y.C. Admin. Code § 8-107(11-a)(b); New York City Commission on Human Rights Legal Enforcement Guidance on the Fair Chance Act, Local Law No. 63 (2015), available on the NYCCHR's website, http://www.nyc.gov/cchr.
11. New York City Commission on Human Rights Legal Enforcement Guidance on the Fair Chance Act, Local Law No. 63 (2015), available on the NYCCHR's website, http://www.nyc.gov/cchr.
12. The Notice is available on the NYCCHR's website, http://www.nyc.gov/FairChanceNYC.
13. New York City Commission on Human Rights Legal Enforcement Guidance on the Fair Chance Act, Local Law No. 63 (2015), available on the NYCCHR's website, http://www.nyc.gov/cchr.
14. N.Y.C. Admin. Code § 8-107(11-a)(e).
15. New York City Commission on Human Rights Legal Enforcement Guidance on the Fair Chance Act, Local Law No. 63 (2015), available on the NYCCHR's website, http://www.nyc.gov/cchr.
16. *Id*.
17. *Id*.
18. N.Y.C. Admin. Code § 8-107(24).
19. *Id*.
20. N.Y.C. Admin. Code § 8-102(29).
21. N.Y.C. Admin. Code § 8-107(24).
22. *Id*.
23. *Id*.
24. New York City Commission on Human Rights Legal Enforcement Guidance on the Stop Credit Discrimination in Employment Act, Local Law No. 37 (2015), available on the NYCCHR website at http://www.nyc.gov/cchr.

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Inside the Courts

An Update by the Attorneys of Skadden, Arps, Slate, Meagher & Flom LLP

Auction Rate Securities

D. Mass. Enters Summary Judgment Dismissing Claims That Financial Institutions Provided Misleading Information Regarding Auction Rate Securities

Tutor Perini Corp. v. Banc of Am. Sec. Litig., No. 11-10895-NMG (D. Mass. Aug. 12, 2015)

Judge Nathaniel M. Gorton of the U.S. District Court for the District of Massachusetts granted summary judgment for the defendants on an investor's claim that a bank and an affiliated broker-dealer violated Section 10(b) of the Securities Exchange Act by concealing material information in connection with certain auction rate securities, which were allegedly unsuitable to the plaintiff. The plaintiff allegedly sustained losses when the market for certain student loan auction rate securities collapsed. The court dismissed all claims against the bank because the plaintiff "failed to identify any misconduct" on the part of that party. Further, although the plaintiff asserted in its briefing papers that the bank was "liable as a controlling person," the plaintiff had "not made that claim in its pleadings." As to the broker-dealer, the court held that the allegedly concealed information about the securities had, in fact, been disclosed to the plaintiff or was available in public documents. In addition, the plaintiff failed to demonstrate the element of reliance. A presumption of reliance was not available because the court found that the defendant had not concealed material information, and the plaintiff could not demonstrate actual reliance because it was a sophisticated investor which "received numerous written disclosures about the risks of auction failure." Regarding the plaintiff's unsuitability claim, the court noted that sophisticated investors like the plaintiff "have difficulty establishing" such a claim and dismissed the claim because the court had already concluded that the defendant did not make any material misstatements. The plaintiff was provided with a prospectus that provided disclosures with respect to suitability. The plaintiff has filed a notice of appeal to the U.S. Court of Appeals for the First Circuit.

Class Actions—Class Action Fairness Act

District Court Denies Remand Without Prejudice, Finds Plaintiffs Failed to Meet Their Evidentiary Burden to Show CAFA Exception Applied, Permits Jurisdictional Discovery

Calderon v. Total Wealth Mgmt., Inc., No. 15CV1632 BEN (NLS) (S.D. Cal. Oct. 8, 2015)

Judge Roger T. Benitez of the U.S. District Court for the Southern District of California denied the plaintiffs' motion to remand a putative class action to California state court, finding that the plaintiffs failed to show by a preponderance of the evidence that one of the exceptions to the Class Action Fairness Act (CAFA) applied.

Twenty-seven named plaintiffs seeking to represent a class of investment advisory clients asserted 14 state law claims against the defendants—purported investment advisers—alleging that the defendants were routing the plaintiffs' funds to investment companies that were paying the defendants a percentage of the money they generated from the funds.

The defendants removed the case to federal court pursuant to CAFA. Under CAFA, federal courts have jurisdiction over certain class actions if the class has more than 100 members, the parties are minimally diverse and the amount in controversy exceeds $5 million. Both parties agreed that those elements were satisfied. The plaintiffs moved to remand, however, arguing that two exceptions to CAFA jurisdiction applied—the local controversy and home-state controversy exceptions.

For the local controversy and home-state controversy exceptions to apply, more than two-thirds of the proposed class must be citizens of the state in which the action is brought. Here, the 27 named plaintiffs were all citizens of California. However, the class was estimated to contain between 400 and 800 members. The only other evidence the plaintiffs submitted regarding the citizenship of class members was a declaration asserting that the plaintiffs' counsel had received inquiries about the case by other plaintiffs that would fit into the class, and every potential class member was a California resident.

The court first noted that, while the two concepts are related, citizenship is not the same as residency. Moreover, the court reasoned that although the court is permitted to make reasonable inferences from facts in evidence, concluding that more than two-thirds of a class of hundreds are California citizens based on the assertion that inquiries have been received and some unknown number of people calling are California residents is not a reasonable inference. The court emphasized that jurisdictional findings of fact should be based on more than guesswork, and the evidence in the record did not support a conclusion that two-thirds of class members were California citizens.

The court allowed plaintiffs to conduct limited jurisdictional discovery tailored to the two-thirds issue and granted leave to file a renewed motion to remand within 90 days.

ERISA

District Court Refuses to Dismiss Putative Class Action Brought Under ERISA

Murray v. Invacare Corp., No. 1:13 CV 1882 (N.D. Ohio Aug. 28, 2015)

Judge Donald C. Nugent of the U.S. District Court for the Northern District of Ohio refused to dismiss a putative class action complaint brought under the Employee Retirement Income Security Act (ERISA). The plaintiff, a participant in her employer's retirement plan, alleged that plan fiduciaries breached their duties of prudence and loyalty under ERISA when they allowed participants to acquire more shares of the employer's stock though they knew the stock was an imprudent investment. According to the plaintiff, the defendants held material, nonpublic, negative information about the company's compliance with Food and Drug Administration safety and compliance standards.

The defendants first argued that the plaintiff failed to state a claim for breach of the fiduciary duties of prudence and loyalty under the pleading standards set forth by the U.S. Supreme Court in *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459 (2014). The court rejected this argument, reasoning that *Dudenhoeffer* requires the court to consider "whether the complaint has plausibly alleged that a prudent fiduciary in the defendant's position could not have concluded that stopping purchases ... would do more harm than good to the fund by causing a drop in the stock price and a concomitant drop in the value of the stock already held by the fund." 134 S. Ct. at 2473. Because the plaintiff alleged that a prudent fiduciary in the defendants' position could have concluded that stopping plan participants from further investing in the company stock would not have caused the plan more harm than good, the court concluded that the plaintiff met her pleading burden.

The defendants further argued that the plaintiff failed to allege loss causation under *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005). The court also rejected this argument, concluding that the plaintiff identified three stock price drops that occurred in reaction to revelations of the truth by the company, which was sufficient to state an artificial inflation claim under *Dura Pharmaceuticals*. Accordingly, the court denied the defendants' motion to dismiss and allowed the putative class action to proceed.

Fiduciary Duties—Mergers and Acquisitions

Delaware Supreme Court Applies Business Judgment Rule to Merger Transaction Approved by Disinterested, Fully Informed Stockholders

Corwin v. KKR Fin. Holdings LLC, No. 629, 2014 (Del. Oct. 2, 2015)

The Delaware Supreme Court affirmed a prior ruling by the Court of Chancery dismissing a complaint challenging a merger that was approved by a vote of fully informed, disinterested stockholders.

In the opinion below, the Court of Chancery held that a stock-for-stock merger between KKR & Co. L.P. (KKR) and KKR Financial Holdings LLC (Financial Holdings) was subject to business judgment review. The plaintiffs had argued that KKR was a controlling stockholder of Financial Holdings because, even though KKR owned less than 1 percent of Financial Holdings, KKR managed Financial Holdings through an affiliate under a contractual management agreement that could only be terminated by Financial Holdings if it paid a termination fee. The Court of Chancery found KKR was not a controlling stockholder and entire fairness did not apply. The Court of Chancery also found that enhanced scrutiny under *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986), did not apply because "the transaction was approved by an independent board majority and by a fully informed, uncoerced stockholder vote" and dismissed the case under the business judgment rule.

Affirming the Court of Chancery's decision, the Supreme Court explained that the business judgment rule, and not enhanced scrutiny under *Revlon*, is the appropriate standard of review for a disinterested merger transaction approved by an uncoerced, informed vote of stockholders. In so holding, the Supreme Court clarified its prior decision in *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009), explaining that *Gantler* dealt with the narrow issue of ratification and did not address the applicable standard of review governing merger transactions approved by fully informed stockholders.

Delaware Supreme Court Finds Allegations Challenging Director Independence Sufficient to Plead Demand Futility

Delaware Cnty. Emps. Ret. Fund v. Sanchez, No. 702, 2014 (Del. Oct. 2, 2015)

The Delaware Supreme Court reversed the Court of Chancery's dismissal of a complaint for failure to plead demand futility.

The transaction at issue involved a multimillion dollar payment to a private company, Sanchez Resources, LLC, wholly owned by the family of A.R. Sanchez, Jr., from a public company, Sanchez Energy Corporation, in which the Sanchez family owned a 16 percent interest.

The appeal focused on whether plaintiffs had raised a pleading-stage doubt about the independence of one of the public company directors from another interested director. According to the complaint, the two directors had been close friends for more than five decades, and the otherwise disinterested director's personal wealth was largely attributable to business interests over which the interested director had substantial influence. The Supreme Court explained that these allegations did not amount to the kind of "thin social-circle friendship" the court typically rejects as demonstrating a director's lack of independence, and found that these allegations were instead sufficient to plead demand futility.

Delaware Court of Chancery Dismisses Aiding and Abetting Claim Against Financial Advisor

In re Zale Corp. Stockholders Litig., No. 9388-VCP (Del. Ch. Oct. 1, 2015)

Vice Chancellor Donald F. Parsons, Jr. of the Delaware Court of Chancery denied a motion to dismiss aiding and abetting breach of fiduciary duty claims asserted against a financial advisor that had advised a target company in connection with a merger transaction, but later granted reargument and dismissed the claims.

The case concerned Signet Jewelers Ltd.'s acquisition of Zale Corporation, which merger the court found was approved by a disinterested majority of Zale's stockholders in a fully informed vote. With respect to the breach of the fiduciary duty claim asserted against Zale's directors, the court held that: (1) duty of care claims against the directors were barred by Zale's exculpatory charter provision, (2) no duty of loyalty violation was alleged because plaintiffs only claimed that up to four of the nine directors were conflicted—meaning a majority were independent and disinterested, and (3) none of the alleged "flaws" in the sale process rose to the level of bad faith. The court accordingly dismissed those claims.

However, the court found that plaintiffs stated a claim for aiding and abetting against Merrill Lynch, Zale's financial advisor in the transaction, based on the Zale board members' alleged breaches of the duty of care. Before the financial advisor was engaged by Zale, the financial advisor made a presentation to Signet regarding a possible acquisition of Zale. While Merrill Lynch was not hired for that work, a managing member of the financial advisor was on both the team that made the presentation to Signet and the team that advised the Zale board during the merger process. The court found that the board's failure to uncover this potential conflict "arguably" constituted gross negligence sufficient to state a claim for breach of the duty of care, and that the financial advisor knowingly participated in such breach because it knew of the alleged conflict and failed to disclose it.

On October 30, 2015, Vice Chancellor Parsons granted Merrill Lynch's motion for reargument and dismissed the case in its entirety. The court reversed its earlier decision based on the Delaware Supreme Court's decision in *Corwin v. KKR Financial Holdings*, which was issued one day after the original *Zale* opinion. Vice Chancellor Parsons held that under *KKR*, the operative standard of review was not enhanced scrutiny under *Revlon*, as he had previously held, but instead reverted to the business judgment rule based on the fully informed vote of Zale stockholders. Under the business judgment standard, the court held that the conduct of the directors did not violate the business judgment rule, and therefore no breach of fiduciary duty was pleaded. Because there was no primary breach of fiduciary duty, there could be no aiding and abetting claim against Merrill Lynch. Therefore, the court dismissed the remaining claim against Merrill Lynch, which disposed of the case in its entirety.

Fraud-on-the-Market Theory

SDNY Holds, for Purposes of Certification, That Plaintiffs Do Not Have to Demonstrate Price Impact to Prove Market Efficiency

Carpenters Pension Trust Fund of St. Louis v. Barclays PLC, No. 12-cv-5329 (SAS) (S.D.N.Y. Aug. 20, 2015)

Judge Shira A. Scheindlin of the U.S. District Court for the Southern District of New York certified a class of shareholders in an action that alleged that an investment bank violated Section 10(b) of the Securities Exchange Act by allegedly understating its borrowing costs through public statements and false London Interbank Offered Rate (Libor) submissions. The court held that the plaintiffs were entitled to a presumption of reliance at the class certification stage because the plaintiffs' expert established that the alleged misstatements were public and material, and that the stock was traded in an efficient market. In determining whether the market for the stock was efficient, the court examined the factors set forth in *Cammer v. Bloom*, 711 F. Supp. 1264, 1283-87 (D.N.J. 1989). The court rejected the defendants' argument that failure to satisfy the fifth factor—evidence of price changes after disclosure of material information, which the plaintiffs did not attempt to prove—was dispositive. At least in cases involving a "high-volume stock followed by a large number of analysts and traded on a national exchange," the court held that no single factor is dispositive and that the plaintiffs were not required to prove the fifth factor through an event study, although the defendants could have utilized price impact evidence themselves to attack the presumption of reliance under the U.S. Supreme Court's decision in *Halliburton Co. v. Erica P. John Fund Inc.*, 134 S. Ct. 2398 (2014). Considering the other *Cammer* factors, the court determined that the market for the bank's shares was efficient because the bank's shares were listed on the New York Stock Exchange, the bank was covered by a large number of analysts, its shares were traded at a high volume, there were a sufficient number of market makers, the bank's market capitalization was high, the market was liquid and the bank was eligible to file SEC Form S-3. However, as to the alleged omission claims, the court concluded that the plaintiffs were not entitled to a presumption of reliance because their claims were not truly based on omissions, and in any event, the defendants had no duty to disclose the allegedly concealed information. In addition, the court held that the plaintiffs' damages model matched its theory of liability and "survive[d] the minimal scrutiny required" at the class certification stage, despite noting that "significant obstacles" may remain at the merits stage.

Loss Causation

SDNY Enters Summary Judgment and Reaffirms Loss Causation Requirement in Fraudulent Inducement Claim

In re Lehman Bros. Sec. & ERISA Litig., No. 09-md-2017 (LAK) (S.D.N.Y. Sept. 10, 2015)

Judge Lewis A. Kaplan of the U.S. District Court for the Southern District of New York granted summary judgment on claims that a former auditor of Lehman Brothers violated Section 10(b) of the Securities Exchange Act in connection with certain cash settled call warrants that tracked the performance of a particular investment fund. The warrants became worthless when Lehman filed for bankruptcy during the financial crisis. The plaintiff's claims against the auditor were based on certain alleged misstatements in audited financial documents filed by Lehman with the SEC and incorporated by reference into the offering memorandum of the warrants. The court held that the plaintiff failed to sufficiently allege loss causation, even though the plaintiff sought only rescissory damages and the securities were not publicly traded and were illiquid even before Lehman's bankruptcy. The plaintiff "relie[d] heavily on two dated Second Circuit precedents"—*Chasins v. Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970) and *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594 (2d Cir. 1978)—which held that rescissory damages were appropriate for instances where an investor is fraudulently induced into purchasing a security. The court, however, found that those cases were inconsistent with the "current doctrine on loss causation, not to mention the Private Securities Litigation Reform Act (the 'PSLRA')," and observed that loss causation is an explicit requirement under the PSLRA. The court also took note of the law in other circuits, which likewise holds that proof of loss causation is required even for fraudulent inducement claims, and therefore the plaintiff had "a theory of causation that simply is not tenable." The plaintiff has filed a notice of appeal to the U.S. Court of Appeals for the Second Circuit.

Manipulative Scheme

SDNY Dismisses Claims in Connection With Alleged High-Frequency Trading

In re Barclays Liquidity Cross & High Frequency Trading Litig., No. 14-MD-2589 (JMF) (S.D.N.Y. Aug. 26, 2015)

Judge Jesse Furman of the U.S. District Court for the Southern District of New York dismissed claims that certain stock exchanges and a financial institution violated Section 10(b) of the Securities Exchange Act by participating in certain alleged high-frequency trading (HFT) practices. Specifically, the complaint alleged that the defendants allowed subscribing HFT firms to obtain proprietary information about trading activity directly from the exchanges, allowed "co-location" (*i.e.*, allowing high-frequency traders to install "servers at, or extremely close to, the servers used to operate the Exchanges") and allowed HFT traders to use complex order types that were unavailable to ordinary investors. The plaintiffs further alleged that the exchanges favored the HFT firms over other investors because the exchanges profited from trading volume, and HFT firms drive up trading volume. The court dismissed the complaint for two reasons. First, it noted that in the securities context, "manipulation" is a term of art that requires an artificial effect on the price of a security, and the plaintiffs did not allege any artificial effect. Further, the exchange defendants had not concealed the "availability of proprietary data feeds and co-location services, and both were publicly approved by the SEC." In addition, the court noted that manipulative-scheme claims implicate only primary violations, and "the most that the Complaints can be said to allege is that the Exchanges aided and abetted the HFT firms' manipulation of the market price." With respect to claims against the financial institution, the court further held that the plaintiffs had failed to plead reliance because the plaintiffs did "not point to any statements by [the financial institution] that could have affected the price at which they decided to trade." Similarly, the plaintiffs were not entitled to a presumption of reliance under *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972), because the gravamen of the claims was based on alleged false statements—that the defendant promoted a private exchange called a "dark pool" as a safe place to trade—and not on an omission. Finally, the court declined to accept the plaintiffs' invitation "to apply a novel presumption of reliance based on the fairness and integrity of the market" because such a theory of reliance "would effectively excuse" plaintiffs from proving the element of reliance "for any market-manipulation claim." The plaintiffs have filed a notice of appeal to the U.S. Court of Appeals for the Second Circuit.

Misrepresentations

SDNY Dismisses Claims Against Oil and Gas Company Because Alleged Misrepresentations Were Not Pleaded With Particularity

In re PetroChina Co. Sec. Litig., No. 13-cv-6180 (ER) (S.D.N.Y. Aug. 3, 2015)

Judge Edgardo Ramos of the U.S. District Court for the Southern District of New York dismissed claims that an oil and gas company violated Section 10(b) of the Securities Exchange Act by falsely representing in annual reports that it had adequate internal controls, complied with applicable laws and maintained high standards of governance and ethics. The plaintiffs alleged that the representations were false because the company and certain of its officers and directors became subject to corruption investigations and disciplinary action in China, and certain of the company's suppliers were under similar investigations. The court determined that the complaint failed to allege a false statement because "rather than precisely identifying the statements" that were purportedly false, the complaint "simply contains large block quotations" from two annual reports, the company's ethics policy and its website, and alleges in conclusory fashion that several paragraphs in those materials were false. Further, the complaint "relie[d] on allegations of bribery and corruption that postdate the time period covered by the 2011 and 2012 annual reports," from which the plaintiffs purported to identify false statements. The court further determined that although the scienter of employees, if any, could be imputed to the company, the plaintiffs failed to adequately plead scienter because the plaintiffs had not alleged facts that showed that any defendant had the motive and opportunity to commit the alleged fraud. The court noted that the complaint failed to allege that any of the individuals "were engaged in corruption of any kind at the time or prior to when the false statements were made and therefore possessed a motive to commit securities fraud." The plaintiffs have filed a notice of appeal to the U.S. Court of Appeals for the Second Circuit.

Scienter

Ninth Circuit Reverses Dismissal of Securities Fraud Claims, Holds Intent of CEO Can Be Imputed to Corporation, Even Where CEO Was Embezzling Funds From Company

Costa Brava Partnership III LP v. ChinaCast Educ. Corp., No. 12-57232 (9th Cir. Oct. 23, 2015)

The U.S. Court of Appeals for the Ninth Circuit reversed the dismissal of claims brought under Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder against an online for-profit education service, holding that a CEO's scienter could be imputed to the defendant corporation even though the CEO acted against the corporation's interest.

The plaintiff shareholders brought suit after it was discovered that the defendant's CEO had intentionally falsified numerous public filings while looting the company of a sizable chunk of its assets. The plaintiffs claimed that the CEO's scienter could be imputed to the corporation because its board of directors failed to take corrective action after a 2011 external audit disclosed that the company suffered from "serious internal control weaknesses." The district court dismissed the suit with prejudice, ruling that under the common law's "adverse interest exception" to the doctrine of *respondeat superior,* scienter could not be imputed to a principal from the fraud of a rogue agent who acted against the interests of the principal.

In reversing the district court, the Ninth Circuit held that the adverse interest exception itself contains an exception: A principal is still liable for the fraud of a rogue agent when an innocent third party relies in good faith on the agent's apparent authority. Thus, because the CEO was authorized to speak on the defendant's behalf, and shareholders had innocently relied on the CEO's fraudulent misrepresentations, the CEO's scienter could still be imputed to the defendant corporation.

The court recognized that this rule may eliminate the adverse interest exception for clean hands plaintiffs. Citing the Third Circuit's analysis in a similar case, however, the court argued that its approach best advances the public policy goals of both securities and agency law. Namely, holding corporations liable for the fraud of rogue executives fairly allocates risk away from innocent investors and encourages corporate boards to closely monitor high-level officials to detect securities fraud. Here, because the corporation's board had failed to institute effective internal controls despite outside warnings, the corporation was not immune from liability under the securities laws.

Second Circuit Vacates Dismissal of Claims Against Chinese Oil Exploration Company and Its Former CEO but Affirms Dismissal as to Directors and Certain Other Officers

Acticon AG v. China Ne. Petroleum Holdings Ltd., No. 15-172-cv (2d Cir. Aug. 28, 2015)

The U.S. Court of Appeals for the Second Circuit vacated in part the dismissal of claims against a Chinese oil exploration company for allegedly violating Section 10(b) of the Securities Exchange Act by making material misrepresentations concerning the company's internal controls. The plaintiffs alleged that the company's former CEO misrepresented the adequacy of the company's internal controls while at the same time engaging in unauthorized transfers of company funds. The Second Circuit determined that the plaintiffs adequately alleged scienter because the CEO had motive and opportunity to commit fraud and personally benefited from the alleged fraud. Likewise, the plaintiffs adequately alleged scienter as to the company because, as the company's CEO, the individual defendant's fraudulent intent could be imputed to the company. However, the Second Circuit found that the plaintiffs failed to adequately allege scienter as to other directors and officers of the company. The plaintiffs' general allegations that the directors and officers were reckless in failing to identify errors in the company's internal controls and accounting statements were insufficient in and of themselves to show scienter. In addition, as to at least one of the individual defendants, allegations that the individual made efforts to uncover the alleged fraud undermined any inference of scienter.

Eighth Circuit Upholds Summary Judgment Against Limited Liability Company for Violations of the Securities Exchange Act

Doud v. Toy Box Dev. Co., 798 F.3d 709 (8th Cir. Aug. 18, 2015)

The U.S. Court of Appeals for the Eighth Circuit upheld summary judgment against a limited liability company (LLC) for violations of Section 10(b) of the Securities Exchange Act and Rules 10b-9 and 10b-5 thereunder, as well as state and common law claims. The plaintiff alleged that the LLC violated federal securities law when it released escrow funds to itself before securing the necessary capital required by the offering. The district court concluded that the LLC's conduct violated Rules 10b-9 and 10b-5 and specifically determined that the plaintiff had established the scienter required to find violations of the Securities and Exchange Commission's rules.

The Eighth Circuit agreed with the district court that the LLC violated Rule 10b-9 and acted with the necessary scienter by breaking escrow before reaching the minimum capital required by the offering and by misrepresenting to investors that it had reached the minimum capital required by the offering. The court rejected the LLC's argument that it had the minimum capital amount in subscriptions at the time it broke escrow, reasoning that it is not enough for the seller merely to have commitments to buy the security being sold. The court further held that the facts were sufficient to show that the LLC employed a manipulative or deceptive device or contrivance in connection with a sale of security in violation of Rule 10b-5.

Securities Fraud Pleading Standards—Omissions

Sixth Circuit Affirms Dismissal of Section 10(b) Claim Against Yum! Brands

Bondali v. Yum! Brands, Inc., No. 15-5064 (6th Cir. Aug. 20, 2015)

The U.S. Court of Appeals for the Sixth Circuit affirmed the dismissal of a securities class action on the grounds that the plaintiffs failed to state a claim upon which relief could be granted. The plaintiffs brought Securities Exchange Act claims under Sections 10(b), 20(a) and Rule 10b-5 against Yum! Brands and certain corporate officers, alleging that the defendants made false or misleading statements by failing to disclose: (1) that chicken being supplied to Yum's KFC China subsidiary had tested positive for drug and antibiotic residues; and (2) that Yum's food standards and safety protocols were inadequate.

The Sixth Circuit rejected the plaintiffs' arguments, agreeing with the district court that the plaintiffs failed to allege a material misrepresentation or omission because they did not assert facts demonstrating the defendants' statements were "objectively false or misleading in light of the information now known," *In re Omnicare, Inc., Sec. Litig.*, 769 F.3d 455, 478 (6th Cir. 2014). The panel further rejected the plaintiffs' contention that courts should consider the overall impression created by the statements at issue when determining whether the defendants' omissions rendered the statements false or misleading, remarking that Sixth Circuit precedent mandated that such an analysis be conducted on a statement-by-statement basis.

The Sixth Circuit also held, in the alternative, that the plaintiffs failed to adequately plead a strong inference of scienter, noting that mere allegations of motive and opportunity are not enough to give rise to the necessary inference.

SDNY Applies *Omnicare* to Dismiss Claims That Insurer's Opinions About Financial Reserves Were False

City of Westland Police & Fire Ret. Sys. v. Metlife, Inc., No. 12-cv-0256 (S.D.N.Y. Sept. 11, 2015)

Judge Lewis A. Kaplan of the U.S. District Court for the Southern District of New York, applying the U.S. Supreme Court's recent decision in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, dismissed claims that an insurer violated Section 10(b) of the Securities Exchange Act by failing to disclose, in connection with the company's reserves, certain death benefits that had been incurred but not yet reported by insureds. Applying *Omnicare*, the court held that the company's statements of opinions were not false or misleading because the plaintiff failed to allege that the company disbelieved its opinions or that it concealed facts that "call[ed] into question the [company's] basis for offering the opinion." Although the company's 2007 "cross-check" of its life insurance records against a government database had revealed certain unpaid death benefits, it did not reveal a shortage in the company's reserves, as alleged by the plaintiff, and the complaint did not plausibly allege that the company believed its reserves were inadequate at that time. Further, the plaintiff failed to allege that the company's calculations "ran afoul of the customs and practices of the life insurance industry" or otherwise "did not comport with what a reasonable person reading the Company's financial statements fairly and in context would have expected." In addition, as to other statements by the company which the court determined to be statements of fact rather than opinion, the plaintiff failed to adequately allege scienter. Although the company's previously disclosed mortality rates were inaccurate in light of the discovery of additional unreported deaths, the complaint's allegations were "conclusory" and failed to plead facts giving rise to a strong inference that the company intended to deceive investors. The plaintiff additionally failed to allege that the company violated SEC Regulation S-K, Item 303 by failing to disclose "known uncertainties" concerning its allegedly inadequate reserves and the potential for regulatory penalties because, as discussed above, the company was not aware of the likelihood of potential fines or liabilities related to its reserves, and the court declined to "punish" the company for "failing to foresee something that [the plaintiff] has not shown was reasonably foreseeable."

Standing

District Court Dismisses Exchange Act Claims Brought Against Nonissuing Company

In re Altisource Portfolio Sols., S.A. Sec. Litig., No. 14-81156 (S.D. Fla. Sept. 4, 2015)

Judge William P. Dimitrouleas of the U.S. District Court for the Southern District of Florida dismissed claims under Sections 10(b) and 20(a) of the Securities Exchange Act brought by shareholders of Altisource Portfolio Solutions, S.A.

In addition to asserting causes of action against Altisource and Altisource officers, the plaintiffs also brought Section 10(b) and 20(a) claims against another company, Ocwen. Altisource was spun off from Ocwen and, according to the plaintiffs' allegations, the two companies continued to do substantial business together following the spin-off. The plaintiffs also alleged that the companies continued to have the same chairman and chief risk officer.

Ocwen moved to dismiss the plaintiffs' claims against it for lack of standing, arguing that the plaintiffs could not assert a federal securities fraud claim against Ocwen when their alleged losses stemmed solely from their purchases of stock in Altisource. In response, the plaintiffs argued that there is an implied right of action in Section 10(b) that covers secondary actors who commit primary violations under the federal securities laws. The plaintiffs further argued that Ocwen affirmatively made statements directly to Altisource shareholders about Altisource and the relationship between the two companies. Moreover, the plaintiffs averred, the close connection between Altisource and Ocwen warranted imposition of liability on Ocwen.

The court rejected the plaintiffs' argument. While the court acknowledged the plaintiffs' attempts to distinguish case law that would otherwise foreclose Section 10(b) actions against other companies, the court noted that the plaintiffs were unable to cite any case in which a court found standing in similar circumstances. Ultimately, the court concluded that the business relationship between the two companies, though substantial, was not enough to confer standing on the plaintiffs in the absence of positive case law.

Statutes of Repose/Statutes of Limitations

Eighth Circuit Affirms Dismissal of Section 10(b) Claim Against Fund Underwriter

Zarecor v. Morgan Keegan & Co., Inc., No. 13-3315 (8th Cir. Sept. 1, 2015)

The U.S. Court of Appeals for the Eighth Circuit affirmed the dismissal of a Securities Exchange Act Section 10(b) claim against the lead underwriter of various mutual funds, holding that the Eastern District of Arkansas had properly ruled the claim was time-barred. The plaintiffs, individual investors, alleged that the underwriter (1) omitted material facts and misrepresented the quality of the funds in conversations with them, and (2) prepared and approved SEC filings, prospectuses and marketing materials that misrepresented and omitted important information about the funds.

In affirming the district court's dismissal of the plaintiffs' claim, the court explained that actions under Section 10(b) must be brought within two years after the violation is discovered, and that the limitations period begins to run when a reasonably diligent plaintiff would have discovered the pertinent facts. The court determined that the plaintiffs discovered the facts constituting the violation more than two years before filing suit, as they had initiated an arbitration with the Financial Industry Regulatory Authority (FINRA) raising similar allegations more than four years before bringing the claim at issue. Moreover, the court rejected the plaintiffs' argument that the FINRA arbitration tolled the statute of limitations, reasoning that the plaintiffs were not required to await the arbitration's outcome before bringing an action in court.

The plaintiffs further argued that, per the U.S. Supreme Court's ruling in *American Pipe & Construction Company v. Utah*, 414 U.S. 538 (1974), the statute of limitations had been tolled during the pendency of an earlier-filed class action brought against the defendant and predicated on the same facts. The court also rejected this argument, concluding that *American Pipe* tolling should be limited to claims filed in a later action that are exactly the same as those alleged in the putative class action. Accordingly, the Eighth Circuit affirmed the lower court's dismissal of the Section 10(b) claim on statute of limitations grounds.

District Court Dismisses Claims Against JPMorgan Chase Arising Out of Madoff Ponzi Scheme

Dusek v. JPMorgan Chase & Co., No. 2:14-cv-184-FtM-29CM (M.D. Fla. Sept. 17, 2015)

Judge John E. Steele of the U.S. District Court for the Middle District of Florida dismissed with prejudice federal securities and racketeering claims brought by 38 of Bernie Madoff's former investors against JPMorgan Chase & Co. (JPMC) and numerous other defendants arising out of JPMC's relationship with Madoff and his company, Bernard L. Madoff Securities LLC (BLMIS).

The plaintiffs' first claim alleged that the defendants were liable under Section 20(a) of the Securities Exchange Act because they controlled Madoff and BLMIS, and were thus derivatively liable for the primary securities law violations Madoff and BLMIS committed. The court rejected this claim for three independent reasons.

First, the court found that the plaintiffs' claims were barred because they violated the statute of repose for

Section 20(a) claims. Under 28 U.S.C. § 1658(b), a private action under Section 20(a) must be brought within five years of the primary violation. Under the plaintiffs' allegations, the final violation of Section 20(a) occurred on or before December 11, 2008, the date of Madoff's arrest and BLMIS' closure. Thus, the plaintiffs' right to bring a control person claim under Section 20(a) expired on December 11, 2013. However, the plaintiffs did not initiate the action until March 28, 2014. To avoid this result, the plaintiffs argued that the statute of repose should have been tolled under the rule enunciated in the U.S. Supreme Court case *American Pipe & Construction Co. v. Utah*, 414 U.S. 538 (1974), because of the pendency of a related class action from which the plaintiffs here were ultimately excluded as class members. Although *American Pipe* applied to statutes of limitations, the plaintiffs argued the reasoning of *American Pipe* should apply to the statute of repose at issue here. The court first noted the difference between statutes of limitations and statutes of repose and explained the difficulty with tolling a statute of repose. A statute of repose is a judgment that defendants should be free from liability after the legislatively determined period of time, beyond which the liability will no longer exist and will not be tolled for any reason. In that way, statutes of repose create a substantive right for would-be defendants. That is critical because statutes of repose cannot "abridge, enlarge or modify" a person's substantive rights. Accepting the plaintiffs' argument would have the effect of abridging the defendants' substantive rights. In any event, the court also concluded that the holding in *American Pipe* is equitable—rather than "legal"—in nature and therefore does not extend to the statute of repose provision in 28 U.S.C. § 1658(b).

Second, even if the plaintiffs' claims were timely, the plaintiffs failed to allege that JPMC "controlled" Madoff, BLMIS or the Ponzi scheme as a matter of law. The court noted the plaintiffs' allegations that Madoff refused to allow JPMC to conduct due diligence on his operations; those allegations alone undermine any claim that JPMC controlled Madoff. The court also reasoned that there are no plausible allegations as to why the defendants would knowingly involve themselves in Madoff's inevitably doomed Ponzi scheme in order to earn routine banking fees.

Third, the court found that the plaintiffs failed to allege that they suffered actual damages. Section 28(a) of the Securities Exchange Act limits recovery in any private damages action brought under the act to "actual damages." Here, however, the plaintiffs alleged that they were all net winners, meaning that they withdrew funds from BLMIS in an amount that exceeded their initial investments and subsequent deposits. The plaintiffs also failed to allege any facts that would permit them to recover any losses other than out-of-pocket losses.

The plaintiffs also asserted a federal Racketeer Influenced and Corrupt Organizations Act (RICO) cause of action, alleging that the defendants violated 18 U.S.C. § 1962(c) "by knowingly participating in Madoff's racketeering enterprise." However, the court concluded that this claim was precluded by the PSLRA. Under the PSLRA, "no person may rely upon any conduct that would have been actionable as fraud in the purchase or sale of securities to establish a violation of section 1962." Moreover, "[a] plaintiff cannot avoid the RICO bar by pleading other specified offenses, such as mail or wire fraud, as predicate acts in a civil RICO action if the conduct giving rise to those predicate offenses amounts to securities fraud." Here, the plaintiffs' underlying allegations of mail and wire fraud were integrally related to the purchase and sale of securities. Thus, the RICO claims are barred under the PSLRA.

After dismissing both the Section 20(a) and RICO claims with prejudice, the court declined to exercise supplemental jurisdiction over the remaining state law claims and dismissed those without prejudice.

D. Conn. Holds That HERA Extender Statute Applies to Statutes of Repose

Fed. Hous. Fin. Agency v. Royal Bank of Scotland Grp. PLC, No. 3:11-cv-01383 (AWT) (D. Conn. Aug. 21, 2015)

Judge Alvin W. Thompson of the U.S. District Court for the District of Connecticut denied a motion for summary judgment filed on claims by the Federal Housing Finance Agency (FHFA) that a bank violated Section 11 and Section 12(a)(2) of the Securities Act by making misrepresentations in offering documents about certain mortgage-backed securities. Although the action was otherwise time-barred by state and federal statutes of repose, the FHFA argued that the Housing and Economic Recovery Act of 2008 (HERA) extender statute overrode those statutes, even though HERA's language addresses only statutes of limitations. The court held that the extender statute applied, even though the U.S. Supreme Court in *CTS Corp. v. Waldburger*, 134 S. Ct. 2175 (2014), had recently held that an analogous extender statute did not apply to statutes of repose because the language of that statute mentioned only statutes of limitations. Although the Court in *Waldburger* identified legislative history (with respect to the statute at issue) demonstrating intent to distinguish between statutes of repose and limitations, Judge Thompson found "nothing comparable in the legislative history of HERA." Further, Judge Thompson rejected the defendants' argument that HERA's reference to an accrual date—a concept used only in the context of statutes of limitations—meant that HERA did not intend to displace statutes of repose. The court determined that HERA "adopts a broader framework in determining the date on which a claim accrues," which permits the limitations period to begin when the injury occurs or when the FHFA is appointed conservator, whichever is later—creating, in the court's view, a "new exclusive time framework" under federal law. The court found the reasoning of the Fifth and Tenth circuits persuasive, each of which determined that an extender statute was intended to create a new federal limitations period displacing conflicting statutes of limitations and repose. *See Nat'l Credit Union Admin. Bd. v. Nomura Home Equity Loan Inc.*, 764 F.3d 1199, 1229 (10th Cir. 2014); *F.D.I.C. v. RBS Sec. Inc.*, 798 F.3d 244, 258-59 (5th Cir. Aug. 10, 2015). In addition, although the court acknowledged the general preference against pre-empting state law, that principle did not apply in this case because unlike *Waldburger*, which involved torts—an area traditionally governed by states—HERA pertains to policing fraud involving federal agencies.

Venue

Second Circuit Affirms Dismissal of Claims Against U.S.-Based Bank on *Forum Non Conveniens* Ground

Rentokil-Initial Pension Scheme v. Citigroup Inc., No. 14-2545-cv (2d Cir. Aug. 25, 2015)

The U.S. Court of Appeals for the Second Circuit affirmed the dismissal of claims against an investment bank that allegedly violated certain provisions of Luxembourg's Civil Code by misrepresenting the quality of certain euro notes and failing to disclose the associated investment risks. The plaintiff, a United Kingdom-based pension fund, had originally alleged violations of U.K. law and then amended its pleading to include violations of Luxembourg's Civil Code. The Second Circuit held that the district court correctly applied the three-part test—set forth in *Iragorri v. United Technologies. Corp.*, 274 F.3d 65 (2d Cir. 2001)—for *forum non conveniens* challenges, concluding that the United Kingdom would be a more convenient forum to adjudicate the action. The plaintiff was afforded less deference to its choice of forum because it was based in the U.K. In addition, the U.K. was an adequate alternative forum because it permits litigation on statements made in connection with the offering of securities. Lastly, other factors weighed in favor of the U.K., including that (1) the most relevant fact witnesses were in the U.K., (2) the U.K. was a member of the governing body that enacted rules on prospectus disclosures, (3) the euro notes were denominated in pounds sterling, not U.S. dollars, and (4) the issues involved foreign law.

Whistleblower Protections

Second Circuit Finds That Dodd-Frank Whistleblower Protections Apply to Employees Who Initially Report Misconduct Internally Rather Than to the SEC

Berman v. Neo@Ogilvy LLC, No. 14-4626 (2d Cir. Sept. 10, 2015)

The U.S. Court of Appeals for the Second Circuit reversed the dismissal of claims that a company violated Dodd Frank's whistleblower protections by retaliating against a former employee after he reported certain illegal accounting practices to management. The former employee was allegedly terminated six months after he reported the misconduct internally, and he thereafter reported the accounting practices to the SEC. The Second Circuit held that the employee could state a whistleblower claim, even though he did not first report the information to the SEC, and one part of the statute defines a "whistleblower" as "any individual who provides… information relating to a violation of the securities laws *to the Commission*." The Second Circuit acknowledged the "tension" between the whistleblower definition under that part of the statute and a different subsection that generally prohibited employers from retaliating against whistleblowers who make disclosures protected by the Sarbanes-Oxley Act. However, the court determined that the whistleblower definition was not intended to "sharply" limit the statute's protections, but rather appeared to be a late addition to the bill that "no one noticed" did not "fit together neatly" with the other provisions. Applying the rule only to individuals who first reported the conduct to the SEC would eliminate protection for certain professionals, such as auditors or attorneys, who are required by other laws to report violations internally before going to an agency. Nevertheless, because the court could not be certain as to the legislature's intent, the Second Circuit held that it was appropriate to defer to the SEC's interpretation of the provision—as set forth by SEC Rule 21F-2—which interprets the law in a way that provides protection to "an employee who reports internally without reporting to the Commission."

The D.C. Circuit: Wrong and Wronger!

By C. Evan Stewart

On October 28, 1980, Ronald Reagan won the Presidency (and I bet *NY Business Law Journal* readers thought national elections only took place on the first Tuesday in November). In the sole Presidential debate of that campaign, and in response to one of President Carter's desperate broadsides attempting to depict the former California Governor as a political troglodyte, Reagan ruefully looked over at his opponent, shook his head sadly, and said: "There you go again." With that devastating rebuke, Carter was effectively done, the polls which had shown a neck-and-neck race underwent a sea change, and Reagan was overwhelmingly elected a week later.[1]

Reagan's famous one-liner applies with equal (if not greater) force to the United States Court of Appeals for the District of Columbia. In 2014, that distinguished court made a horrendous ruling; in 2015, it doubled down with another one, in the same litigation.

The First Time: Not a Charm

On June 27, 2014, the U.S. Court of Appeals for the D.C. Circuit handed down, in one commentator's opinion, "one of the most important decisions in recent memory concerning internal investigations."[2] Unfortunately, the D.C. Circuit in *In re Kellogg Brown & Root* got it wrong.[3]

The litigation arose out of allegations that a major defense contractor's employees had given "preferential treatment" to a subcontractor in exchange for bribes. Prior to the litigation and on its own initiative, the defense contractor, employing its "Code of Business Conduct" protocols, had initiated an internal investigation; it was conducted by non-lawyers. Those non-lawyer employees "interviewed personnel with potential knowledge of the allegations, reviewed documents, and obtained witness statements." Upon completing their investigation, the non-lawyers wrote up seven reports, which were then forwarded on to the defense contractor's internal legal department.

Thereafter, in subsequent *qui tam* litigation, the plaintiff sought the seven reports in discovery. The defense contractor demurred, citing the attorney-client privilege and the attorney work product doctrine. Upon a motion to compel, the U.S. District Court for the District of Columbia conducted an in-camera review of the materials and then ruled that neither position held water.

The District Court Gets One Right, but One Wrong

As to the work product argument, the district court observed both (i) that the investigation was conducted by non-lawyers—not at the direction of counsel, and (ii) that it was not undertaken in anticipation of litigation. That analysis was clearly correct, and it proved not to be controversial.

On the attorney-client privilege issue, the district court ruled that a "party invoking the privilege must show 'the communication would not have been made *but for* the fact that legal advice was sought.'"[4] Citing Department of Defense requirements of self-disclosure of improper conduct, the court found that the "but for" standard had not been met. The court also noted (i) that the "employees who were interviewed were never informed that the purpose of the interview[s] was to assist the [defense contractor] in obtaining legal advice;" and (ii) that the "employees certainly would not have been able to infer the legal nature of the inquiry by virtue of the interviewer[s], who [were] non-attorn[eys]."[5]

The defense contractor was extremely unhappy with this latter ruling, asked the district court for an interlocutory appeal on the privilege issue *only* (which was denied),[6] and then petitioned the D.C. Circuit for a writ of mandamus on that one issue (which was granted). Obviously, the grant of mandamus was a sure sign that the district court's privilege ruling was not long for this world. But would the D.C. Circuit get it right?

The D.C. Circuit Gets One Right, and Five Wrong

The speed with which the circuit court took on and resolved the case had underscored the serious concern at hand with the district court's ruling. Indeed, in the higher court's view, the lower court's decision not only had the potential to "disable most public companies from undertaking confidential internal investigations," it had also so fundamentally misunderstood and misinterpreted the Supreme Court's seminal ruling in *U.S. v. Upjohn Co.* that the decision "threaten[ed] to vastly diminish the attorney-client privilege in the business setting."[7] Unfortunately, not only were those dire consequences not well-founded, the D.C. Circuit's analysis justifying reversal was wide of the mark as well—with one exception.

So what did the higher court get right? In rejecting the district court's "but for" test, the circuit court was right-on in observing that such a test "is not appropriate for [an] attorney-client privilege analysis"; the court was also spot-on that there is "no Supreme Court or Court of Appeals decision that has adopted a test of this kind in this context."[8] Unfortunately, that was all that the D.C. Circuit nailed correctly.

What did the circuit court miss? Not much in fact, only that: (i) it did not understand the basic and fundamental precepts underlying the privilege; (ii) it misapplied *Upjohn*; (iii) it confused the attorney-client privilege with attorney work product; (iv) it did not understand lawyers' ethical duties in these circumstances; and (v) it flouted the law vis-à-vis interlocutory appeals.

It is axiomatic that client communications with non-lawyers, especially non-lawyers not acting under the specific guidance of lawyers (pursuant to Fed. R. Civ. P. 26(b)(3)), are not confidential, privileged, or protected from discovery.[9] Thus, when the D.C. Circuit wrote that the case before it was "materially indistinguishable" from *Upjohn*, it was simply wrong; in the court's own words: "In *Upjohn*, the communications were made by company employees to company attorneys during an attorney-led internal investigation[,]"[10] which clearly was not the situation in the case before the D.C. Circuit, and no amount of invoking the policy underpinnings of *Upjohn* can change that structural problem. As compliance personnel and internal auditors are regularly told (even those who are licensed lawyers), this privilege does not apply to them or to their communications. Period.

By its frequent "cf" citations, and most particularly its citation to *Hickman v. Taylor*[11]—the seminal Supreme Court decision underpinning the attorney work product doctrine and Fed. R. Civ. P. 26(b) (3)—it seems apparent that the D.C. Circuit was confusing the attorney-client privilege with the work product doctrine. If, in fact, the defense contractor's legal department had established the internal investigation in anticipation of litigation and had specifically designated the non-lawyer personnel as its agents to assist lawyers in the investigation, then the work product generated would have been protected—not under the privilege, but instead under the work product doctrine.[12] It is indisputable, however, that that is not what happened in this case.

With respect to the failure to inform employees that the interviews were of a legal nature, the circuit court's ethical antennae were clearly turned off. The court was simply wrong in stating: "nothing in *Upjohn* requires a company to use *magic words* to its employees in order to gain the benefit of the privilege for an internal investigation…*here as in Upjohn* employees *knew* that the company's legal department was conducting an investigation of a sensitive nature *and* that the information they disclosed would be protected."[13]

Unlike in *Upjohn*, the defense contractor's employees certainly did *not* know of the legal department's role or involvement; and as for the interviewees' confidentiality expectations, how would (or could) they have had an informed view on that subject? Lawyers were not conducting the interviews, and thus were not giving the employees the "magic words" required by the canons of ethics, i.e., the Corporate Miranda Warning—to warn them that, in fact, the information they were disclosing might well not be confidential or protected.[14]

As if that were not enough, the circuit court then correctly cited to binding Supreme Court precedent that "an interlocutory appeal under the collateral order is *not available* in attorney-client privilege cases."[15] It also correctly noted that taking a contempt citation is the only appropriate means to get immediate appellate review.[16] Nonetheless, believing (wrongly) that it had to step in because "the District Court's decision [had] the potential to 'work a sea change in the well-settled rules governing internal corporate investigation,'"[17] the circuit court convinced itself that "granting the writ [was] 'appropriate under the circumstances.'"[18]

Well, that is a lot to get wrong.[19] Little did I think that the D.C. Circuit would compound those errors in the same case fourteen months later!

The Second Time Around: Dumb and Dumber To

On August 11, 2015, the same appellate court (albeit a different panel[20]) took on a later facet of the Kellogg Brown & Root (KBR) saga, and this time drove the car into a different ditch.[21] On a second writ of mandamus from an adverse ruling from the district court, the defense contractor was (again) able to get the higher court to block discovery into obviously damaging materials relating to alleged wrongdoing.

In February 2014 (one month after the original district court decision and five months before the first opinion of the D.C. Circuit), the defense contractor had put forward for a Rule 30(b)(6) deposition a lawyer in its internal legal department. Among the topics the internal lawyer was to testify about (as a corporate officer on behalf of the organization, per Fed. R. Cir. P. 30(b)(6)) was:

> Any investigation or inquiry, internal or external, formal or informal, of [the KBR employee and subcontractor at the center of the alleged fraud] or any of the matters identified in [the above listed topics]. The scope shall include knowledge of everyone who participated in the investigation.

At the deposition, the KBR internal lawyer acknowledged that, in preparation for his testimony, he had reviewed the documents that had been prepared by the KBR *non*-lawyers in their investigation (and which were the subject of both appeals to the D.C. Circuit). Notwithstanding that "preparation," there were material differences between the lawyer's testimony and the contents of the investigatory materials.

Five days thereafter, KBR moved for summary judgment. And in its motion (in a footnote), KBR put forward the following piece of advocacy:

> KBR has an internal Code of Business Conduct ("COBC") investigative mecha-

> nism that provides a means of identifying any potentially illegal activities within the company. When a COBC investigation reveals reasonable grounds to believe that a violation of 41 U.S.C. §§ 51-58 (the "Anti-Kickback Act") may have occurred requiring disclosure to the government under FAR 52.203-7, KBR makes such disclosures. Stmt. ¶ 27. KBR has made reports to the Government when it had reasonable grounds to believe that a violation of the Anti-Kickback Act occurred. *Id.* KBR intends for these investigations to be protected by the attorney-client privilege and attorney work product privilege (indeed, they are not even given to the Government as part of disclosures), but has not asserted privilege over the fact that such investigations occurred, or the fact of whether KBR made a disclosure to the Government based on the investigation. Therefore, with respect to the allegations raised by [the plaintiff], KBR represents that KBR did perform COBC investigations related to [the KBR subcontractor and employee at the center of the fraud alleged by the plaintiff], and made no reports to the Government following those investigations.[22]

This motion practice led to two decisions by the district court. On November 20, 2014, the court ruled that there was an "implied waiver" of the attorney-client privilege and work product doctrine because KBR had put privileged materials at issue: "KBR has actively sought a positive inference in its favor based upon what KBR claims the documents show." In other words, (wrote the court):

> KBR carefully used the inference that the COBC documents do not support any reasonable belief that fraud or kickbacks may have occurred. KBR has, on multiple occasions, advanced a chain of reasoning. First, whenever KBR has reasonable grounds to believe that a kickback or fraud had occurred, its contracts and federal regulation required it to report the possible violation.
>
> Second, KBR abides by this obligation and reports possible violations. Third, KBR investigated the alleged kickbacks that are part of Barko's complaint. Fourth, after the investigation of the allegations in this case, KBR made no report to the Government about an alleged kickback or fraud.[23]

The district court also ruled that Federal Rule of Evidence 612 further mandated a waiver because the internal KBR lawyer had used the contested materials to prepare for his deposition; and the balancing test under that Rule (and the "fairness considerations" that underlie that Rule) required disclosure, especially given that (i) the lawyer "necessarily relied on the… documents for his testimony because he had no personal, first-hand knowledge of whether fraud or kickbacks occurred," and (ii) "major discrepancies exist between [the lawyer's] testimony and the contents of the writings [the lawyer] had received."[24]

On December 17, 2014, the district court issued a separate opinion, finding that disclosure was justified on a third basis: the disputed materials were "discoverable fact work product and [the plaintiff] shows substantial need."[25]

Two days later, KBR filed a petition for writ of mandamus, which the D.C. Circuit promptly granted, staying the implementation of the district court's decisions. With these decisions having some flaws, would the higher court merely correct them, or would it do a running dive into a shallow pool?

Starting Off on the Wrong Foot

Unfortunately, and even beyond the D.C. Circuit's decidedly wrong June 2014 ruling (which the 2015 panel of judges felt constrained to build upon as the "law of the case"), the district court's two decisions in November and December of 2014 suffered from a basic defect that helped ensure that the appellate train wreck would become even more problematic. The district court had *correctly* determined in its March 2014 decision that the investigatory materials were **not** attorney work product (the investigation was **not** conducted by lawyers, was **not** done at the direction of lawyers, and was **not** done in anticipation of litigation) and that ruling was **not** appealed to the D.C. Circuit (and thus *was* the "law of the case;") **but** the district court's more recent decisions did a complete 180 (degrees) and now labeled the materials as attorney work product, notwithstanding that they were the exact "same documents" which the court had earlier (and correctly) ruled were not work product. Thus, the entire basis for the district court's December 2014 "substantial need" decision was wrong; and the court's November 2014 "waiver" decision—to the extent it was equally premised on both the attorney-client privilege and the work product doctrine—was clearly *one* legal bridge too far.

Not understanding this basic problem with the lower court's November and December rulings now teed up to the D.C. Circuit on the writ of mandamus, the appellate court jumped back into the discovery imbroglio with both feet, hell-bent to protect KBR from its own investigatory and litigation foul-ups. What followed is not pretty.

One Potato

The D.C. Circuit first tackled the November 2014 "waiver" decision of the district court. With respect to the Rule 612 issue, the appellate court determined that (i) as a threshold matter, the district court's use of the Rule's balancing test was "inappropriate" and "clear error," and (ii) even using the balancing test, the scales weighed indisputably in favor of non-disclosure. Both prongs of that determination were, unfortunately, wrong.

For its the initial proposition, the D.C. Circuit cited Judge Weinstein's famous treatise on evidence;[26] but the treatise (and the Rule) stand for exactly the opposite proposition. First off, most courts that have looked at the use of written materials to "refresh" a witness's memory (including privileged materials and work product) have reflexively ruled that the materials are fair game under Rule 612.[27] Second, the leading case applying the balancing test—and not ordering disclosure—is *Sporck v. Peil*.[28] That case involved several hundred thousand documents, a select number of which counsel picked out, compiled, and presented to a witness prior to a deposition. When this preparatory process was revealed at the deposition, opposing counsel moved for the documents' production. The trial court granted the motion. The Third Circuit reversed, however, and did so principally on two grounds: (i) the attorney's selection of the materials reflected his own work product; and (ii) there was no evidence that the witness relied upon the documents or that they had influenced his testimony. Neither circumstance, of course, was present in the KBR situation.[29]

Third is the fact that Judge Weinstein is himself a major proponent of the balancing test; thus, the D.C. Circuit's out-of-hand dismissal of its use while citing him is quite bizarre. Furthermore, Judge Weinstein also is on record as urging lawyers *not* to show witnesses privileged materials or work product:

> In the present state of uncertainty [i.e., the policy conflict between *Hickman v. Taylor* and Rule 612], attorneys should ***not*** refresh prospective deponents or witnesses with material containing counsel's theories or thought processes. Not only may such documents ultimately fall into opposing counsel's hands if Rule 612 is satisfied, but there are too many risks of unethical suggestions to witnesses when they see such material.[30]

Finally, the D.C. Circuit's own, sort-of application of the balancing test was clearly wrong. Did the "writing influence[ ] the witness's testimony" (Judge Weinstein's words)? The answer is obviously *yes*—unless one's view is that the KBR lawyer's inconsistent testimony meant that he was not in fact "influenced" by the writing! But that was not even the rationale offered by the D.C. Circuit in support of its *no* answer. Instead, the appellate court's take was that, with KBR having chosen the in-house lawyer to be the Rule 30(b)(6) witness—a mistake in and of itself[31]—the lawyer had no choice *but* to review the investigatory materials. It then resolved the matter by labeling the plaintiff's position on waiver as "absurd;" as such, the D.C. Circuit did not even have to confront the "influence" issue, or address the fact that all of this could have been avoided by KBR putting up a corporate employee who had first-hand knowledge of the investigation in the first place.[32]

Two Potato

Having "neatly" disposed of the Rule 612 issue, the D.C. Circuit next moved on to the "at issue" waiver, arising from what KBR had argued in its summary judgment papers. "[A]t first glance," wrote the court, this appeared to present a "more difficult question."[33] But the appellate court was undeterred, finding that the seemingly obvious inference drawn by the district court— i.e., KBR was contending that: (i) it always self-reports to the government when there has been illegality; (ii) it did not do that here; and (iii) thus, there must be no evidence (privileged or otherwise) that it engaged in any illegality—was *not* what KBR was putting forward at all.

Rather, the D.C. Circuit postulated an "alternative inference": that KBR was *really* confessing "that the investigation showed wrongdoing but KBR nonetheless made no report to the government."[34] In my margin notes on the court's opinion next to this point I wrote: "Huh?!!!!" That obviously makes *no* sense. The appellate court then tried to support its "alternative inference" (a/k/a/ alternative universe) by further noting that KBR had tried this advocacy "only in a footnote," and that in any event all inferences should have been drawn against KBR on its summary judgment motion (and the district court should thus have adopted the appellate court's "alternative inference").[35] Such "reasoning" and "analysis" leave me speechless.

Three Potato

And the D.C. Circuit was not done yet. It next turned to the district court's December 2014 "substantial need" decision. Incredibly (and notwithstanding the discussion above on that decision), the appellate court determined that the lower court's 180-degree turn on work product was *correct* ("we think the District Court got the law right") but then ruled that the lower court "misapplied the law to the documents it ordered disclosed."[36]

To support those misjudgments, the D.C. Circuit made numerous, additional errors. First of all, it continued its blurring of the lines between the attorney-client privilege and the work product doctrine (continuing to cite as "controlling precedent" the *Upjohn* decision, which has nothing to do with the "substantial need" standard set forth in Fed. R. Civ. P. 26(b)(3)). Then the court miscited and misapplied the *Kovel* exception,[37] as well as the "Della Street" rule of ethics.[38] As a final matter, the D.C. Circuit then faulted the lower court's failure to delineate between opinion work product and fact work product, and thus felt justified in not even reaching the question of whether the lower court had erred in its determination of "substantial need."[39] That the disputed materials were *neither* opinion work product *nor* fact work product was of no importance or matter.[40]

Conclusion

As did the prior appellate panel, the August 2015 panel felt justified in its extraordinarily wrong set of determinations because "well founded" "alarm bells" would sound in corporate America if the D.C. Circuit had not acted "in order to protect our privilege waiver jurisprudence."[41] Not surprisingly, many of the commentators the appellate court cited (often wrongly or with "Cf." citations) professed to be pleased with the August 2015 decision.[42] But the repetition (or compounding) of error does not turn a wrong into a right.[43]

The whole, sorry history of the KBR litigation got started when KBR itself did not follow the basic precepts of how to conduct an internal investigation.[44] KBR then compounded things when it also did not handle the 30(b)(6) deposition correctly. Throw on top of those errors three not-so-great district court decisions and two manifestly wrong decisions by the D.C. Circuit, and we are left with legal precedents that lawyers advising clients in this space should be *extremely* loath to follow.

Litigating privilege and work product issues is tricky enough when you handle the process correctly; handling the process incorrectly and then expecting a court to do somersaults to misapply the law in order to help you and your client out of self-imposed jams is likely to be asking too much.[45]

Endnotes

1. Steven R. Weisman, *Reagan Takes Oath as 40th President; Promises an 'Era of National Renewal, New York Times,* available at: http://www.nytimes.com/learning/general/onthisday/big/0120.html#article. That debate was also memorable for Reagan asking the American public a compelling, rhetorical question: "Are you better off than you were four years ago?" (The answer for almost every American was an emphatic "no!") Carter, by contrast, had tried to suggest Reagan would be untrustworthy in charge of the nuclear arsenal by invoking his daughter Amy. This only led to the immediate creation of a memorable political button: "Ask Amy." With its usual, unbiased reporting, *The New York Times* told its readers the next day "no clear winner [was] apparent." *Id.*
2. *See* J. McLaughlin, *Attorney-Client Privilege in Internal Investigations*, *New York Law Journal* (August 14, 2014).
3. *In re Kellogg Brown & Root*, 756 F.3d 754 (D.C. Cir. June 27, 2014), *rev'g United States ex rel. Barko v. Halliburton Co.*, 2014 WL 1016784 (D.D.C. March 6, 2014).
4. *Id*. at *2 (quoting *United States v. ISS Marine Servs*., 905 F. Supp. 2d 121, 128 (D.D.C. 2012) (emphasis added)). The court also later referenced a "primary purpose" standard. *Id.* at *4.
5. *Id.* at *3.
6. *United States ex rel. Barko v. Halliburton Co.,* 2014 WL 929430 (D.D.C. March 11, 2014).
7. 756 F.3d at 762 (the first quote was taken by the Court of Appeals straight out of the defense contractor's brief). *See infra* note 14 for the formal citation to the *Upjohn* decision.
8. *Id.* at 758-60. As for the "primary purpose" test, that type of standard was a gloss that many courts attempted to impose upon Fed. R. Civ. P. 26(b)(3) with respect to attorney work product, until Judge Leval properly (and hopefully) put an end to all that in *U.S. v. Adlman*, 134 F.3d 1194 (2d Cir. 1988). *See* C.E. Stewart, *Hickman v. Taylor Reinvigorated by the Second Circuit, With Important Benefits for Litigants*, *ABA Pretrial Practice & Discovery* (July 1998). Unfortunately, Judge Furman in *In re General Motors LLC Ignition Switch Litigation*, 2015 WL 22105 (S.D.N.Y. January 15, 2015) recently adopted a "primary purpose standard" in ruling on whether the privilege applied to a General Motors internal investigation. *Id.*
9. For the privilege to exist, there must be the 5 Cs: (i) a client; (2) a communication; (3) confidentiality; (4) counsel (an attorney); and (5) counsel (the giving of legal advice by an attorney). Four out of five Cs is not sufficient; there must be all five for the privilege to exist. *See* C.E. Stewart, "*Attorney-Client Privilege: Misunderestimated or Misunderstood?*, *New York Law Journal* (Oct. 20, 2014).
10. 765 F.3d at 757.
11. *Id.* at 764. *See* 329 U.S. 495 (1947).
12. *See* C.E. Stewart, *Think Twice: The Good, Bad, and Ugly of Corporate Investigations*, *New York Law Journal* (Mar. 27, 2006).
13. 756 F.3d at 758 (emphasis added) (this is one of the "Cf." citations to *Upjohn*).
14. *See* C.E. Stewart, "Thus Spake Zarathustra (And Other Cautionary Tales for Lawyers)," *NY Business Law Journal* (Winter 2010). For purposes of lawyers complying with their ethical obligations, the Corporate Miranda Warning (Rule 1.13) does in fact contain "magic words." This warning is sometimes mistakenly called an *Upjohn* warning, as derived from the Supreme Court's ruling in *U.S. v. Upjohn Co.*, 449 U.S. 383 (1981). But this is a mischaracterization of *Upjohn*, which (i) has nothing to do with lawyers' ethical duties under Rule 1.13, and (ii) stands for the proposition that all corporate employees are covered by the corporate attorney-client privilege for purposes of discovery under the Federal Rules of Civil Procedure.
15. 756 F.3d at 761 (emphasis added) (citing *Mohawk Industries v. Carpenter*, 558 U.S. 100 (2009)).
16. The court of appeals, however, did not view going the contempt route as an "'adequate' means of relief in these circumstances." *Id.* Why that is so is quite unclear, especially since the leading case on opinion work product was established by precisely that route. *See In re Murphy*, 560 F.2d 326 (8th Cir. 1977).
17. 756 F.3d at 762 (quoting verbatim the amicus brief of the Chamber of Commerce).
18. *Id.* at 763 (citing *Cheney v. U.S. District Court of the District of Columbia*, 542 U.S. 367, 380 (2004)), which stands for the proposition that mandamus is a "drastic and extraordinary" remedy "reserved for really extraordinary causes."). In support of this relief, the court also cited one of the worst opinions regarding privilege, *ever*: *In re Von Bulow*, 828 F.2d 94 (2d Cir. 1987). *See* C.E. Stewart, *Will Waiving the Privilege Save It?*, *NY Business Law Journal* (Spring 2007).
19. By sheer dumb luck, I discovered that a lawyer recently employed by the Association of Corporate Counsel published a blog on the ACC website critical of my prior critique of the D.C. Circuit ruling (*see supra* note 9); in his view, I was/am "[q]uite simply… wrong." In his blog, Amar Sarwal contended (i) "the opinion makes clear that the district court's imposition of a second-class citizen status on in-house counsel is unwarranted and incorrect as a matter of law;" (ii) the opinion "also amply demonstrates that the panel is

quite familiar with privilege and work product doctrine"; and (iii) "the court of appeals only protected communications that were conducted at the direction of a lawyer and for the purpose of seeking legal advice." When I contacted Mr. Sarwal to take issue with the obvious incorrectness of each of those three propositions and to ask for equal time on the ACC website, he refused my request. I subsequently was surprised to learn that his prior employer was the U.S. Chamber of Commerce, which had quite a stake (and played quite a role) in the appeal to the D.C. Circuit on behalf of Kellogg Brown & Root. *See supra* note 17.

20. The new panel was Circuit Judges Griffith, Kavannaugh, and Srinivasan; the prior panel was Circuit Judges Sentelle, Tatel, and Wilkins.

21. *See* 796 F.3d 137 (D.C. Cir. August 11, 2015).

22. *Id.*

23. *See* 796 F.3d at 142.

24. *See id.* at 144.

25. 2014 WL7212881, at *2 (D.D.C. December 17, 2014).

26. *See* J. Weinstein & M. Berger, *Weinstein's Federal Evidence* (2d ed. 1997). The court also cited the leading balancing test decision under Rule 612: *Sporck v. Peil*, 759 F.2d 312 (3d Cir. 1985).

27. *See, e.g., Wheeling-Pittsburgh Steel Corp. v. Underwriters Laboratories Inc.*, 81 F.R.D. 8 (N.D. Ill. 1978); *James Julian, Inc. v. Ratheon Co.*, 93 F.R.D. 138 (D. Del. 1985); *U.S. v. 22.80 Acres of Land*, 107 F.R.D. 20 (N.D. Cal. 1985); *Leybold-Heracus Technologies Inc. v. Midwest Investment Co.*, 118 F.R.D. 607 (D. Wis. 1987); *In re Joint Eastern and Southern District Asbestos Litigation*, 119 F.R.D. 4 (E.D.N.Y. & S.D.N.Y. 1988); *Redvanly v. NYNEX Corp.*, 152 F.R.D. 460 (S.D.N.Y. 1993); *Audiotext Communications Network v. US Telecom*, 164 F.R.D. 250 (D. Kan. 1996).

28. *See supra* note 25. This case, as well as the broader issue of what can be shown witnesses as part of preparation, are the subject of my prior article: *'Positively 4th Street': Lawyers and the 'Scripting' of Witnesses*, *NY Business Law Journal* (Summer 2014).

29. KBR made a huge mess of this by having an internal lawyer be a Rule 30(b)(6) witness in the first place—that should *never* be done. It then compounded the error by showing him the materials KBR was so desperately trying to keep from producing to the plaintiff's lawyers. Perhaps the company was attempting to be too clever by half—putting forward its own lawyer and then attempting to bar discovery on the Rule 30(b)(6) subject by invoking privilege and work product. This should *never* be attempted by careful lawyers, unless (apparently) you are litigating such matters in the D.C. Circuit. *See* 796 F.3d 137.

30. *See* Weinstein & Berger, *supra* note 26, at 10:05 (3), 10-30 (emphasis added).

31. *See supra* note 28.

32. Once again showing its confusion between the attorney-client privilege and work product doctrine, the D.C. Circuit based its "legal" analysis on this point on the lower court's ruling being "counter" to *Upjohn Co. v. United States*, 449 U.S. 383, 393 (1981). *See* 796 F.3d at 144. Under any scenario, however, *Upjohn* has no factual applicability to the KBR situation (*see supra* note 10 and accompanying text); and, of course, to the extent the ruling was based upon work product, *Upjohn* is legally inapposite.

33. *See* 796 F.3d at 146.

34. *See id.*

35. *See id*. at 148.

36. *See id.*

37. *See United States v. Kovel*, 296 F.2d 917 (2d Cir. 1961). This case allows a narrow exception to the 5 Cs requirement vis-à-vis the attorney-client privilege (*see supra* note 9)—where an attorney uses specific technical support to assist in the representation of a client (e.g., a translator, a financial expert on a highly technical matter, etc.) it does not waive the privilege. *See* A.J. Schoenthal, "*Risk of Waiving Privilege When Hiring Third-Party Consultants*," *New York Law Journal* (November 9, 2015). That was clearly not the case involving KBR.

38. Della Street, of course, was Perry Mason's confidential secretary. She was (and is) covered by professional ethics Rule 5.3, which concerns the supervision of non-lawyers who are *employed* by lawyers. The Della Street situation is obviously not implicated by the KBR set of facts.

39. *See* 796 F.3d at 150.

40. The D.C. Circuit then went on to justify its second (and improper) granting of the most recent writ of mandamus—*see supra* notes 16-18 and accompanying text—as "law of the case." *See* 796 F.3d at 150.

41. *See* 796 F.3d at 151.

42. *See* J. Rogers, "KBR's Actions in Whistle-Blower Case Didn't Waive Privilege for Internal Probe," *ABA/BNA Lawyers' Manual on Professional Conduct* (August 26, 2015).

43. Hopefully, no one alive today subscribes to the doctrine of Joseph Goebbels: "If you tell a lie big enough and keep repeating it, people will eventually come to believe it."

44. *See supra* note 12.

45. I previously wrote that the initial D.C. Circuit opinion could lead to the reverse of the court's intent—instead of strengthening the attorney-client privilege and work product doctrines, it might well lead corporate clients to ape what KBR did, with judges who understand these issues then rejecting ill-founded privilege and work product claims. *See supra* note 9. The August 11, 2015 double-down decision by the D.C. Circuit only heightens that concern. One of the commentators cited in that second decision, Thomas Spahn, has been quoted as saying he believes other courts will follow the D.C. Circuit's determination on Rule 612 (and that "most lawyers would be astounded" if showing privileged materials to a top corporate executive in preparation for a deposition would cause a Rule 612 problem). *See supra* note 41. As set forth above (*see supra* notes 25-30 and accompanying text), I obviously do not agree with those cheery (but wrong) assessments. Mr. Spahn was also "pleasantly surprised" by the appellate court's "at issue" waiver ruling. As even he noted, however, the privilege cannot be used as a sword and shield (exactly what KBR was trying to do); so presumably, Mr. Spahn knows that KBR dodged a huge bullet.

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Can Regulators Compel Banks to Disclose Privileged Documents?

By Clifford S. Weber

The Scenario

Bankers know this scene well. The examiners are in your bank conducting a compliance exam. They've focused on your overdraft program and your Regulation O reports on insider transactions. Now they're asking you to produce all of your materials pertaining to these matters, including bank counsel's legal analyses and opinions. Bank files on both matters contain your attorney's written legal analyses, including advice that some of the bank's practices are non-compliant. The bank has not yet corrected these practices, but the failure to correct is explainable—the bank has finite resources and had to prioritize its Dodd-Frank compliance efforts. Still, you're pretty certain the examiners won't sympathize.

> *"There is simply no legal basis for the notion that the regulators' need to know supersedes the attorney-client privilege and its protection of client confidences."*

You remember that communications from bank counsel are confidential and protected by the attorney-client privilege from disclosure to third parties without the client's consent. What do you do? Will you turn over counsel's memoranda pointing out that the bank can't process checks in high-low order to maximize fee income or the advice pointing out that a loan to a director's affiliate should have been reported? *Must* you deliver it? Can you invoke the attorney-client privilege to resist disclosure?

Bankers routinely comply with regulators' demands for counsel's opinions. They may believe the privilege doesn't apply to regulators or they may not want to risk the possible consequences of refusing the request. Invoking the attorney-client privilege poses a real dilemma—the privilege may shield a smoking gun from scrutiny, but what's the cost? Is the benefit of protection worth souring the relationship with the regulators, a rating downgrade, or worse?

Must You Disclose Your Lawyer's Advice?

Rooted in the common law,[1] the attorney-client privilege is a pillar of our legal system. It serves to safeguard the bond of trust between lawyer and client and promote the candid communication between them vital to effective legal representation.[2] Without the protection of the privilege, disclosure might be compelled, exposing the client to embarrassment, possible civil liability or even criminal prosecution.[3] Those threats could shade the content and reduce the value of a lawyer's advice and thereby jeopardize the client. Does the regulator's need for access to the bank's books and records, in the service of safety and soundness and regulatory compliance, trump the attorney-client privilege? The regulators think it does.

In a 1991 guidance,[4] the Deputy Chief Counsel for the Office of the Comptroller of the Currency, citing the agency's congressionally mandated mission to thoroughly examine national banks, opined that national banks must comply with the OCC's requests for privileged materials. In 2012, in testimony before the House of Representatives Committee on Financial Services, the Federal Reserve's General Counsel stated that the Federal Reserve "has complete and unfettered access to an institution's most sensitive information and processes, *including information that would otherwise be privileged and not subject to public disclosure*"[5] (emphasis supplied). Also in 2012, the Consumer Financial Protection Bureau directly addressed the subject in its rule entitled "Confidential Treatment of Privileged Information." In this rule, the CFPB stated flatly, "The Bureau continues to adhere to the position that it can compel privileged information pursuant to its supervisory authority."

This position may reflect regulatory policy, but as commentators have noted,[6] no statute or judicial decision supports it. There is simply no legal basis for the notion that the regulators' need to know supersedes the attorney-client privilege and its protection of client confidences. Regulators may have other persuasive tools—like long memories—but, at this writing, they cannot use the courts to compel disclosure of bank counsel's memoranda.

What If You Do Disclose to Your Regulator?

Ordinarily, a client's disclosure of privileged material to third parties waives the attorney-client privilege.[7] Once the privilege is waived, the client cannot regain its protection. So, if you decide to furnish bank counsel's opinions to your regulator, has the bank waived the privilege and opened the door to compulsory disclosure to plaintiffs in civil litigation and other potentially adverse third parties? Thankfully, the answer is no.

Section 18 of the Federal Deposit Insurance Act[8] provides that:

> The submission by any person of any information to the Bureau of Consumer

> Financial Protection, any Federal banking agency, State bank supervisor, or foreign banking authority for any purpose in the course of any supervisory or regulatory process of such Bureau, agency, supervisor, or authority *shall not be construed as waiving, destroying, or otherwise affecting any privilege* such person may claim with respect to such information under Federal or State law as to any person or entity other than such Bureau, agency, supervisor, or authority (emphasis supplied).

This "selective waiver" law is peculiar to depository institutions and non-bank financial service providers regulated by the CFPB. It enables banks to share privileged information with regulators without waiving the privilege vis-à-vis third parties, which would be the traditional result, absent the statute. Ironically, as one writer has asserted,[9] this statute may have emboldened regulators to demand protection of otherwise privileged materials because it strips banks of their concern regarding waiver with respect to third parties. Moreover, while the CFPB has announced a policy of "selective disclosure" of confidential materials to other regulators,[10] the extent of the privilege in the event of such disclosure is unclear.

Should You Disclose?

Like other important management decisions, considering whether to waive the attorney-client privilege in response to a regulatory demand involves balancing the risks and benefits of the available choices. In most situations, bankers will probably conclude that the risk of refusing a demand (damage to the regulatory relationship and possible related consequences) is not worth the rewards of maintaining confidentiality (uncensored legal advice), especially because the FDIC Act preserves the privilege as to third parties (except perhaps other regulators). But in some cases, resistance may be the better choice, not to vindicate an abstract legal principle, but because the unimpeded flow of candid legal advice is critically important. Like other tough decisions, such as fighting a meritless fair lending enforcement action, the choice to resist disclosure may best serve the bank in the long run. And at least for now, a regulator seeking to compel disclosure of communications shielded by the attorney-client privilege would face an uphill court battle.

Endnotes

1. *See Hulburt v. Hurlburt*, 128 N.Y. 420, 28 N.E. 651 (1891). The privilege is now codified in N.Y. Civil Practice Law & Rules § 4503 (CPLR).
2. *See Spectrum Systems International Corporation v. Chemical Bank*, 78 N.Y.2d 371, 575 N.Y.S.2d 809, 581 N.E.2d 1055 (1991)(citing *Upjohn Co. v. United States*, 449 U.S. 383, 390 (1980), where the Court said "Its purpose is to encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice. The privilege recognizes that sound legal advice or advocacy serves public ends and that such advice or advocacy depends upon the lawyer's being fully informed by the client.")
3. *People v. Cassas*, 84 N.Y.2d 718, 622 N.Y.S.2d 228, 646 N.E.2d 449 (1995).
4. Interpretive Letter from Robert B. Serino, Deputy Chief Counsel, Office of the Comptroller of the Currency (Dec. 3,1991) 1991 WL 338409 (O.C.C.)
5. *Examining the Settlement Practices of U.S. Financial Regulators: Hearing Before the Comm. on Fin. Serv.*, 125th Cong. 112-128 (2012) (statement of Scott G. Alvarez, General Counsel, Board of Governors of the Federal Reserve System).
6. Bruce A. Green, *The Attorney Client Privilege-Selective Compulsion Waiver and Selective Disclosure: Is Bank Regulation Exceptional?* 2013 J. of the Prof. Law. 85, 86-106 (2013).
7. *See* AFA *Protective Systems, Inc. v. City of N.Y.*, 13 A.D.3d 564, 788 N.Y.S.2d 128 (2d Dep't 2004).
8. 12 U.S.C. § 1828(x)(1) (2013).
9. Thomas Vartanian, *Do Financial Institutions Have Any Attorney-Client Privilege Left?*, American Banker (Aug. 28, 2015), http://www.americanbanker.com/bankthink/do-financial-institutions-have-any-attorney-client-privilege-left-1076390-1.html
10. "[T]he Bureau will not routinely share confidential supervisory information with agencies that are not engaged in supervision. Except where required by law, the Bureau's policy is to share confidential supervisory information with law enforcement agencies, including State Attorneys General, only in very limited circumstances and upon review of all the relevant facts and considerations." Letter from Leonard J. Kennedy, General Counsel, Consumer Financial Protection Bureau, to the Chief Executive Officers of Depository Institutions, Credit Unions, and their Affiliates Subject to the Bureau's Supervision Authority (Jan. 4, 2012), http://files.consumerfinance.gov/f/2012/01/GC_bulletin_12-01.pdf.

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Considerations for Audit Committee Members

By Samuel P. Gunther

Introduction

Many current discussions about corporate governance describe the increasing role of an Audit Committee in enterprise risk management oversight as well as additional disclosures of what the Audit Committee does and what it knows. By contrast, this article focuses on several suggested actions to be undertaken by individual audit committee members when evaluating information for actual or potential financial reporting implications.

Corporate management has the primary responsibility for causing a company (Company) to produce financial statements that are fairly presented in accordance with generally accepted accounting principles (GAAP). To enhance the reliability and credibility of those financial statements, the Audit Committee, on behalf of the Board of Directors, oversees the Company's financial reporting process and its internal controls over financial reporting.

An individual Audit Committee Member (ACM) should be self-starting, scouring available information for the financial reporting implications of past and possible future events applicable to his/her Company. The ACM should be assertive and curious and should not simply attend Committee meetings, read agendas for those meetings, read financial statements and stop. The ACM should be a voracious reader of his/her Company's SEC filings and news releases. He/She should also use those sources to track information about peer companies and compare their reporting to the Company's to determine possible additional disclosure by the ACM's Company. This article discusses four issues: 1. Considering Information with Direct Accounting Implications, 2. Considering Information with Possible Accounting Implications, 3. Performing Meaningful Accounting Analysis, and 4. Considering New Revenue Recognition Requirements.

1. Considering Information with Direct Accounting Implications

An Audit Committee Member should evaluate financial reporting implications of developing issues and notable events that have taken place, regardless of the source of the information. That includes obtaining an understanding, through documented history and explanations of not only matters that occur in the ordinary course of business, but also one-time events and surprises. Potential sources of information include SEC filings (focusing especially on financial statements, financial information, MD&A and independent auditor reports on financial statements and internal accounting controls), press releases, SEC, FASB and PCAOB pronouncements and discussions with Company personnel, directors and independent auditors. Actual and potential significant events include, but are not limited to: asset impairment charges; restructurings; acquisitions; divestitures; discontinued operations (the definition of which has recently been dramatically restricted by the FASB); charges reported as income statement line items (certain of which, until recently, would have been called extraordinary items); significant new borrowings; share reacquisitions; developments in existing or new litigation; and actual or potential threats to the Company's "going concern" status.

When considering the effects of income statement charges for asset impairments, unusual items and restructurings and the presentation of discontinued operations, the ACM should review the chronology of events and support for the income statement characterization of the events and any required authorization for what has been reported.

The ACM should scrutinize stated reasons for, and the possible effects of, a proposed change in an accounting principle (e.g., to better match costs and revenues, to better conform to industry practice, or to adopt a new FASB accounting standard) and support for the proposed change. If a new FASB pronouncement must be applied by a specified future date, but that date has not arrived and the Company has not elected early adoption of the new principle, the ACM should ascertain what the estimated effects of adopting the future accounting will be, and whether management can presently estimate those impacts. The ACM should examine disclosure made, or proposed, about the new principle.

The ACM should pay particular attention to whether and why the Company has been late in its SEC filings or has failed to deliver on time previously promised earnings releases. Those events may be the "tip of the iceberg" and may relate to circumstances underlying a reported accounting restatement or may suggest that a restatement should be considered. If an ACM learns that management is considering a restatement of financial statements, the member should read recent SEC filings, SEC staff letters of comment and discuss issues with Company accounting personnel, internal auditors, inside and outside counsel, and independent auditors. If, during this process, an ACM identifies differing views about accounting within management or between management and independent auditors, that difference is important. Circumstances may be exacerbated by a history of contentious dealings between management and the independent auditors or by the resignation of those auditors. The chronology of events that leads up to a restatement might suggest weaknesses in internal accounting controls and related or threatened litigation, SEC inquiries, SEC investigations, and SEC enforcement actions. Similarly, whistleblower complaints, published anonymous rumors or "over the transom" letters should be investigated, if practicable, for their factual accuracy.

When performing these analyses, the ACM should consider information derived from reports of internal auditors, from discussions with independent auditors, from examining internal budget and internal forecast information and from forward-looking information released to the public. The ACM should also compare the written texts of analysts' calls to analysts' questions to determine whether management's responses to those questions are consistent with other information of which the ACM is aware. Those texts can also give insights into what analysts view as important.

Scrutiny of historical (and draft current) MD&As provides significant information about what management believes is most important to disclose about the Company, trends and forward-looking information and whether or not prior events are reasonably expected to continue in the future. MD&A is also important for disclosure of the Company's critical accounting estimates which the ACM should review for substance and completeness. The ACM should scrutinize non-GAAP financial information presented in MD&A. The ACM should ascertain why that non-GAAP information has been included in MD&A and should identify the basis for making those non-GAAP disclosures. The ACM should read non-GAAP information not only for what it says and to determine whether it is useful but also whether it might inappropriately imply that the non-GAAP information is more meaningful than the disclosures in GAAP financial statements.

2. Considering Information with Possible Accounting Implications

An ACM should pay attention to apparent one-time events that do not initially seem to be rooted in accounting issues, but which may have accounting implications. Thus, the ACM should scrutinize periodic Company SEC filings, daily financial news, media and the internet for disclosures of:

a. Purchases or sales of large blocks of company stock by third parties, officers or directors

b. Resignations of the CEO, the CFO or of board members

c. Notice of informal and/or formal SEC investigations

d. Potential or actual decisions to effect an acquisition by or of the Company or large dispositions of assets

e. New litigation and developments in existing litigation

f. Criminal investigations and indictments

g. Allegations of illegal acts, FCPA actions, bribery allegations or antitrust issues

h. Whistleblower complaints

Although SEC filings provide important sources of information about these matters, an effective ACM should be an avid reader of other available information, for example, the *Wall Street Journal* and internet and news services that describe events not only about the ACM's Company but also about peer companies.

The AC member should, if practicable, ascertain the reasons why events occurred. By probing, the AC member may also learn about other matters of potential significance not listed above, including correspondence addressed to the ACM's Company, such as shareholder demand letters or draft complaints. The information learned may give the ACM valuable insights into evaluating financial information prepared for SEC filings.

3. Performing Meaningful Accounting Analysis

Whether labeled good practice, due diligence, or some other descriptive phrase, an ACM should have the background, expertise and inquisitiveness to regularly obtain and analyze financial information, ask probing questions and use the information gleaned to evaluate the Company's financial statements, financial information and MD&A. That process includes comparing the financial statements of the Company for the current quarter and current year to date to the comparable quarter and year to date of the prior year, segment information (and possibly sub-segment information) for those periods, and a comparison of information obtained about peer companies. The nature of the information sought and studied will vary based upon the nature of the Company's businesses, changes in those businesses because of internal and external growth and contraction, and consideration of comparable information about competitors, including changes in their businesses.

Evaluation of a manufacturer or distributor of products, including a comparison to competitors, involves considerations of factors that differ dramatically from considerations when studying information about service businesses, financial institutions, long-term construction contractors, utilities and entities involved in entertainment businesses, among others. For example, for a company that manufactures inventory to sell or is a distributor of inventory for sale, the ACM should ask and obtain answers concerning the balance sheet, the income statement, the statement of cash flows and MD&A, ascertaining whether and why (partial list follows):

a. Receivables increased faster than sales (possible uncollectible sales).

b. The average age of receivables is getting older (e.g., due to an unexplained change in credit terms, raising questions about the adequacy of the bad debt expense and bad debt allowance).

c. The methodology for aging receivables has changed and/or the point in time when a receivable is “probably” uncollectible, in whole or in part, has changed, and if so, why that has occurred (e.g., to defer reporting losses).

d. Inventory increased faster than cost of sales (possible unrecorded obsolescence).

e. Accounts payable are being paid more slowly than in prior periods (suggesting a possible liquidity crunch).

f. Gross margin percentages changed (e.g., downward pressure on selling prices, and/or changes in the composition of sales of higher margin items to lower margin items).

g. Significant changes in estimates occurred (including changes in bases for making estimates) and effects of those changes (e.g., changes in the method of estimating bad debts or inventory obsolescence).

h. Changes occurred in the contribution to total sales of percentages of sales revenues compared to service revenue.

i. Deterioration (or improvement) of operating cash flow took place when considered with other metrics.

j. An apparent, unexplained aberration in seasonal results occurred.

k. New and/or increased levels of related party transactions occurred.

l. Increases (decreases) occurred in billings or bookings.

m. Complex transactions occurred (especially if they were booked immediately before period ends).

n. Increases occurred in the amounts of and changes in the trend of the percentages of revenue generated from transactions with new large customers and/or old large customers (especially at period ends and/or if done on a bill-and-hold basis).

o. The Company booked significant period end transactions (e.g., large amounts of sales or financing, including replacements of existing financing, identifying amounts/terms/maturities and the relationship of the parties).

p. There are also possible implications and interrelationships between and among two or more of the events above.

q. The company was involved in recent cybersecurity events and has incurred or may incur actual and projected future cyber costs, including estimates of liability to third parties, actual cybersecurity events; appropriate disclosures were made with respect to those events.

r. Consider the results of discussions with the Company’s independent auditors about internal control weaknesses they have identified, how such weaknesses have been dealt with, difficulties the independent auditors encountered in their audit and/or accounting disputes with independent auditors, and proposed but unrecorded journal entries; consider these discussions in light of the analytical information obtained in answers to points in this list.

s. If the business is not a manufacturer or distributor, identify the important metrics used to evaluate what makes the business go and apply analytical review techniques to information derived from the balance sheet, the income statement and the cash flow statement.

4. Considering New Revenue Recognition Requirements

In May 2014, FASB issued Accounting Standards Update No. 2014-09, “Revenue from Contracts with Customers,” Topic 606 (606) in FASB’s Accounting Standards Codification. That change in U.S. GAAP will affect the reporting of revenue recognition by all companies, other than certain excluded entities (e.g., lessors and insurance), eliminating most existing industry-specific accounting guidance in GAAP. 606 also adds new disclosure requirements to GAAP, including additional interim period information. 606 will be effective for reporting on annual periods (and interim periods within those annual periods) commencing after December 15, 2017 for public companies and after December 15, 2018 for non-public entities.

Topic 606, a 700 page document, prescribes following a series of five steps to determine whether and when contract revenue should be recognized. Because of the significance of the conceptual changes in revenue recognition wrought by Topic 606, FASB has given issuers more than two years to prepare for these changes. Once 606 becomes effective, conformity to GAAP under that standard will be mandatory. Implementation of Topic 606 will affect activities not only of issuers of financial statements but also independent auditors and their audit committees.

Absorbing and preparing to deal with the significance of Topic 606 will be the most important activity of AC members and audit committees in the immediate future. Individual audit committee members should immediately begin to teach themselves what Topic 606 means. An audit committee member should read the entirety of 606 with a particular focus on how its terms will apply to the entity of which he or she is an audit committee member. When reading 606, the audit committee member should identify questions with respect to the meanings of the concepts and terms in that standard and how the standard will apply to the entity of which he/she is an audit committee member.

The ACM should supplement reading 606 by obtaining available applicable interpretative guidance issued by FASB, AICPA, accounting firms (including the independent auditor of the client in issue), internal company documents and memoranda, applicable industry-wide publications and other available useful information, such as SEC filings by peer entities.

Based on reading Topic 606 and the available guidance, as well as meetings of the audit committee and discussions with company accounting personnel and independent auditors, the ACM should identify:

- How topic 606 changes existing GAAP applicable to the company
- What company accounting personnel have done to understand 606
- How internal accounting personnel have been and will be educated to make the necessary changes demanded by Topic 606
- Which company accounting systems and/or accounting controls must be changed to accommodate 606
- Whether and when those changes will be made and who will make them

The ACM and the audit committee should ascertain whether the reporting company has made appropriate progress to prepare for the changes. The ACM and the audit committee should also request notification of problems encountered by the Company adopting 606.

In addition to developing an understanding of the new revenue recognition standard and tracking the Company's progress preparing for adopting the new requirements, the ACM must also consider disclosure requirements for the remaining periods that precede mandatory adoption of 606. SAB Topic 11M of the Codification of Staff Accounting Bulletins issued by the Staff of the SEC, entitled "*Disclosure of the Impact that Recently Issued Accounting Standards will have on the Financial Statements of the Registrant when Adopted in a Future Period*," (originally issued as Staff Accounting Bulletin 74) sets forth proposed disclosures. Although not required by SEC policy, registrants in SEC filings apply the terms of SAB Topic 11M, which requires financial statement disclosure describing the new revenue recognition standard, the date of adoption of that standard, whether early adoption of the standard will be made, and the method expected to be used to report revenue recognition, if determined. If that determination has not been made, note disclosure should describe alternative adoption methods permitted under the new standard. If management has quantified the expected impact of adopting the new standard, effects of that quantification on the balance sheet and results of operations should be disclosed. If management has not made these determinations, that should be disclosed. SAB Topic 11M also states that the disclosure of other potential effects of the change on other significant matters, such as technical violation of loan covenants or on planned or intended changes in business practices, is encouraged.

Closing Observations

An Audit Committee Member is not merely a part of a larger whole. The ACM has an obligation to take the initiative in becoming well informed, asking hard questions, considering past history and analyzing current data and future projections.

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Enforcement Risk: The Long Length of the CFTC's Reach

By Geoffrey F. Aronow, Thomas K. Cauley, Nathan A. Howell, Kenneth A. Kopelman, William J. Nissen, Michael S. Sackheim

The Commodity Futures Trading Commission (CFTC) recently garnered attention by announcing two settled cases involving the agency's jurisdiction over bitcoin products.[1] While these cases focused attention on the status of digital currency as a "commodity" under the jurisdiction of the CFTC,[2] they also serve as an important reminder that, under the Commodity Exchange Act (CEA), CFTC rules and enforcement powers are extensive and cover derivative instruments, "swaps"[3] and "futures" on nearly anything, from a physical "thing" such as wheat or coal, to a virtual financial instrument. This means that the possibility of CFTC regulatory requirements and regulatory risk now needs to be considered when dealing with a product or transaction that has characteristics of a derivative instrument. This realization may be particularly jarring for those who are newly subject to CFTC regulation due to the expansion of its jurisdiction to cover swaps as a result of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).

Simply put, the CFTC has jurisdiction over swaps and futures on commodities. Although every issue must be addressed on its specific facts, and the CFTC may take positions that may be successfully challenged, a quick recitation of five aspects of the statutory scheme provides a sense of how far the CFTC may claim that its jurisdiction can reach:

1) "Commodity" is defined in a somewhat circular fashion to include (with a couple of very specific exceptions)[4] "all…goods and articles, and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in."[5]
2) A "futures contract" is not defined in the statute, and "swap" is very broadly defined.[6]
3) CFTC jurisdiction also reaches in certain respects what are called "retail commodity transactions,"[7] e.g., cash-settled precious metals transactions offered or sold to retail investors on a leveraged or margined basis, or financed by the counterparty.
4) CFTC jurisdiction includes "retail forex" transactions,[8] e.g., cash-settled over-the-counter forex transactions offered or sold to retail investors.
5) Finally, CFTC jurisdiction over manipulation and, arguably, fraud is not limited to derivative transactions, but reaches any "contract of sale of *any commodity* in interstate commerce."[9] In other words, manipulation in respect of cash commodity transactions, including, for example, foreign currency spot and forward transactions, can trigger CFTC scrutiny and action.

Moreover, Dodd-Frank grants the CFTC jurisdiction beyond the United States if swap activity is deemed to have a "direct and significant" connection with the U.S. activities or have a direct and significant effect on U.S. commerce. The CFTC may assert jurisdiction over any transaction, wherever it may occur and whoever may be trading, that meets this test.[10]

Here are some of the key areas of regulation and enforcement risk, when trading products subject to CFTC regulation:

- Certain derivatives (futures and certain specified swaps) are required to be traded on an appropriate platform, such as a Swap Execution Facility (SEF) or a Designated Contract Market (DCM) or otherwise in a manner consistent with CFTC requirements. Those requirements may constrain with whom and how you may enter a transaction. For instance, swaps generally cannot be traded other than on a DCM with anyone who is not an "eligible contract participant."[11]
- Certain swap contracts are designated by the CFTC as being required to be cleared through a registered derivatives clearing organization.[12]
- Involvement in trading swaps may require registration with the CFTC. Providing swaps advice to others, or being involved in placing the trades of others, may require CFTC registration, as may forming a pooled investment vehicle that trades swaps.[13] There are thresholds for those "dealing" regularly in swaps that can also trigger swap dealer registration requirements.[14] Providing a trading facility for entering into swaps could also require registration.[15] There is also a registration category of "major swap participant" that applies to persons who have a significant swaps exposure.[16]
- Reporting and recordkeeping requirements are applicable to most swaps, and margin is required to be posted for cleared swaps and may soon be required for many uncleared swaps.[17]
- U.S. law and regulations prohibit a transaction that can be characterized as a "wash trade," an "accommodation trade," or a "fictitious sale," or a trade that "is used to cause any price to be reported, registered, or recorded that is not a true or bona fide price."[18] Any type of pre-arrangement or method of trading used to increase the likelihood that your trade will match with a particular other counterparty at a particular price on a trading platform may result in the CFTC asserting that you have run

afoul of these requirements. For trades executed on a CFTC registered platform, there are specific prohibitions against (1) violating bids or offers, (2) intentional or reckless disregard for the orderly execution of transactions during a closing period, or (3) "spoofing," which is defined in the statute as "bidding or offering with the intent to cancel the bid or offer before execution."[19] Both the exchanges and the CFTC—and criminal prosecutors—have been actively pursuing spoofing cases. They are carefully scrutinizing situations where it appears traders are entering trades and either cancelling them or entering them in a manner that suggests to the CFTC (or self-regulatory organization, such as the exchange) that the trader never intended for that bid or offer to be consummated.

- The CEA broadly prohibits fraud and manipulation in connection with any transaction under the CFTC's jurisdiction. The law allows the CFTC to investigate and bring fraud and manipulation cases for any cash commodity transaction in interstate commerce, as well as cases involving futures, swaps and commodity options.[20] Moreover, the CEA specifically prohibits a person from entering into a swap transaction "knowing, or acting in reckless disregard for the fact, that its counterparty will use the swap as part of a" fraud against a third party.[21] Generally speaking, the CFTC may seek to bring a fraud case based on reckless as well as intentional conduct.
- As mentioned above, the CFTC has broad anti-manipulation authority, not just for derivatives markets, but also in the "cash" markets. Indeed, the agency often looks for indications of trading in one market that it thinks is designed to manipulate or create artificial prices in the other market. Again, the CFTC can bring a case based on recklessness at least in some cases; in such cases after the passage of Dodd-Frank, it no longer needs to prove actual intent. The CFTC can also bring cases for *attempted* manipulation, which requires only proof of an intent to manipulate and an act taken in furtherance of the intended conduct.[22]

In most cases under the CEA and CFTC rules, persons can be civilly charged with being aiders or abettors, and can face principal-agent liability (or for "controlling" the person who engaged in the conduct) for any of the violations of law that the CFTC oversees.[23] And, with regard to fraud and manipulation in particular, egregious cases may well draw scrutiny from local or federal criminal prosecutors.

The CFTC can impose substantial monetary penalties, often ranging into the millions of dollars. Besides substantial civil monetary penalties, the CFTC may seek cease-and-desist orders or injunctions against further misconduct, disgorgement of profits and/or restitution to injured parties, and registration, trading bans and suspensions. Unlike the Securities and Exchange Commission, the CFTC can actually suspend or ban non-registrants from trading in derivatives markets it regulates.[24]

What all of this means is that care must be taken when dealing in a form of transaction that could be a "future," "swap," other derivative, or even a "retail commodity transaction." The enactment of Dodd-Frank and the implementation of subsequent regulation means that the CFTC rules must be considered by market participants. The recent bitcoin cases provide a warning to those who do not adequately consider the regulatory waters into which they may be wading.

An end-user of swaps should not simply defer to its dealer's characterization of a transaction, particularly when entering into a highly tailored or complex derivative. Oftentimes the characterization of an instrument as being subject to CFTC jurisdiction (or not) is not intuitively obvious on the face of the transaction. Further, transactions conducted outside of the United States often raise unique issues that may not be specifically addressed in CFTC rules; in those circumstances, the CFTC may view itself as having jurisdiction, and may apply a U.S.-centric view of the way derivative markets are structured and should operate. It is critical to have in place a process for identifying and analyzing new products and new transactions that you might pursue. Care and caution are the watchwords in this new era of expanded regulatory reach.

Endnotes

1. On September 17, 2015, against Coinflip, the operator of an online trading platform that facilitated the trading of derivatives on bitcoin and other digital currencies, including U.S. dollar cash-settled options, for marketing bitcoin derivatives without being properly registered with the CFTC. In re Coinflip, Inc., Dkt. No. 15-29 (CFTC Sept. 17, 2015), available at: http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfcoinfliprorder09172015.pdf. On September 24, 2015, the agency announced a settlement of charges against TeraExchange, a CFTC-registered Swaps Execution Facility (SEF), for allowing a digital currency swap trade that was both a "wash trade" and a "prearranged trade" in violation of U.S. law and regulations. In re TeraExchange LLC, Dkt. No. 15-33 (CFTC Sept. 24, 2015), available at: http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfteraexchangeorder92415.pdf.
2. The CFTC treats digital currencies as commodities, but not as currencies, in the same category as precious metals. This treatment has a significant regulatory impact by taking digital currencies out of the so-called Treasury exemption, which exempts certain foreign currency products from CFTC regulation. *See* Sidley Update, "CFTC Asserts Jurisdiction Over Bitcoin Derivatives," available at http://www.sidley.com/en/news/10-15-2015-derivatives-update.
3. Swaps based on single securities, narrow-based security indices and single loans are regulated by the Securities and Exchange Commission as security-based swaps and therefore are not subject to the CFTC's jurisdiction. *See* https://www.sec.gov/spotlight/dodd-frank/derivatives.shtml.

4. Onions and motion picture box office receipts are the exceptions. 7 U.S.C. §1a(9). There is a history behind these seemingly random exceptions, but among regulatory implications, the import is that futures contracts based on onions or movie box office receipts are prohibited and unlawful.
5. 7 U.S.C. §1a(9).
6. 7 U.S.C. §1a(47).
7. 7 U.S.C. §2(c)(2)(D).
8. 7 U.S.C. §2(c)(2)(C).
9. 7 U.S.C. §9(a)(2) (emphasis added).
10. *See, e.g.*, 7 U.S.C. §2(i).
11. 7 U.S.C. §2(e)
12. 7 U.S.C. §§2(h).
13. *See* Sidley Updates, "CFTC Issues Final Rules Amending CPO and CTA Registration and Compliance Obligations," available at\" available at "HYPERLINK ."./../../NRPortbl/ACTIVE/AppData/Local/Microsoft/Windows/Temporary Internet Files/Content.Outlook/SQD6ZCZS/CFTC Issues Final Rules Amending CPO and CTA Registration and Compliance Obligations,\" available at": http://www.sidley.com/en/news/cftc-issues-final-rules-amending-cpo-and-cta-registration-and-compliance-obligations-02-10-2012; "CPO/CTA Registration Requirements Under Dodd-Frank," available at: http://www.sidley.com/en/news/cpocta-registration-requirements-under-dodd-frank-09-07-2010.
14. 7 U.S.C. §§6s, 1a(49).
15. 7 U.S.C. §1a(50).
16. 7 U.S.C. §1a(33). The CFTC's website lists only two registrants in this category as of March 2013.
17. See Sidley Updates, "Margin Requirements for Uncleared Swaps Continue to Take Form: Prudential Regulators and CFTC Re-Propose Similar Rules," available at: http://www.sidley.com/news/11-12-14-derivatives-update; "Prudential Regulators Re-Propose Rules for Mandatory Margining of Uncleared Swaps; Similar CFTC Re-Proposal Anticipated Shortly," available at: http://www.sidley.com/en/news/09-15-14-derivatives-update.
18. 7 U.S.C. §6c(a)(1)(2).
19. 7 U.S.C. §6c(a)(5).
20. 7 U.S.C. §9.
21. 7 U.S.C. §6c(a)(7).
22. 7 U.S.C. §9.
23. 7 U.S.C. §§13c, 2(a)(1)(B).
24. 7 U.S.C. 7 U.S.C. §§13a-1, 13b.

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The Flash Crash Case Against Sarao—Will the CFTC Prevail?

By Professor Ronald Filler and Professor Jerry W. Markham

Introduction

On May 6, 2010, the so-called Flash Crash Day, the prices of e-mini S&P 500 futures contracts, the S&P 500 SPDR and other equity products dramatically dropped in value, followed by an almost immediate recovery. Some $600 billion in market value disappeared briefly, and the Dow Jones Industrial Average plunged nearly 1000 points within a few minutes, before it recovered.[1] We will refer to the May 6, 2010 market freefall simply as the "Flash Crash" although several other names have been used for that event.

A joint-study of the Flash Crash by the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) resulted in a report that largely blamed the event on a faulty order entered by Waddell & Reed, a large mutual fund complex. The Joint CFTC/SEC Report stated that:

> May 6 started as an unusually turbulent day for the market.… Around 1:00 p.m., broadly negative market sentiment was already affecting an increase in the price volatility of some individual securities.… By 2:30 p.m., the S&P 500 volatility index was up 22.5 percent from the opening level, yields of ten-year Treasuries fell as investors engaged in a '"light to quality," and selling pressure had pushed the Dow Jones Industrial Average ("DJIA") down about 2.5%.… At 2:32 p.m., against this backdrop of unusually high volatility and thinning liquidity, a large fundamental trader (a mutual fund complex) initiated a sell program to sell a total of 75,000 E-Mini contracts (valued at approximately $4.1 billion) as a hedge to an existing equity position.… This large fundamental trader chose to execute this sell program via an automated execution algorithm ("Sell Algorithm") that was programmed to feed orders into the June 2010 E-Mini market to target an execution rate set to 9% of the trading volume calculated over the previous minute, but without regard to price or time. … However, on May 6, when markets were already under stress, the Sell Algorithm chosen by the large trader to only target trading volume, and neither price nor time, executed the sell program extremely rapidly in just 20 minutes.…[2]

The CME Group conducted its own study of the Flash Crash and issued a statement that objected to the blame placed on Waddell & Reed by the Joint CFTC/SEC Report.[3] The CME noted that Waddell & Reed's orders were only a small part of the volume of related trades and that traders paid little attention to those orders.

Nanex, a market data provider, also analyzed data from the Flash Crash and suggested that high-frequency traders (HFTs) might have been trying to outsmart each other's computers with massive amounts of orders that were not intended to be filled. It further suggested that HFTs might also have been trying to paralyze the exchanges with massive orders in order to obtain an advantage over other traders.[4] Another analysis of the trading data by a group of economists concluded that HFTs did not trigger the crash but that their responses to the abnormally large sell orders may have worsened the situation.[5]

The Congressional Research Service also examined the Flash Crash and other high frequency trader concerns. Its report noted these differences in opinion on the reason for the Flash Crash, but did not seek to resolve those differences.[6] The CFTC seemingly stuck to its guns on what caused the Flash Crash for over four years. Therefore, it came somewhat of a surprise when the CFTC announced on April 21, 2015 that it had filed a lawsuit against a London trader and his firm in which it blamed those defendants as having materially contributed to the Flash Crash through "spoofing" orders that the trader entered from his parents' modest home in a London surburb.[7]

This article will examine, among other things, (1) the allegations set forth in the CFTC Complaint; (2) the theories of liability covering both the pre-Dodd-Frank Act[8] period and the post Dodd-Frank Act period; (3) how these differing theories of liability compare to other CFTC cases; and (4) whether the CFTC will prevail in this case against the defendants.

Allegations in the CFTC Complaint

The CFTC's Complaint against the London trader and his firm (Navinder Singh Sarao and Nav Sarao Futures Limited (collectively, the "Defendants" or "Sarao")) charges those Defendants with unlawfully manipulating, attempting to manipulate and "spoofing," all with respect to the e-mini S&P futures contract.[9] Judge Wood of the U.S. District Court for the Northern District of Illinois issued an *Order Granting the CFTC's Ex Parte Motion for Statutory Restraining Order and Other Relief on April 21, 2015.*[10] Also, on April 21, 2015, the U.S. Department of Justice filed a Criminal Complaint against Sarao.[11]

The CFTC Complaint had been kept under seal since April 17, 2015 and was released on April 21, 2015, when Sarao, a UK resident, was arrested by UK authorities at the request of the U.S. Department of Justice.[12] The Complaint, which will be discussed in greater detail below, covers trading by the Defendants in the e-mini S&P 500 stock index futures contract for the period of April 2010 through April 6, 2015, during which time the Defendants utilized a "Layering" Algorithm on over 400 different trading days.[13] Accordingly, the CFTC is alleging fraudulent trading by the Defendants covering both pre-and post-Dodd Frank Act standards of liability.

The CFTC asserts, in essence, that the Defendants engaged in a massive effort to manipulate the CME's e-mini S&P 500 futures contracts (hereinafter referred to as "S&P e-minis") by "utilizing a variety of exceptionally large, aggressive, and persistent spoofing tactics" and that Defendants "schemed to design an automated system to manipulate the E-mini S&P price to their benefit."[14] The Complaint further alleges that "Defendants' actions caused artificial prices to exist in the intra-day price of the lead month of the E-mini S&P" on at least twelve trading days during the five-year period.[15] To achieve this manipulative trading activity, the CFTC Complaint alleges that:

> Defendants utilized an automated "layering" algorithm (the Layering Algorithm) that typically simultaneously layered four to six exceptionally large sell orders into the visible E-mini S&P central limit order book (Order Book). Each sell order was one price level from the next, generally beginning at least three or four price levels from the best asking price in the Order Book. As the market price moved, Defendants' Layering Algorithm automatically simultaneously moved the large sell orders, resulting in the orders remaining at least three or four price levels from the best asking price in the Order Book. This caused the orders to remain visible to other market participants in the Order Book, with very little risk of the sell orders resulting in a consummated trade because each order was several price levels above the best asking price.[16]

The CFTC alleges that the Defendants "placed hundreds of orders for tens of thousands of contracts that were modified thousands of times and eventually canceled over 99% without ever resulting in a trade."[17] Also, the CFTC alleges that the Defendants "'flashed' large lot orders in a variety of lot sizes in the Order Book that were quickly canceled with no intention of these orders resulting in trades (Flash Spoofing)," although some orders were executed.[18] As a result of these trading tactics, the CFTC Complaint alleges that the Defendants "traded on average $7.8 billion in notional value, resulting in daily profits averaging approximately $530,000. Defendants profited approximately $6.4 million on the twelve" days noted above, and $40 million in total.[19]

The most interesting of the various CFTC allegations is that Defendants used their trading strategies on May 6, 2010, the so-called Flash Crash Day, to create artificial prices. In support of this allegation, the CFTC alleges:

> Defendants first turned on the Layering Algorithm at 9:20 a.m. CT, placing four orders totaling 2,100 contracts. These orders were each one tick apart, starting three ticks away from the best ask. The orders were modified 604 times over the following six minutes so the orders were always at the third level of the sell-side of the order book or deeper, and then canceled with no executions, as the layering Algorithm was turned off.… While the first cycle of the Layering Algorithm was active, Defendants bought 1,606 contracts and sold 1,032 contracts.
>
> At 11:17 a.m. CT, Defendants turned the Layering Algorithm on for more than two consecutive hours, until 1:40 p.m. CT. During this cycle, Defendants utilized the Layering Algorithm to place five orders, totaling 3,000 contracts. A sixth order was added at around 1:13 p.m. CT, increasing the total to 3,600 contracts.
>
> Between 11:17 a.m. CT and 1:40 p.m. CT, Defendants' actions contributed to an extreme order book imbalance in the E-mini S&P market. That order book imbalance contributed to market conditions that caused the E-mini S&P price to fall 361 basis points.[20]

As a result of the Defendants' trading schemes, the CFTC has alleged that the Defendants violated the CEA as follows:

1. Count One: Sections 6(c)[21] and 9(a)(2)[22] of the Commodity Exchange Act ("CEA") for the period prior to August 15, 2011 and CFTC Regulation 180.2[23] for the period after August 15, 2011 for manipulating the E-mini S&P futures contract.
2. Count Two: Sections 6(c)(3)[24] and 9(a)(2)[25] of the CEA for the period prior to August 15, 2011 and Sections 6(c)(3), 9(a)(2) and 13(a)(2)[26] of the CEA and CFTC Rule 180.2 for the period after August 15, 2011 for attempting to manipulate the E-mini S&P market.
3. Count Three: Section 4c(a)(5)(c)[27] of the CEA for spoofing of the E-Mini S&P futures contract for the period of July 16, 2011 to the present.

4. Count Four: Sections 6(c)(1)[28] and 9(c)(1)[29] of the CEA and CFTC Rule 180.1[30] for use of manipulative devices in connection with trading the E-mini S&P futures contract.[31]

The CFTC Complaint seeks a host of remedies, including civil penalties of the greater of $140,000 or three times the monetary gain from each of the thousands of alleged violations of the CEA.[32]

Allegations in the Criminal Complaint

The Department of Justice (DOJ) alleged most of the same facts set forth in the CFTC Complaint through an Affidavit of Gregory LaBerta, a Special Agent of the Federal Bureau of Investigation (FBI).[33] What is interesting is that the LaBerta Affidavit refers to a "consulting group" that assisted the DOJ in connection with its investigation and filing of the criminal complaint, but this firm is not identified in the Affidavit. The Affidavit stated that this Consulting Group determined that:

> 1. Sarao "typically executed a series of trades to exploit his own manipulative activity by repeatedly selling futures contracts only to buy them back at a slightly lower price."
>
> 2. The Consulting Group "examined over 400 days on which Sarao traded E-Minis between April 2010 and April 2014… and found that Sarao used the dynamic layering technique on approximately 63 percent of those days."
>
> 3. Sarao also repeatedly used a different trading technique "188- and/or 289-lot orders on the sell side of the market, nearly all of which he canceled before the orders were executed" to "intensify the manipulative effects of his dynamic layering technique."
>
> 4. Sarao used a third trading technique whereby he "flashed a large 2,000-lot order on one side of the market, executed an order on the other side of the market, and canceled the 2,000-lot order before it was executed."[34]

LaBerta also stated that he spoke with another expert, who was not identified, who reviewed the analyses done by the Consulting Group and opined that Sarao's "dynamic layering technique affected the market price of the E-Minis during that time period, creating artificial prices."[35]

The Criminal Complaint, like the CFTC Complaint, alleges that Sarao's actions contributed to the Flash Crash.[36] In particular, based on analyses done by the Consulting Group and the other expert, it was asserted that Sarao contributed to the order-book imbalance and was thus a cause of the Flash Crash.[37]

The Criminal Complaint charges wire fraud (18 U.S.C. §1343); criminal commodity fraud (18 U.S.C. §1348); criminal manipulation under the CEA (7 U.S.C. §13(a)(2)); and criminal spoofing (7 U.S.C. §§6(a) and 13(a)(2)).[38] Those charges carry a maximum of 380 years in prison if Sarao is convicted on all counts and given consecutive sentences. In the meantime, Sarao was unable to raise money for bail because his assets were frozen worldwide by U.S. authorities.[39]

Comparing the Old and the New Theories

The CFTC's Complaint against Sarao contains charges of: (1) actual and attempted price manipulation in violation of provisions of the CEA that existed before it was amended by the Dodd-Frank Act in 2010;[40] (2) manipulation under amendments added by Dodd-Frank;[41] and (3) "spoofing" violations under another provision added by Dodd-Frank.[42] The following is an analysis of the elements required to prove each of those charges.

Old School Anti-Manipulation Authority

The original anti-manipulation prohibitions contained in the CEA, when it was enacted in 1936, were at the very heart of the effort by Congress to regulate the commodity futures markets. However, the CEA failed to define what it meant by manipulation. It was, therefore, left to the government and the courts to define the term.[43] They came up with a four-part test that requires the following elements to be proved in order to establish an actual commodity price manipulation:

1. The trader had the ability to influence market prices;
2. The trader specifically intended to create an artificial price;
3. An artificial price occurred; and
4. The trader caused the artificial price.[44]

In an attempted manipulation case, the CFTC has asserted that it need only prove specific intent through some overt act that was intended to be manipulative.[45]

The elements of manipulation and attempted manipulation under this pre-Dodd Frank authority are very difficult to prove. Indeed, while obtaining numerous settlements, the CFTC has won only one adjudicated manipulation case in its forty-year history.[46]

The reasons for this difficulty are many. For example, prominent economists testifying as experts on whether a price was artificial often disagree on that issue. Regression analyses by those experts, such as the one filed by the CFTC in support of its complaint,[47] are difficult for a fact finder to understand and subject to attack by other experts. In proving that a defendant caused an artificial price opposing experts may disagree over whether the price was actually artificial. Expert economic analysis claiming that the defendant caused an artificial price is often subject to criticism for failing to account for every factor that might have affected the price.[48]

The intent requirement in the old CEA manipulation definition is even more problematic. The CFTC has held that "the requisite level of *mens rea* required to prove manipulation or attempted manipulation under the Commodity Exchange Act is that of 'specific intent,' or as that term is also commonly understood to mean today, 'purposeful conduct.'"[49]

The CFTC Complaint alleges that the trading at issue was intended to move market prices so that Defendants could profit. However, the fact that a trader is seeking to move prices in one direction or another is not itself sufficient proof of manipulative intent. As the district court held in *CFTC v. Delay* in a similar context:

> Simply stated, it is not a violation of the statute to report feeder cattle sales to the USDA with the intention of moving the CME index up or down—rather, to be unlawful, the reported sales must be sham or nonexistent transactions, or the reports must be knowingly false or misleading. In this case, it turns out that the sales were real and the reports were true.[50]

In this case, as described below, Sarao will undoubtedly argue that his trades were real ones because he was at market risk.

New School Anti-Manipulation Authority

The CFTC's claims under the new Dodd-Frank anti-manipulation authority also face some formidable obstacles. The language in that provision was borrowed from Section 10(b) of the Securities Exchange Act of 1934 ("34 Act"), which prohibits any "manipulative or deceptive device or contrivance."[51] Under familiar canons of statutory construction, this means that this new language in the CEA will be interpreted in the same manner as it has been under the 34 Act.[52]

The Supreme Court held in *Ernst & Ernst v. Hochfelder*[53] that the use of the word "manipulative" in Section 10(b) of the 34 Act was "especially significant. It is and was virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities."[54] Later, as it did in the *Hochfelder* case, the Supreme Court in *Santa Fe v. Green*[55] defined the term manipulation for purposes of Section 10(b) to refer "generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity."[56]

This same approach has been taken in criminal cases charging Section 10(b) violations. In *United States v. Mulheren*,[57] the Second Circuit set aside the conviction of the chief trader for a broker-dealer on manipulation charges brought under Section 10(b). That trader, John Mulheren, had been told by Ivan Boesky that a particular stock was a good buy and that it "would be great" if it traded at $45, a price that would benefit Boesky's holdings. Mulheren then entered an order for the stock at that price. The Second Circuit held that this conduct was too ambiguous to support a manipulation charge because there was no evidence of trading practices commonly associated with manipulation, e.g., wash trades.

The decision in the *Mulheren* case gave rise to a debate over whether "open market" trades, *i.e., bona fide* orders that are subject to market risk, cannot be manipulative because they are real trades, as opposed to wash trades, matched trades, or other rigged trades.[58]

Subsequently, in *ATSI Communications Inc. v. The Shaar Fund Ltd.*,[59] the defendants were charged with engaging in a "death spiral" strategy in which they sold short to drive down prices and then covered their short position with securities bought at the lower prices set by their own short sales. The Second Circuit held that manipulation under Section 10(b) requires a showing that the defendant "engaged in market activity aimed at deceiving investors as to how other market participants have valued a security."[60] The inquiry that must be made is to determine "whether [trading activity] sends a false pricing signal to the market."[61] In that regard, the Court gave some assistance to Defendants because it held that short selling in large volume to the distress of other market participants is not in and of itself actionable. Rather, to be manipulative, the short sales had to be willfully combined with some other activity that created a false impression of how market participants were valuing the security.[62]

Less helpful to the Defendants is a decision by the District of Columbia Court of Appeals in *Markowski v. SEC*,[63] where the open market trade defense was rejected. There, the defendants were supporting the price of a stock through real bids and offers. The Court noted the debate over whether open market trades could ever be manipulative, but concluded that the SEC's *contra* position was not unreasonable, at least under the circumstances of that case. However, the Court noted that, in the absence of fictitious trades, it could be difficult to "separate a 'manipulative' investor from one who is simply overenthusiastic, a true believer in the object of investment. Both may amass huge inventories and place high bids, even though there are scant objective data supporting the implicit estimate of the stock's value."[64] In such circumstances, legality would "depend entirely on whether the investor's intent was 'an investment purpose' or 'solely to affect the price of [the] security.'"[65] Here, Sarao claims the former as his motive.

In any event, there are other defenses available to Sarao. The 34 Act language was borrowed by Dodd-Frank in order to reduce the CFTC's burden to prove manipulative intent.[66] However, it is not entirely clear that the burden will be much different under the new provision. The Supreme Court held in *Ernst & Ernst v. Hochfelder*[67] that scienter must be proven in order to succeed in a claim brought under Section 10(b), i.e., that the defendant acted with a mental state embracing intent to deceive, manipulate, or defraud.[68] This sounds like a specific intent requirement.

The Supreme Court has not further defined the standard for scienter under Section 10(b), but the lower courts have concluded that "reckless" conduct is sufficient to establish the requisite intent. However, that is still a high standard of proof of intent. The Seventh Circuit, which is the circuit where the *Sarao* case is lodged, has defined reckless conduct under Section 10(b) as a "highly unreasonable [act or] omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."[69] This is a very high standard of intent, and the difference between that standard and the specific intent required under the pre-Dodd-Frank anti-manipulation authority is apparently slight.[70]

The New Spoofing Authority

The spoofing prohibition cited in the CFTC Complaint against the Defendants was also added by Dodd-Frank. That provision prohibits any transaction that "is, is of the character of, or is commonly known to the trade as, 'spoofing' (bidding or offering with the intent to cancel the bid or offer before execution)."[71]

The CFTC contends that Defendants placed hundreds of thousands of orders for the E-mini S&P futures contract in the near-month with the "intent" of cancelling those orders before execution.[72] Again, this raises the issue of the degree and nature of the required intent because, as noted below, Saro contends that he was engaged in a bona fide market strategy that required frequent cancellations.

The CFTC issued an interpretive guidance and policy statement after the anti-spoofing provision was added to the CEA by Dodd-Frank in which it addressed the issue of intent in spoofing cases.[73] The CFTC stated that a trader must be shown to:

> act with some degree of intent, or *scienter,* beyond recklessness to engage in the "spoofing" trading practices prohibited by CEA section 4c(a)(5)(C). Because CEA section 4c(a)(5)(C) requires that a person intend to cancel a bid or offer before execution, the Commission does not interpret reckless trading, practices, or conduct as constituting a "spoofing" violation. Additionally, the Commission interprets that a spoofing violation will not occur when the person's intent when cancelling a bid or offer before execution was to cancel such bid or offer as part of a legitimate, good-faith attempt to consummate a trade.[74]

This specific intent requirement will be difficult to meet.

The CFTC interpretive statement also stated that spoofing would occur where a party submitted or canceled bids or offers with the intent to create artificial price movements upwards or downwards.[75] This raises the issue of whether Defendants thought they were responding to market changes or whether they were seeking to create such price changes artificially.

This new spoofing authority has been attacked in another criminal case, *United States v. Coscia*,[76] as being void for vagueness. Although the district court rejected that claim in that case, it may have some credence on appeal.[77] The word "spoofing" is certainly a vague term. It appears to have originated as the name of a card game invented by a comedian in the 1880s. It was also later used as a term to describe a harmless hoax or gentle mocking of another person.[78]

Spoofing appears to have been applied in the first instance in financial markets to a form of Internet scam. The spoofer in those cases sent out mass emails with false originating addresses in an effort to manipulate the price of a stock. For example, a blast email would be sent out that falsely indicated that the officer of a public company was publishing information that would have market effect. The perpetrator would trade in advance of the email and profit from the market reaction.[79]

The new use of the term spoofing, *i.e.*, to prohibit orders not intended to be filled, is a far different creature than that originally attacked in the email cases. This suggests that the term can be given any meaning desired by regulators and provides little guidance on what is permitted and what is prohibited. In that regard, the use of the term spoofing in the context of cancelling orders conflicts with other permitted market practices.

Historically, "flash" orders, *i.e.*, orders that are flashed and immediately canceled, have long been considered to be permissible because they can attract trading interest to a market.[80] "Pinging" is another permissible practice that involves the entry of an order that is immediately cancelled. These orders are used as a means to determine if there is a trader on the sidelines seeking a better than existing market price. The pinging order seeks to draw out that interest from dark pools or other venues. This is considered a permissible practice because the order may be executed before cancellation. This raises a vagueness issue because there is no clear line between pinging, flash trades and spoofing.[81] As noted in the *New York Times*:

> High-frequency traders often 'ping' different markets by sending orders to gauge interest in a stock, and more than 90 percent are estimated to be canceled. That is not spoofing because there is a chance the order will be filled but illustrates the fine line between accepted practices and illegal conduct.[82]

As the CFTC has also noted with respect to manipulation claims, "a clear line between lawful and unlawful activity is required in order to ensure that innocent trading activity not be regarded with the advantage of hindsight as unlawful manipulation."[83] That bright line may not exist in the *Sarao* case.

Prior Cases

Not many helpful precedents exist, though, by which to analyze the *Sara*o case under the old CEA manipulation provisions. Manipulation cases brought under that authority tend to be in one of three classes: (1) market power in which the trader has control of supply and a corresponding futures position; (2) false reports of trading activity at artificial price levels; and (3) rigged trades. The *Sarao* case, unfortunately, does not fit squarely into any of those categories.

Presumably, the CFTC will argue that the Defendants' trading was some form of rigged trade, which was the basis for its only success in an adjudicated manipulation proceeding. In that case, *In the Matter of Diplacido*,[84] the Second Circuit (in an unpublished opinion) upheld a CFTC administrative decision which held that a trader engaged in manipulation by "banging the close" with orders that violated the bids and offers of other traders. There does not appear to be any such conduct in this case.

An earlier decision by a hearing officer in the Department of Agriculture, which predated the CFTC, found manipulation where a trader bought up all the orders posted on the close of trading in constant ascending prices and then offered and bought at even higher prices.[85] This was found to be manipulation, but it too does not seem to fit this case.

The CFTC also settled a pre-Dodd-Frank manipulation case by consent in which it charged that the respondent traded on the CME with the intent to "push" the prices of nonfat dry milk futures contracts higher.[86] The respondent was seeking to establish a large short position in those same futures contracts with the hope that the market would then sell off and allow a profit. The CFTC charged that the trader attempted to manipulate futures prices higher by: (1) executing trades by "lifting" offers, and then immediately bidding a higher price than just paid in the trade; (2) placing both bids and offers above prevailing market prices across multiple contract months in order to establish higher price ranges in the market; and (3) consistently placing bids above the opening price or the prevailing price across multiple contracts. This case was based on the premise that traders normally buy low and sell high, while here the trader was allegedly buying high rather than low. This too does not seem to fit the *Sarao* facts. In any event, that case was settled by consent and, therefore, may have little precedential value.

With respect to the "layering" charges under the new Dodd-Frank anti-manipulation authority, the SEC and FINRA have brought actions making such claims under the 34 Act.[87] In a case that was settled by consent, the SEC defined layering/spoofing as follows:

> Layering concerns the use of non-bona fide orders, or orders that the trader does not intend to have executed, to induce others to buy or sell the security at a price not representative of actual supply and demand. More specifically, a trader places a buy (or sell) order that is intended to be executed, and then immediately enters numerous non-bona fide sell (or buy) orders for the purpose of attracting interest to the bona fide order. These non-bona fide orders are not intended to be executed. The nature of these orders is to induce, or trick, other market participants to execute against the initial, bona fide order. Immediately after the execution against the bona fide order, the trader cancels the open, non-bona fide orders, and repeats this strategy on the opposite side of the market to close out the position.[88]

The CFTC brought an earlier layering/spoofing case which was similar to those brought by the SEC. In *In re Panther Trading LLC*,[89] the CFTC charged that respondents placed small orders to sell futures they wanted executed, followed quickly by several large buy orders at successively higher prices that they intended to cancel before execution. The buy orders were intended to give the impression that there was significant buying interest that would lift prices. This increased the likelihood that the respondents' small sell order would be executed, raising the likelihood that other market participants would buy from the small order. This process would then be reversed with a small buy order and several sell orders that would be canceled. These cancellations were done very quickly, but the Defendants' order imbalance offers remained open for some time even as they were being adjusted for all the market to see. In any event, the *Panther* case was settled by consent and without any admission of wrongdoing.

Also of interest is CME Rule 575, which prohibits certain disruptive trading practices. Specifically, that rule states that "[n]o person shall enter or cause to be entered an order with the intent, at the time of order entry, to cancel the order before execution or to modify the order to avoid execution." The CFTC complaint states that Sarao is a member of the CME,[90] but that exchange has brought no action against him. Moreover, that rule is premised on business principles, not on criminal or statutory manipulation.[91] In contrast, the government is seeking to criminalize such conduct through *Sarao* and other cases.

Does the Government Have a Case?

The facts in *Sarao* appear to be, in at least some aspects, *sui generis*, which will require a review of those unique facts to determine if the conduct in question was manipulative or intended to be disruptive. The filing of the complaint in the CFTC's case against Sarao was accompanied by a Declaration by a CFTC investigator,[92] the Declaration of Professor Terrence Hendershott, a professor at the University of California at Berkeley Business School,[93] and emails from Sarao detailing his trading strategies and giving instructions on how to modify his trading system to accommodate his trading strategies.[94] This documentation allows an unusual opportunity for an analysis of the strength of each party's case before trial.

Sarao will likely argue that his trades were bona fide positions that put him at risk and that he did not have any manipulative intent. Indeed, Sarao so stated to the Financial Conduct Authority (FCA) in London, *i.e.*, "[m]y orders are 100% at risk, 100% of the time."[95] Also, according to the CFTC Complaint, Sarao was a very successful trader who netted profits totaling $40 million from his trading strategies.[96] If so, this presumably reflects the fact that there was considerable risk in his trading. This is because the amount of risk in an investment or trade is usually commensurate with the possible reward. The CFTC's expert report also concedes that, *albeit* in small amounts, some of the away-from-the-market orders entered by Sarao were actually executed before they could be canceled.[97]

Sarao also documented the reason for his practice of entering and cancelling orders to keep them away from the best bid or offer, which is the crux of the government's case:

> The other orders I sometimes place during the day are slightly away from the market price and move up and down as the market moves with it. This is to catch any blips up/down in the market so that I can make a small profit as the market comes back into line (almost immediately). These orders are placed rarely and only when I believe the market is excessively weak or strong. Again, this was inspired by other traders I could see doing the exact same thing.[98]

This strategy might have had price effect, but all volume traders will affect the market price. Moreover, if taken at his word, Sarao seems to believe that market forces rather than his orders were causing the market correction. This could negate a claim of manipulative intent.

Another wrinkle in this case is the fact that its filing resulted in worldwide headlines in April 2015, since the government charged that Sarao's trading had contributed to the Flash Crash that occurred on May 6, 2010.[99] However, if his trading actually had such a massive destabilizing effect, why did it take the government so long to figure out his role? Instead, the government, after much investigation, initially concluded that its cause lay elsewhere. Further, as noted by the *New York Times*, if Sarao's trading was so destabilizing, and it is charged that he was trading often, why did it not crash the market on other occasions?[100]

Another gap in this case is a failure by the government or its expert to explain why the market dropped simply because Sarao's algorithm kept his order at a given distance from the best bid or offer. The Complaint makes numerous references to the fact that these orders created an imbalance on the sell side, but why did the market react to an order that was keeping a constant distance from better orders? Did the market react the same way for every order imbalance created in this manner? If not, why not? And why did not market participants just ignore the Defendants' orders, which could readily be observed displayed on the order book at always a constant distance from the best offer?

Another question lacking an answer is why did high-frequency-traders (HFTs) not adjust their algorithms to profit from any market effect caused by Sarao's orders? Sarao was a relatively unsophisticated, and very slow trader. In his words, he was "an old school point and click prop trader" who used a mouse for order entry and a limited algorithm to move the order imbalance as the market changed.[101] As the *New York Times* noted, HFTs in the market "could reasonably be expected to adjust their algorithms to recognize the type of orders he used and discount their likely effect on prices."[102]

Sarao also pointed out to the FCA that he was trading on a very popular U.S. market from London without a high-speed trading line.[103] In contrast, his competition, the HFTs, have co-located servers in Chicago and have access to high-speed communication lines.[104] As Saro stated to the FCA, he was at a disadvantage compared to the HFTs:

> Certainly not for a guy like me who is trading from the UK and whose system is miles too slow compared to these people due to the fact that my orders have to travel further than everyone else's who are trading in the USA. No wonder they can manipulative (sic) on top of my orders without any risk, for even when I change my mind and decide to sell into my buy order, the manipulative orders disappear in the 4 milliseconds it takes for my buy order to be canceled and replaced with my sell order so that I do not trade with myself!!!![105]

Sarao further complained to the FCA that others were manipulating the market through fake orders and were taking advantage of his orders. Sarao asserts that 95 percent of HFT orders are not "genuine" or "possibly even tradable."[106] Sarao seems to be claiming that he is defending himself from the HFTs, as opposed to manipulating the market. This seems to be confirmed by a newspaper report that Sarao made over 100 complaints to the CME over the course of several years about the trading activities of HFTs that he claimed were manipulative.[107]

Surely, the nimble HFT traders would have spotted this order imbalance phenomenon allegedly created by Sarao and should have taken advantage of his relatively large latency in order entry. Surely, large institutional traders in the market would have spotted this strategy if it was really impacting the market and responded to rob Sarao of this opportunity. How then could Sarao defeat the HFTs unless, as he claims, his "intuition" was the reason for his trading success?

In seems from Sarao's view that he discovered a market flaw and developed a trading strategy that allowed him to avoid the predations of the HFTs, which strategy was successful. Sarao, it appears, does not understand why is he prohibited from using a successful trading strategy, especially since he views the HFTs as the real villains in the market. Further, Sarao actually executed trades and made money. In this case, he must be providing liquidity to someone. In all events, it is difficult to understand how the Defendants' trading was a cause of the Flash Crash.[108]

Conclusion

The case against Sarao raises many interesting issues, but it is an *ad hoc* approach to regulation that provides little guidance for traders. What is needed are exchange controls that limit cancellations of orders that continually create an order imbalance at a given distance from the market. In that case, there would be no need for doubtful criminal and civil charges against traders seeking to take advantage of market flaws, as traders have done since time immemorial.

Endnotes

1. *See* "Report of the Staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues," entitled "Findings Regarding the Market Events of May 6, 2010" (hereinafter referred to as the "Joint CFTC/SEC Report"), issued on Sept. 30, 2010.
2. *Id.* at pages 1-2.
3. CME Group Statement on the Joint CFTC/SEC Report Regarding the Events of May 6, CME Group (Oct. 1, 2010), *available at* http://cmegroup.mediaroom.com/index.php?s=43&item=3068.
4. Gary Shorter & Rena S. Miller, *High Frequency Trading: Background, Concerns, and Regulatory Developments*, Congressional Research Service 29, n. 120 (June 19, 2014), *available at* http://fas.org/sgp/crs/misc/R43608.pdf (accessed on May 1, 2015).
5. Andrei Kirilenko, Albert Kyle, Mehrdad Samadi, & Tugkan Tuzun, *The Flash Crash: The Impact of High Frequency Trading on an Electronic Market*, Social Science Research Network (Sept. 24, 2014), *available at* http://ssrn.com/abstract=1686004.
6. *See* Shorter & Miller, *supra* note 4, at pages 34-36.
7. Guy Adams, *Is the Hound of Hounslow Innocent?*, Daily Mail (May 8, 2015), *available at* http://www.dailymail.co.uk/news/article-3074206/Is-Hound-Hounslow-Innocent-s-Briton-accused-triggering-500billion-Wall-Street-crash-suburban-semi-Guy-Adams-poses-disturbing-question.html.
8. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (hereinafter referred to as the "Dodd-Frank Act" or "Dodd-Frank").
9. *U.S. Commodity Futures Trading Commission v. NAV Sarao Futures Limited PLC and Navinder Singh Sarao*, U.S. District Court for the Northern District of Illinois, 1:15-cv-03398, before Judge Andrea Wood and Magistrate Michael Mason (hereinafter referred to as the "CFTC Complaint"). The CFTC Complaint is available at www.cftc.gov.
10. Order Granting Plaintiff's Ex Parte Motion for Statutory Restraining Order and Other Relief, U.S. District Court for the Northern District of Illinois, Civil Action No. 15-cv-03398, Apr. 17, 2015. The Order can be found on the CFTC website at www.cftc.gov.
11. *United States of America v. Navinder Singh Sarao*, for the U.S. District Court for the Northern District of Illinois, Eastern Division, 15 CR 75, before Magistrate Judge Martin.
12. *CFTC Charges U.K. Resident Navinder Singh Sarao and His Company Nav Saro Futures Limited PLC With Price Manipulation and Spoofing*, U.S. Commodity Futures Trading Commission (Apr. 21, 2015), http://www.cftc.gov/PressRoom/PressReleases/pr7156-15.
13. *Id.* For a detailed explanation of the Layering Algorithm, see pages 12-17 of the CFTC Complaint.
14. See CFTC Complaint, *supra* note 9, at page 1.
15. *Id*. at page 2.
16. *Id*. What is interesting here is that the Defendants' orders remained in the Order Book, and thus visible to other participants, even though the process was always a few ticks away from the best asking price. As will be discussed later, the CFTC Settlement in a previous spoofing case, Panther Energy, was based primarily on the fact that the orders were pulled almost instantaneously and not left open.
17. *Id.*
18. *Id.* at page 3. For a more detailed explanation of the Flash Spoofing allegation, see page 20 of the CFTC Complaint. The "spoofing" allegations took place throughout the five-year period, even before the enactment of the Dodd-Frank Act.

19. *Id.*

20. *Id.* at pages 20-21.

21. 7 U.S.C. § 8(c).

22. 7 U.S.C. § 11(a)(2).

23. 17 C.F.R. § 180.2.

24. 7 U.S.C. § 8(c)(3).

25. 7 U.S.C. § 13(a)(2).

26. 7 U.S.C § 15(a)(2).

27. 7 U.S.C. § 6c(a)(5)(c).

28. 7 U.S.C. § 8(c)(1).

29. 7 U.S.C. § 11(c)(1).

30. 17 C.F.R. § 180.1.

31. *See* CFTC Complaint, *supra* note 9, at page 30.

32. *Id.*

33. LaBerta Aff. at 1, U.S. v. Sarao, 15 CR 75 (N.D. Ill. 2015), *available at* http://www.justice.gov/sites/default/files/opa/press-releases/attachments/2015/04/21/sarao_criminal_complaint.pdf.

34. *Id.* at 10–12.

35. *Id.* at 16–17 n. 3 (showing LaBerta identifying the expert as a professor and academic researcher. The CFTC attached to its Complaint an Appendix that included an Affidavit of Professor Terrence Hendershott, which one can only assume is the same expert used by the DOJ).

36. *Id.* at 21–24.

37. *Id.* at 21.

38. Complaint at 1, U.S. v. Sarao, 15 CR 75 (N.D. Ill.), *available at* http://www.justice.gov/sites/default/files/opa/press-releases/attachments/2015/04/21/sarao_criminal_complaint.pdf (accessed on May 10, 2015).

39. Chiara Albanese, *U.K. 'Flash Crash' Trader Navinder Singh Sarao Says He Did Nothing Wrong*, Wall St. J. (May 16, 2015 12:34PM), http://www.wsj.com/articles/u-k-flash-crash-trader-cant-pay-bail-due-to-asset-freeze-lawyer-says-1430915094.

40. 7 U.S.C. § 9(c)(3), § 13(a)(2) (2015). The complaint also charges violations of CFTC Rule 180.2. 17 C.F.R. § 180.2. That rule was adopted after Dodd-Frank but seeks to encapsulate the pre-Dodd Frank anti-manipulation provisions of the CEA. 76 Fed. Reg. 41398, 41406 (Jul. 14, 2011).

41. 7 U.S.C. § 9(c)(1). The complaint also charges violation of CFTC Rule 180.1. 17 C.F.R. § 180.1. That rule seeks to define the new Dodd-Frank anti-manipulation provisions. 76 Fed. Reg. 41398 (Jul. 14, 2011).

42. 7 U.S.C. § 6c(a)(5)(C).

43. Jerry W. Markham, *The Manipulation of Commodity Futures Prices The Unprosecutable Crime*, 8 Yale J. on Reg. 281 (l99l) (describing the background for this legislation and the effects of a lack of definition). *See also* Ronald Filler & Jerry Markham, Regulation of Derivative Financial Instruments (Swaps, Options and Futures) Ch. 9 (West 2014).

44. *In re* Cox, Comm. Fut. L. Rep. (CCH) ¶23, 786 (CFTC 1982). *See also* Filler & Markham at 519–529.

45. *In re* Hohenberg Bros., Comm. Fut. L. Rep. (CCH) ¶20, 271, n. 39 (C.F.T.C. 1977).

46. *In re* Diplacido, Comm. Fut. L. Rep. (CCH) ¶30, 970 (C.F.T.C. 2008), *aff'd sub nom.*, DiPlacido v. CFTC, No. 08-5559-ag, 2009 U.S. App. LEXIS 22692 (2d Cir. 2009), *cert denied*, 2010 U.S. LEXIS 2461 (2010).

47. Declaration for Petitioner, CFTC v. Sarao 15 CR 75 (2015).

48. Notably, the CFTC, in proposing rule 180.2, which defines its pre-Dodd Frank manipulation authority, sought to read out the requirement of proving an artificial price, but backed off that claim in adopting the rule. *See* Jerry W. Markham, Law Enforcement and The History of Financial Market Manipulation 329, 331(2014) (describing that effort).

49. Indiana Farm Bureau Coop. Assoc. & Louis M. Johnston, Comm. Fut. L. Rep. (CCH) P21, 796, (1982), *available at* http://www.cftc.gov/idc/groups/public/@lrceacases/documents/ceacases/indiana-johnston-dec1982-9.pdf.

50. 2006 U.S. Dist. LEXIS 85068, at *9-10 (D. Neb. 2006).

51. 15 U.S.C. § 78j(b).

52. *See*, Markham, *supra* at 331 (describing the borrowing of this language and the canons of statutory construction that apply to borrowed language).

53. 425 U.S. 185 (1976).

54. *Id.* at 199.

55. 430 U.S. 462 (1977).

56. *Id.* at 476.

57. 938 F.2d 364 (2d Cir. 1991).

58. *See*, Markham, *supra* note 52, §8:3 (describing that debate).

59. 493 F.3d 87 (2d Cir. 2007).

60. *Id.* at 100–01.

61. *Id.* at 100.

62. *Id.* at 101; *See also, FL Advantage Fund Ltd. v. Colkitt*, 272 F.3d 189 (3d Cir. 2001), *cert. denied*, 536 U.S. 923 (2002) (short selling scheme not manipulative unless defendant was trying to create a false appearance of market activity through wash sales, matched orders or other improper trades).

63. 274 F.3d 525 (D.C. Cir. 2001), *cert. denied*, 537 U.S. 819 (2002). *See also* Filler & Markham, at 537.

64. *Id.* at 528.

65. *Id.*

66. *See*, Markham, *supra* note 52, §8:1 (describing the borrowing of this language and the canons of statutory construction that apply to borrowed language).

67. *See supra* note 53.

68. *See also*, *Tellabs Inc. v. Makor Issues & Rights*, 551 U.S. 308, 319 (2007); *Herman & Maclean v. Huddleston*, 459 U.S. 375, 382 (1983).

69. *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977), *cert. denied*, 434 U.S. 875 (1977).

70. *See*, Markham, *supra* note 52, §8:2 (further describing why the two standards may vary only slightly, if at all).

71. 7 U.S.C. §6c(a)(5)(C). On May 5, 2015, the CFTC brought another spoofing case against Heet Khara and Nasim Salim, residents of the UAE, for engaging in spoofing in the gold and silver futures markets between February and April 2015 "by placing bids and offers with the intent to cancel them before execution." The CME had previously investigated this trading activity and denied the Defendants access to its markets. See CFTC Press Release No. PR7171-15, available at http://www.cftc.gov/PressRoom/PressReleases/pr7171-15.

72. *See, e.g.*, CFTC Complaint ¶101, 1:15-cv-03398 (N.D. Ill.).

73. CFTC, *Anti-disruptive Practices Authority*, 78 Fed. Reg. 31890 (May 28, 2013).

74. 78 Fed. Reg. at 31896.

75. *Id.*

76. *U.S. v. Coscia*, 2015 U.S. Dist. LEXIS 50344 (N.D. Ill. 2015).

77. The Sullivan & Cromwell brief in support of that motion is well worth reading, and available at http://www.bridgingtheweek.com/ckfinder/userfiles/files/Coscia-%20Memo%20to%20Dismiss%20Indictment(2).pdf (accessed on April 28, 2015).

78. Dictionary.com, *Spoofing*, available at http://dictionary.reference.com/browse/spoofing (accessed on April 28, 2015).

79. *See, e.g., Wendler & Erza P.C. v. American International Group*, 521 F.3d 790, 791 (7th Cir. 20) ("'Spoofing' means taking steps that make a message appear to originate from an address other than its actual source").

80. *See,* Markham, *supra* note 52, at 323 (describing the use of flash trades and SEC rules allowing such trading).

81. Note that the CME recently suspended two gold and silver traders for "laddering." Nick Baker, *CME suspends Traders for Alleged Sarao-Like Futures Manipulation,* Bloomberg Business, April 30, 2015, available at: http://www.bloomberg.com/news/articles/2015-05-01/cme-suspends-traders-for-alleged-sarao-like-futures-manipulation (accessed on May 1, 2015).

82. Peter J. Henning, *The Fine Line Between Smart and Illegal*, N.Y. Times, April 27, 2015, available at http://www.nytimes.com/2015/04/28/business/dealbook/the-fine-line-between-smart-and-illegal.html (accessed on April 28, 2015). *But see*, Gregory Scopino, *The Questionable Legality of High-Speed "Pinging" and "Front Running" in the Futures Markets*, 47 Conn. L. Rev. 607 (2015) (noting that pinging is generally viewed to be legal but making arguments for violations for at least some forms of pinging).

83. *In re Indiana Farm Bureau Cooperative Association*, Comm. Fut. L. Rep. (CCH) ¶21,796 (C.F.T.C. 1982).

84. *See supra* note 48, *In re Diplacido*, COMM. FUT. L. Rep. ¶30,970 (C.F.T.C. 2008), *aff'd sub nom., DiPlacido v. CFTC*, No. 08-5559-ag, 2009 U.S. App. LEXIS 22692 (2d Cir. 2009), *cert denied,* 2010 U.S. LEXIS 2461 (2010).

85. *In re Henner*, 30 Agric. Dec. 1151 (1971).

86. *In re Ecoval Dairy Trade Inc*., 2011 CFTC LEXIS 44 (2011).

87. *See,* Markham, *supra* at 335-336 (2014) (describing those cases).

88. *In re Hold Brothers On-Line Investment Services, LLC.,* 2012 SEC LEXIS 3029 (S.E.C.)

89. CFTC Doc. No. 13-26 (2013) (hereinafter referred to as "Panther Energy").

90. CFTC Complaint at ¶18.

91. *See* CME, Market Regulation Advisory Notice (Aug. 29, 2014), available at http://www.cmegroup.com/tools-information/lookups/advisories/market-regulation/files/RA1405-5.pdf (last visited Nov. 21, 2015).

92. Declaration of Jessica M. Harrison submitted in Support of the CFTC's motion for a statutory restraining order against Sarao, (Apr. 14, 2015).

93. Declaration of Terrence Hendershott submitted in Support of the CFTC's motion for a statutory restraining order against Sarao, ¶13 (Apr. 14, 2015).

94. *See supra* note 92, Declaration of Jessica M. Harrison submitted in Support of the CFTC's motion for a statutory restraining order against Sarao, Exhibits 2-4 (Apr. 14, 2015).

95. *Id*. at Exhibit 2 at 48 (Apr. 14, 2015).

96. CFTC Complaint at ¶9.

97. *See supra* note 93, Declaration of Terrence Hendershott submitted in Support of the CFTC's motion for a statutory restraining order against Saraos, ¶13 (Apr. 14, 2015). In the Complaint, the CFTC acknowledged that Sarao did incur both trading gains and losses in connection with his trading activities.

98. *See supra* note 92, Declaration of Jessica M. Harrison submitted in Support of the CFTC's motion for a statutory restraining order against Sarao, Exhibit 2 at 48 (Apr. 14, 2015).

99. *Compare* the Joint CFTC-SEC Study that did not acknowledge any such imbalances by Sarao or any other traders. This Study consisted of 104 pages of extensive data, and refers primarily to a large fundamental trader as the primary cause of the Flash Crash. *See also supra* note 5*, The Flash Crash: The Impact of High Frequency Trading on an Electronic Market*, written by Andrei Kirilenko (Former CFTCF Chief Economist), Albert Kyle, Mehrdad Samadi and Tugkan Tuzun, on October 1, 2010 and updated as of May 5, 2014, in which the authors stated: "We show that High Frequency Traders (HFTs) did not cause the Flash Crash but contributed to it by demanding immediacy ahead of other market participants." *Id.* at 1.

100. Peter J. Henning, *The Fine Line Between Smart and Illegal*, N.Y. Times, April 27, 2015, available at http://www.nytimes.com/2015/04/28/business/dealbook/the-fine-line-between-smart-and-illegal.html (last visited Nov. 21, 2015).

101. *See supra* note 92, Declaration of Jessica M. Harrison submitted in Support of the CFTC's motion for a statutory restraining order against Sarao, Exhibit 2 at 48 (Apr. 14, 2015).

102. *See supra* note 100, Peter J. Henning, *The Fine Line Between Smart and Illegal*, N.Y. Times, April 27, 2015, available at http://www.nytimes.com/2015/04/28/business/dealbook/the-fine-line-between-smart-and-illegal.html (last visited Nov. 21, 2015).

103. *Id.*

104. *See* Jerry W. Markham, *High Speed Trading on Stock and Commodity Markets—From Courier Pigeons to Computers*, 52 San Diego L. Rev. 1, 20 (Fall 2015) (describing the operations of HFTs).

105. *See supra* note 92, Declaration of Jessica M. Harrison submitted in Support of the CFTC's motion for a statutory restraining order against Sarao, Exhibit 2 at 48 (Apr. 14, 2015).

106. *Id.*

107. Aruna Viswanatha, Bradley Hope & Chiara Albabese, *Trader Accused in 'Flash Crash' Accused Rivals of Misconduct*, Wall St. J., May 14, 2015, available at http://www.wsj.com/articles/trader-accused-in-flash-crash-accused-rivals-of-misconduct-1431556193 (last visited Nov. 21, 2015).

108. *See* article prepared by *Blackrock* on *Understanding the 'Flash Crash,' What Happened, Why ETFs Were Affected and How to Reduce the Risk of Another* (Nov. 2010), in which the paper listed "The Four Factors That Converged on May 6: First, the sudden market freefall in U.S. equity prices caused market makers in ETFs that seek to track benchmarks heavy in the falling stocks to have difficulty valuating the ETF's underlying assets. Second, anxiety over potential trade cancellations caused liquidity providers to fear that normal ETF hedging strategies would be interrupted, which caused them to pull back from bidding for ETF shares. Third, several other exchanges stopped routing orders to NYSE Arca because they believed the NYSE Arca was not reporting trade executions back in a timely manner. And Fourth, there was additional selling because stop-loss orders were triggered, which increased the volume of sell orders on affected securities, including ETFs."

Ronald Filler is a Professor of Law and the Director of the Financial Services Law Institute at New York Law School ("NYLS"). He has taught courses on Commodities Law, Derivatives Law, Securities Regulation, the Regulation of Broker-Dealers and FCMs and other financial law issues since 1977. Prof. Filler is a Public Director and Member of the Executive Committee of the National Futures Association, a Public Director and Member of the Regulatory Oversight Committee ("ROC") of SwapEX, a swap execution facility owned in part by the State Street Corporation, and is a Board Member of GCSA, a company that is offering insurance to CCPs around the globe to strengthen their financial resources, especially in the event of a default. Before joining the NYLS faculty in 2008, he was a Managing Director in the Capital Markets Prime Services Division at Lehman Brothers Inc. in its New York headquarters. Prof. Filler has co-authored, with Prof. Markham, a new law book on *Regulation of Derivative Financial Instruments (Swaps, Options and Futures)*, published by West Academic in May 2014. He also provides consulting and expert witness testimony services on a variety of financial services law and business matters.

Jerry Markham is Professor of Law, Florida International University at Miami (FIU). He came to FIU from the University of North Carolina at Chapel Hill, where he was a member of the law faculty for twelve years. He had previously taught a course on Commodities Regulation at Georgetown for ten years. Markham also served as chief counsel, Division of Enforcement, U.S. Commodity Futures Trading Commission; secretary and counsel, Chicago Board Options Exchange, Inc.; attorney, Securities and Exchange Commission; and a partner with the international firm of Rogers & Wells (now Clifford Chance) in Washington, D.C. Professor Markham has published numerous books and articles on derivative regulation, including a recent book on the law of commodity and stock price manipulation entitled *Law Enforcement and The History of Financial Market Manipulation* (M.E. Sharpe 2014). Markham is the chairman of Markham Consulting Inc., which provides consulting and expert witness testimony on financial market issues including manipulation claims. He is on the board of directors of Nomura Derivative Products, Inc., as a swap dealer.

Committee Reports

Report of the Section Chair

It is hard to believe that, as I write this report, I am six months into my year-long term as Chair of the Business Law Section. Since June, the Executive Committee has been very busy pursuing some key initiatives that will lead to increased value for our entire membership. We have also continued to provide high quality programming and written materials which are so important to our Section members.

In this Report, I want to highlight three initiatives that our membership has benefited from in the Summer and early Fall of 2015.

Mid/Long-Term Strategic Planning.

In the Spring of 2015, the Executive Committee decided to engage in mid- to long-term strategic planning to take a close look at the Section to determine what is important to our membership and how to deliver additional value to our members in the future. Some of you may have participated in our random survey designed to assess overall satisfaction with the Section and those areas (e.g., programming, written materials, legislative activities, etc.) which are most important to you. As a result of your responses and the work of the Task Force and ultimately, the entire Executive Committee, we have identified the following four goals which will guide us as we move into 2016 and beyond: 1) **advocacy** (work to make New York a more "business friendly" state); 2) **focus on Membership** (both existing and new members) by assisting members to become more efficient and effective providers of legal services to their business clients; 3) **be a Legal Resource** by providing quality, timely and relevant information to assist our members in staying current on business law issues; and 4) **establish effective governance** by developing systems and procedures for providing effective on-going leadership in order to meet the Section's objectives.

For the remainder of my term and beyond, our Executive Committee will be focused on pursuing key objectives and strategies designed to achieve our goals. In that regard, there will be ample additional opportunities for those interested in getting more involved in Section leadership. We are a completely voluntary organization. If you are interested in becoming more involved, please contact me by e-mail at oppenheimd@gtlaw.com.

The Launch of our Section Community

Thanks to the efforts of Past Chair Jay Hack, in October 2015 the Section launched its virtual Community, an Internet-based private online professional forum for the Business Law Section. The main page of the Community is a general information page where members can ask questions and get more information about accessing and using the Community. Because our Section is comprised of so many diverse Committees, we have created sub-Communities for our practice area committees. If you are a member of the Section, you have access to all of the sub-committee discussions and information. If you join that committee, you can post on that committee's sub-Community. The Community is a major improvement over our current Listserve and it will ultimately replace the Listserve. All members will receive notice before that happens. The Community, like our Listserve, is only effective if members use it. We encourage you to visit the NYSBA homepage and join the the Community today!!

Meetings

On October 1-3, our Section held its Fall Meeting at the Doubletree Hotel in Tarrytown, New York. Co-Chairs Sarah Gold and Kathleen Scott did an excellent job in planning an excellent meeting. The sessions were very well received by all attendees. Meeting highlights included plenary sessions addressing escrow accounts in New York, including NYS' Interest in Lawyers Account Fund (IOLA); technology tips for practicing lawyers (including a discussion about integrated billing, document management and calendaring); a discussion of SEC examination issues for investment advisors to private funds, led by two members of the SEC's New York Regional Office; virtual currency and technology issues; and mobile and internet banking. The program also included breakout sessions led by our Bankruptcy and Banking Law Committees. The media also included several social networking opportunities highlighted by dinner at the Tappan Hill Mansion.

Our Winter Meeting is scheduled for January 27, 2016. Once again, the Section will be co-sponsoring the morning program with the Corporate Counsel Section. As this issue went to press, we were still putting the final touches on the program, we expect to offer a timely session on Crowdfunding, including a review of the SEC's new crowdfunding regulations and a program in Cybercrime, where the panelists will discuss key legal and strategic considerations and practical tips on how organizations can navigate issues of civil liability, regulatory enforcement and criminal prosecution. We encourage you to attend the meeting and a networking luncheon immediately following the program. Please hold the date and be on the lookout for additional program details which can be found on our website and in our upcoming mailings.

David Oppenheim, Business Law Section Chair

Banking Law Committee

The Committee on Banking Law held a meeting on October 2, 2015, during the NYSBA Business Law Section Fall Meeting in Tarrytown, New York. The topic was "AML Compliance—Stories from the Front Lines," and featured speakers from the FDIC's New York Office, the UN Federal Credit Union, NBT Bank and First National Bank of Long Island. The bank panelists discussed their experiences as compliance officers at NY banking institutions and the FDIC speaker spoke about current AML topics. A lively discussion ensued between the panelists and the audience. The next Banking Law Committee meeting is scheduled for January 27, 2016, during the NYSBA Annual Meeting.

Kathleen Scott, Chair

Bankruptcy Law Committee

No report submitted.

Scott Bernstein, Chair

Corporations Law Committee

No report submitted.

Richard DeRose, Chair

Derivatives and Structured Products Law Committee

No report submitted.

Ilene K. Froom, Chair

Franchise, Distribution and Licensing Law Committee

The Franchise, Distribution and Licensing Law Committee continues to hope that, over time, it will be able to reach a mutual understanding with the New York State Attorney General's Office with respect to the proposed modifications to the New York State Franchise Sales Act, originally promulgated by our committee and presently scheduled for eventual consideration by the New York State Legislature. After a hiatus of several months, the Committee's negotiating team of David Oppenheim, Tom Pitegoff and Richard Rosen, together with Kevin Kerwin, legislative liaison, met with representatives of the Attorney General's office on December 7th, 2015 for the purpose of addressing several of the open issues in connection with the proposed legislation. Discussions are continuing.

In addition, the Committee is scheduled to hold a meeting on January 27, 2016, in conjunction with the Bar Association's Annual Meeting. At the meeting, a presentation, for full CLE credit, will take place covering the topic of the means, methods and protocols to be considered and utilized in the context of the economic valuation of a franchised business. Attendees will have an opportunity to engage in a question and answer session following the presentation.

For further information regarding the Committee, its activities or the upcoming Committee meeting, please contact Committee Chair Richard Rosen (rlr@rosenlaw-pllc.com or at 212-644-6644).

Richard Rosen, Chair

Legislative Affairs Committee

The Legislative Affairs Committee has joined with members of the International Law Section to form a joint legislative committee to propose repeal of Section 630 of the Business Corporation Law and Subsections (c) and (d) of Section 609 of the New York Limited Liability Company Law. These laws make the ten largest shareholders of closely held corporations and the ten largest members of limited liability companies personally liable for wages. The position of the joint committee is that these laws should be repealed because:

- They discourage new businesses from incorporating in New York and they act as an impediment to business and employment in the state.
- They violate the bedrock principle of shareholder and member limited liability that applies throughout the United States.
- They are unfair. Passive owners are liable jointly and severally and regardless of knowledge or fault.
- This type of wage protection is an anachronism. Workers are protected today by veil-piercing principles and by labor and bankruptcy laws that did not exist when New York first imposed shareholder liability for wages in 1848.

The Legislative Affairs Committee is also in continuing discussions with the New York Attorney General's Office in an effort to revise the New York Franchise Sales Act.

Thomas M. Pitegoff, Chair

Membership Committee

As of November 1, our Section stands at 3,792 members, of which 27.4% are new lawyers or students. Part of our strategic plan for the Section going forward is to involve and provide value not only to those members who are already part of our Section, but also to this new influx of younger members through the Pathway to the Profession. This new initiative involves connecting the NYSBA to the fifteen law schools within New York to provide resources and opportunities to those students who are looking to join us in our practice. The Business Law Section is always looking for people who want to become more involved in the Section and in turn provide value to all of our members through committee work, speaking opportunities, writing pieces for the *NY Business Law Journal*, or through our legislative initiatives. No idea is too small (or too large!), and your input is welcome.

Sarah Gold, Chair

Not-for-Profit Corporations Law Committee

The Not-for-Profit Corporations Law Committee has been working with the Lawyers Alliance for New York, the Non-Profit Coordinating Committee of New York, the New York Law Revision Commission and the New York City Bar Association to consider possible changes to the Nonprofit Revitalization Act ("Act") with a view to eliminating unintended consequences of the Act that do not appear to further its objectives. These groups have now reached out to legislative subcommittees and the Charities Bureau to achieve a consensus over the possible revisions which they believe to be in the public interest. The interaction of these groups has been constructive and our Committee believes that they will resolve many of the most problematic issues created by the Act. The Committee also believes that beyond these major changes there needs to be an ongoing modernization of the Not-for-Profit Corporation Law to deal with issues not addressed by the Act. The Committee will have a panel discussion at the winter meeting of the Business Section of the New York State Bar Association to review these proposals for change and new issues that need to be addressed.

Frederick Attea, Chair

Public Utility Law Committee

No report submitted.

Kevin Long, Chair

Securities Regulation Committee

The Securities Regulation Committee meets monthly, except during August, generally on the third Wednesday of the month. The January meeting is held in connection with the Annual Meeting, and the first regular meeting of 2016 will be on February 17. Meetings begin at 6:30 with cocktails and dinner and include two hours of presentations, usually for CLE credit. Topics span the spectrum of securities law practice, including securities exemptions, securities registration and financial reporting, investment company registration and investment adviser and broker-dealer regulation, and provide updates on new developments as well as new insights on more established rules. Recent topics have included: the new Regulation A+ amendments; crowdfunding and funding portals; the proposed SEC rule on executive pay clawbacks mandated by the Dodd-Frank Act; operational challenges to the proposed best interest contract exemption to the DOL's fiduciary standard; the Citizen VC no-action letter and procedures for the conduct of online offerings by issuers without general solicitation; and Regulation S revisited. The Private Investment Funds Subcommittee, chaired by Anastasia Rockas of Skadden Arps, also has periodic meetings with presentations by invited guests. The November 10 topic was the SEC's recent scrutiny of conflicts of interest, featuring Troy Paredes, former SEC Commissioner and founder of Paredes Strategies LLC, and Tram Nguyen, partner at Stroock & Stroock & Lavan and former Chief of the Private Funds branch of the SEC's Division of Investment Management. Both the Committee and Subcommittee submit comment letters on rulemaking proposals by the SEC, FINRA, the MSRB and other regulatory agencies.

Peter LaVigne, Chair

Publication Policy and Manuscript Guidelines for Authors

All proposed articles should be submitted to the *Journal*'s Editor-in-Chief. Submissions should be e-mailed or sent on a disk or CD in electronic format, preferably Microsoft Word (pdfs are not acceptable). A short author's biography should also be included.

The editors reserve the right to edit the manuscript to have it conform to the *Journal*'s standard in style, usage and analysis. All citations will be confirmed. Authors should consult standard authorities in preparing both text and footnotes, and should consult and follow the style presented in *Bluebook: A Uniform System of Citation*. An *Author's Guide* can be obtained by contacting the Editor-in-Chief. The revised manuscript will be submitted to the author for approval prior to publication.

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The Section's Committees are also encouraged to submit for publication in the *Journal* notices of committee events, Annual Meeting notices, information regarding programs and seminars and other news items of topical interest to the members of the Business Law Section.

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NEW YORK STATE BAR ASSOCIATION

Business Law Section

ANNUAL STUDENT WRITING COMPETITION

The Business Law Section sponsors an annual Student Writing Competition, open to all students who are candidates for the J.D. or LL.M. degree at an accredited law school during the year in which the article is submitted. The student articles submitted in a given year that are judged first and second best, provided they are of publishable quality and otherwise meet the criteria of the Competition, will receive cash prizes of $1,500 and $1,000, respectively. At the discretion of the editors, they also will be published in the NYSBA *NY Business Law Journal*, which is sponsored by the Section in cooperation with Albany Law School. Additional cash prizes may be awarded in the discretion of the Section. Entries that do not qualify for cash prizes may also be considered for publication in the *Journal*.

Articles submitted will be judged on the following criteria:

- Relevance to the *Journal*'s audience (New York business lawyers)
- Timeliness of the topic
- Originality
- Quality of research and writing
- Clarity and conciseness

The manuscript should follow Bluebook cite format (using endnotes rather than footnotes) and be a minimum of 3,000 words (there is no maximum). All submissions become the property of the NYSBA and the *NY Business Law Journal*. By submitting an article, the student is deemed to consent to its publication, whether or not a cash prize is awarded.

To enter, the student should submit an original, unpublished manuscript in Word format to David L. Glass, Editor-in-Chief, NYSBA *NY Business Law Journal* (david.glass@macquarie.com). The student should include a brief biography, including law school attended, degree for which the student is a candidate, and expected year of graduation.

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