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NY Business Law Journal

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of the New York State Bar Association

Inside

The Business Law Section Small Business Support Fund

The Business Law Section is proud to announce that, as part of its continuing effort to serve the legal profession as well as the community at large, it has established The Business Law Section Small Business Support Fund ("Fund").

The Fund, to be administered through The New York Bar Foundation, will supply grant money to non-profit legal services organizations for the purpose of providing legal advice and assistance to military veterans, minorities and other underserved New York residents seeking to establish their own small business enterprises in the State of New York.

The grantee organizations will advise on such matters as form of organization, basic commercial agreements, shareholder, partnership or operating agreements, intellectual property, regulatory issues, etc. While emphasizing assistance to military veterans, the Fund will be available to all persons seeking to establish small businesses in the state who might otherwise be unable to obtain legal advice.

In announcing the establishment of the Fund, John H. Gross, the Foundation's Board President, said:

> The Foundation thanks the Business Law Section for the opportunity to administer this Fund. This Fund will achieve the very laudable goal of facilitating the provision of legal advice and assistance to military veterans, minorities and other underserved New York residents seeking to establish their own small business enterprises in the State of New York. Please accept the sincere appreciation of the Foundation Board for this opportunity.

For decades it has been the mission of the Business Law Section to provide its membership with valuable services such as topical CLE programs, research and informational resources through the Section's interactive website and the *New York Business Law Journal*, published twice annually. It has also been the Section's mission to serve all New York citizens by promoting diversity and sponsoring legislative initiatives and reforms, such as recent changes in the New York Not-for-Profit Corporation Law, to improve the quality of life in our state. The Section's Small Business Support Fund is viewed as another step in fulfillment of that mission.

To donate, visit www.tnybf.org/donation and note your gift is in Honor of the Business Law Section Small Business Support Fund.

Or send a check to: The New York Bar Foundation, 1 Elk Street, Albany, NY 12207.

THE NEW YORK BAR FOUNDATION

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HeadNotes

As this issue was going to press it appeared that significant progress was finally being made on President Trump's stated agenda of tax reform and reduced regulatory burden. The Senate has passed its tax reform package by the narrowest of margins, with all 48 Democrats and one Republican voting against. Earlier the House passed a package, also along strict party lines. Both would reduce the basic corporate tax rate from 35 to 20 percent. But the two bills differ significantly in a number of areas, including controversial proposals to limit or eliminate the deductibility of state and local taxes and mortgage interest—changes that could dramatically affect individual taxpayers and the housing markets in blue states. Thus, while it seems likely that tax reform will be enacted, the exact form it will take was not clear.

On the financial regulatory front, it appears that a bipartisan consensus has emerged in the Senate regarding a package of reforms to the Dodd-Frank Act, the 2010 law passed in the wake of the financial crisis—something of a minor miracle, the words "bipartisan" and "consensus" having been largely banished from the vocabulary in Washington in recent years. The reforms mainly benefit smaller community banks, but also provide some relief for larger institutions. The House earlier had passed a more far-reaching package, the Financial CHOICE Act; however, that version was generally considered dead on arrival in the Senate, as it was aimed, among other things, at reducing the power of the Consumer Financial Protection Bureau (CFPB). The CHOICE Act would have made the CFPB subject to a governing board, similar to the Securities and Exchange Commission (SEC), the Federal Deposit Insurance Corporation (FDIC) and other agencies, and would also subject its budget to the Congressional appropriations process—under the Dodd-Frank Act, the CFPB is funded by the Federal Reserve, although it is not controlled by the Federal Reserve. But the Democrats have opposed these changes, believing they will diminish the CFPB's power. The Senate bill does not address the CFPB.

Meanwhile, fulfilling its mandate under an Executive Order signed by President Trump in February, the Treasury Department has been releasing a series of reports outlining and advocating reforms in various aspects of the markets, aimed at enhancing growth and reducing regulatory burden. The first three reports dealt with banks and credit unions, capital markets, and the insurance and asset management industries. The fourth report, due in December, will address financial technology (fintech). The reports issued to date generally have been moderate and balanced in tone; however, they do contain a large number of recommended changes, some of which can be implemented by regulators but others that would require legislation.

In a closely watched case with major implications for the power of the CFPB, the D.C. Circuit in May reheard *en banc* the case of *PHH Corporation v. Consumer Financial Protection Bureau*. As we discussed in the last issue, the CFPB had fined PHH for retroactive violation of a CFPB interpretation under the Real Estate Settlement Procedures Act (RESPA) prohibiting certain reinsurance arrangements, even though the arrangement was concededly valid under the interpretation of the Federal Housing Administration (FHA) at the time it was made. In arguing that the retroactive application of the new interpretation was invalid, the plaintiff also contended that the structure of the CFPB itself was unconstitutional, in that it vests all power in a single Director who cannot be fired by the President except for cause. In finding for the plaintiff, the Court held that the structure was indeed unconstitutional and the Director could be dismissed at will. But the Court stayed its decision pending reargument *en banc*. Oral arguments were heard on May 24, and a decision is still pending at this writing. Just before press time CFPB Director Richard Cordray resigned, reportedly to run for Governor of Ohio in 2018, and appointed his hand-picked deputy to replace him. But President Trump promptly appointed Budget Director Mick Mulvaney, who in the past has stated his opposition to the CFPB, to the post, creating an anomaly whereby two people showed up for work for the same job on the same day. A federal court promptly affirmed the President's right to fill the job. But the "red-blue" controversy around the agency continues to swirl.

David L. Glass

Another area of law that has been subject to bitter partisan divide is the use of arbitration, especially in consumer disputes. On the one hand, arbitration reduces the burden on the court system and often leads to effective and pragmatic outcomes, since arbitrators typically are people with experience in the industry involved. But on the other hand, for the same reason consumer advocates may argue that arbitration deprives the consumer of her "day in court" and is unfairly stacked against her. As it did in other areas of controversy, the Dodd-Frank Act kicked the can down the road by not resolving the issue, but instead instructing the CFPB to evaluate the widespread use of mandatory arbitration clauses in consumer financial contracts, most notably in the credit card area. This summer the CFPB finalized a controversial rule proposed a year earlier, which would prohibit mandatory arbitration clauses—but only to the extent they prohibit the consumer from participating in a class action lawsuit. But the House during the summer, and the Senate in October, voted to block implementation of the rule, and President Trump promptly signed the joint resolution of the two Houses.

Leading off this issue, Joseph Neuhaus and Thomas Walsh discuss the CFPB's arbitration rule, what it was intended to accomplish and the mechanism by which it was defeated. In "Senate Votes to Overturn CFPB Arbitration Rule," the authors explain that the Congressional Review Act enables Congress to overturn agency rules with which it disagrees by adopting a joint resolution of both Houses, which is then approved by the Senate (by a filibuster-proof simple majority) and signed by the President. The authors provide the background for the rule—its statutory authorization and the process, much criticized by the Republicans, by which it determined that rule-making was needed. With the demise of the rule and the Republicans in control of the government, the ability of financial firms to continue to use mandatory arbitration rules in consumer agreements appears unimpeded. Messrs. Neuhaus and Walsh are a partner and special counsel with Sullivan & Cromwell in New York; Mr. Neuhaus coordinates the firm's arbitration practice.

Next up is some practical and timely advice for New York attorneys who advise on business formations. As business lawyers know, unlike a corporation or an LLC a partnership can result from the acts and intentions of the parties, even without any effort to establish a formal agreement or reduce it to writing. In "Recent Trends in New York Partnership Law—Written, Oral and Implied Partnerships, Fiduciary Duties, and Remedies," Gerard Mantese and Emily Fields outline the factors cited by New York courts in determining whether the acts and intentions of the parties actually do give rise to a partnership. The article begins by quoting a scene from the movie "The Social Network," based on the founding of Facebook, in which Mark Zuckerberg orally commits to partner with several fellow students to create the new website—or does he? Mr. Mantese is the CEO and Ms. Fields is an associate at the firm Mantese Honigman, PC, with offices in New York, Michigan and Missouri.

Another practical concern for attorneys advising businesses is the potential environmental liability a business might incur when it acquires another company or its assets. In "Top Ten Environmental Due Diligence Considerations for Acquiring Companies, Assets, and Real Property Interests," Christine Fazio, Christopher Rizzo, and Julie Weisman provide a useful and timely checklist for the basic considerations any lawyer should take into account to assure that her client has not overlooked the environmental risks inherent in any acquisition. In addition to recommending a comprehensive environmental review, the authors note the importance of being aware of potential new rule-makings by the Environmental Protection Agency (EPA). Ms. Fazio is managing partner and with Mr. Rizzo is a co-head of the Environmental Practice group at Carter, Ledyard & Millburn in New York; Ms. Weisman is counsel with the firm.

In the *Upjohn* case in 1980, the Supreme Court held that the attorney-client privilege does apply in the corporate context; but as applied to internal investigations the privilege continues to be a source of confusion and vexation, for business practitioners as well as their clients. In "Mad Dogs and Englishmen (Part Deux)," the *Journal's* ethics guru, Evan Stewart, tells us that the situation may be even more confusing across the pond. Reprising an earlier article on this subject, Mr. Stewart discusses how two recent English cases have laid new traps for the unwary international practitioner. In his inimitable style, as always he displays his erudition in the area of '60s popular music, while offering several suggestions (emphasizing that they are only suggestions) on how to approach internal corporate investigations where English courts may be involved. Mr. Stewart, a partner in the New York law firm Cohen & Gresser LLP, was the 2016 recipient of the Sanford D. Levy award, given annually by the New York State Bar Association's Committee on Professional Ethics to a person who has contributed most to the advancement of legal ethics.

Employment is an area of law that is in continuous dynamic change and that affects every business in New York. For this reason, "Employment Law Update," a regular feature of the *Journal*, is required reading for business practitioners. In our latest installment David Douglas and Pamela Gallagher address new legislation enacted by New York City and New York State, respectively, both of which may significantly impact the employment practices of private employers. In "New York City Shakes Up the Freelance Sector," Mr. Douglas discusses the City's first-in-the-nation ordinance, the Freelance Isn't Free Act, which was enacted last May. The new law mandates that any agreement with an independent contractor calling for compensation of $800 or more must be in writing, and imposes additional requirements with respect to payment and other matters. Any employer inside the City, and any employer elsewhere who might retain a City-based independent contractor, will need to be aware of and comply with the law, which gives remedies to the freelancer and allows the Corporation Counsel to impose civil money penalties in certain circumstances. In "New Regulations Clarify NY's Upcoming Paid Family Leave Benefits Act," Ms. Gallagher discusses the regulations implemented by the New York Workers' Compensation Board to implement the Act, which takes effect January 1, 2018. The law applies to virtually all New York employees, full or part time, and mandates the provision of paid family leave on a schedule that depends on a number of factors. All New York employers and their counsel would be well advised to closely review the regulations with respect to their own employment situations. Mr. Douglas is a partner in the New York firm Gallet, Dreyer & Berkey; Ms. Gallagher is an associate with the firm and is a current member of the NYSBA's House of Delegates.

No issue of the *Journal* would be complete without "Inside the Courts," in which the attorneys of Skadden Arps provide a concise but exhaustive overview of significant corporate and securities litigation in the federal courts—in the current installment, from Class Representation to Statute of Limitations. Among the featured cases are recent decisions relating to insider trading, liability for securities fraud, and pleading requirements for securities fraud cases. "Inside the Courts" is an invaluable tool for our readers, pulling together in one place a complete picture of what is happening in the courts at any time that is relevant for business practitioners. The editors remain indebted to our colleagues at Skadden for their continuing generosity in sharing their knowledge and expertise.

An area of ongoing tension for financial firms and their counsel is the interplay of anti-money laundering (AML) requirements, which mandate that financial institutions closely monitor transactions by their customers and report on those that appear suspicious, and a customer's expectation of privacy in his or her financial records. The reconciliation of AML and privacy becomes even more complex in the international context, due to differing standards and expectations in different jurisdictions. In "Anti-Money Laundering and Privacy: Are They Interrelated or in Conflict?" Davide Szep compares and contrasts how these laws are applied in the U.S. and the European Union. In the seminal U.S. case of *California Bankers v. Schultz*, decided in 1970, the Supreme Court held that the bank was the owner of customer records in its possession and, therefore, there was no expectation of customer privacy in those records. The decision paved the way for the subsequent expansion of AML regulations. But there are differing, and overlapping, privacy requirements under state law, including some embedded in state constitutions. In the EU context, the first AML Directive was issued in 1991 and has subsequently been expanded; but recently data protection concerns have come to the fore. Mr. Szep, a 2017 cum laude graduate of Fordham Law School, explains the differing approaches, and discusses efforts by the Financial Action Task Force (FATF), an international body concerned with AML enforcement, to harmonize and reconcile them.

The spectacular increase in value of bitcoin and other virtual currencies in the past year has attracted the attention of not only investors, but also regulators concerned by overheated speculation in these markets. In "LabCFTC Primer: The CFTC's Views on Regulation of Virtual Currencies," Byungkwon Lim and Gary Murphy discuss the CFTC's efforts to regulate virtual currencies. The key points are that the CFTC has determined that these currencies are commodities—as with other commodities, it does not regulate cash or spot trades—and that various trading platforms are subject to regulation as swap exchanges (one such exchange, Coinflip, was the subject of an article in the *Journal's* Summer 2016 issue). "LabCFTC" refers to an initiative launched by the CFTC in May 2017 to serve as the focal point for its consideration of issues related to financial technology, or "fintech," pursuant to which the agency has published an online Primer (while emphasizing that the Primer is an educational tool and not intended as an official statement of CFTC policy). Messrs. Lim and Murphy are partner and counsel, respectively, with Debevoise & Plimpton; Mr. Lim leads the firm's Hedge Funds and Derivatives & Structured Finance Groups.

Beginning with the Sarbanes-Oxley Act enacted in the wake of the Enron failure in 2002 and extending through the 2008 financial crisis and beyond, the Securities and Exchange Commission (SEC) has increasingly relied on whistleblowers to unveil corporate wrongdoing and enforce the securities laws. The Dodd-Frank Act of 2010 extended the same authority to the Commodity Futures Trading Commission (CFTC), which finalized its rules earlier in 2017. Both laws provide protection to whistleblowers against retaliation, and both agencies obviously have a vested interest in rewarding whistleblowers and in protecting them from retaliation. Our next two articles deal with two different aspects of this issue.

In "What Is the Impact of the Recent Ninth Circuit Case of *Paul Somers v. Digital Realty Trust, Inc.* on Dodd-Frank's Anti-Retaliation Provision Involving Whistleblowers?" Ronald Filler reviews and discusses a recent case in the context of earlier litigation surrounding whistleblower protection. In the *Somers* case, the plaintiff pursued his complaint not with the SEC, but internally with the company. Eventually he was dismissed, and he sued alleging violation of, among other laws, the provision of the Securities Exchange Act of 1934, added by Sarbanes-Oxley, that protected whistleblowers. Professor Filler explains the significance of the court's holding that the whistleblower protection applies in this context, as well as when the whistleblower goes directly to the SEC. Professor Filler is Director of the Financial Services Law Institute at New York Law School and a member of the *Journal's* Advisory Board.

In "The Supreme Court's Dodd-Frank Dilemma: Should Internal Whistleblowers Be Protected?" Grace Nealon provides a more comprehensive overview of the question regarding the reporting requirements that must be met for a person to receive whistleblower protection. Ms. Nealon reviews the case law in different federal circuits, noting that while the Ninth Circuit *Somers* case followed precedent in the Second Circuit that whistleblower protection extends to an internal whistleblower, a Fifth Circuit decision followed more literally the definition of the term "whistleblower" in the Act, holding that it did not apply unless disclosure had been made to the SEC. The resulting "circuit split" is, of course, a classic reason for the Supreme Court to review a case, and it in fact granted *certiorari* in the *Somers* case. So the status of whistleblowers is up in the air: both politically, as Professor Filler questions whether the SEC will be as vigorous in encouraging and defending whistleblowers in the Trump Administration, and legally, pending the outcome of the *Somers* case in the Supreme Court. Ms. Nealon is a third year law student at Albany Law School

Concluding this issue is a review of the newly published fourth edition of the treatise *Business and Commercial Litigation in Federal Courts* by John McCahey, a partner at Hahn & Hessen LLP in New York City and a member of the Business Law Section. Originally conceived by Robert L. Haig, a partner of Kelley Drye & Warren who serves as its Editor, the treatise is now a joint venture between Thomson Reuters and the American Bar Association's Section of Litigation. Since the first edition it has expanded dramatically in size and scope, with articles on substantive areas of law by some 296 different authors, as well as detailed procedural guides for practitioners.

Senate Votes to Overturn CFPB Arbitration Rule

By Joseph Neuhaus and Thomas Walsh

The Senate voted on October 24 to block the Consumer Financial Protection Bureau's rule prohibiting financial institutions from requiring consumers to waive class actions in pre-dispute arbitration agreements. As expected, President Trump signed the resolution of disapproval on November 1.

The Senate vote, 51-50, was largely along party lines. The House of Representatives had voted to block the rule in July. The rule was the product of a three-year study by the CFPB and would have prohibited companies from the use of mandatory pre-dispute arbitration agreements that prevented consumer finance class actions in court. The rule would not have affected the use of mandatory pre-dispute arbitration clauses for individual consumer finance disputes. Prior to the Senate vote, the Treasury released a 17-page analysis opposing the rule. The CFPB issued a response shortly thereafter.

> *"The CFPB found that prohibiting class action waivers would strengthen incentives for companies to avoid potentially risky activities."*

The underlying statutory command in the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") remains in effect. That law called for the CFPB to study pre-dispute arbitration agreements and issue regulations restricting their use if such rules would be in the "public interest" and for the "protection of consumers." Thus, the CFPB must presumably make a new determination on that question. Under the Congressional Review Act, however, now that the President has signed the resolution, the CFPB is barred from issuing a new rule that is "substantially the same" as the overturned rule.

Background

Pursuant to the Dodd-Frank Act, the CFPB conducted a three-year study and released its results in March 2015.[1] The CFPB found that precluding certain financial providers from blocking consumer class actions in litigation and arbitration through arbitration agreements would better enable consumers to enforce their rights and obtain redress when their rights are violated.[2] Further, the CFPB found that prohibiting class action waivers would strengthen incentives for companies to avoid potentially risky activities.[3]

After its release, the CFPB invited stakeholders to provide feedback on the study, and after reviewing the feedback, the CFPB issued a proposed rule on May 24, 2016. Following a public comment period on the proposed rule and review of the comments received, the CFPB issued its final rule governing class action waivers in pre-dispute arbitration agreements between consumers and providers of certain financial products and services ("Covered Providers") on July 19, 2017. The final rule became effective on September 18, 60 days after its publication in the *Federal Register*.[4] The compliance date was 180 days after the final rule became effective, so Covered Providers would have had until March 19, 2018 ("Compliance Date") to comply with the regulation.[5]

Under the Congressional Review Act (CRA),[6] Congress had 60 legislative days after the final rule was published to overturn the rule by adopting a "joint resolution of disapproval," passage of which requires a simple majority in both chambers (i.e., it is not subject to filibuster in the Senate). On July 25, the House of Representatives voted almost exclusively along party lines (231-190 vote) to strike down the final rule. The Senate in October took up the House-passed joint resolution of disapproval, consideration of which occurred under the expedited parliamentary procedures provided for in the CRA.[7]

Summary of CFPB Rule

The final rule would have imposed two sets of limitations on the use of pre-dispute arbitration agreements by Covered Providers. First, Covered Providers would have been prohibited from using new pre-dispute arbitration agreements entered into after March 19, 2018 to block consumer class actions in court, and Covered Providers, with a limited exception,[8] would have been required to insert language into their arbitration agreements that reflected this limitation: "We agree that neither we nor anyone else will rely on this agreement to stop you from being part of a class action case in court. You may file a class action in court or you may be a member of a class action filed by someone else."[9] When a pre-dispute arbitration agreement applied to multiple products or services, only some of which were covered by the rule, Covered Providers would have been allowed to insert a modified version that specified that the ban on class action waivers applied only to the covered products or services.[10] In addition, the rule provided that Covered Providers could include a sentence at the end of the required disclosures that indicated that the provision did not apply to parties

Joseph Neuhaus is a partner and **Thomas Walsh** is special counsel at Sullivan & Cromwell. Mr. Neuhaus coordinates the Firm's arbitration practice.

that entered into the agreement before March 19, 2018, or to products or services that were first provided before March 19, 2018, and were subject to an arbitration agreement entered before that date.[11]

Second, the final rule would have required Covered Providers to submit to the CFPB, within 60 days of filing or receipt, certain records relating to arbitral and court proceedings concerning consumer financial products or services covered by the rule.[12] Specifically, Covered Providers would have been required to submit to the CFPB: (i) the pre-dispute arbitration agreement filed with the arbitrator; (ii) the initial claim and any counterclaim; (iii) the answer to any initial claim and/or counterclaim; (iv) any judgment or award; (v) any communication from the arbitrator or administrator regarding dismissal of arbitration because of failure to pay fees; (vi) any communication from an arbitrator or administrator related to a determination that the arbitration agreement did not comply with fairness principles, rules, or similar requirements of the arbitral forum; and (vii) any submission to a court that relied on the pre-dispute arbitration agreement to seek dismissal, deferral, or stay of a case.[13] The requirement would have applied to any arbitration and related court proceedings regardless of whether there were any class action proceedings involved. When it released the Rule, the CFPB stated that it intended to publish collected materials with redactions on its website in order to "provide greater transparency into the arbitration of consumer disputes," and it planned to use the collected information to monitor "arbitral and court proceedings to determine whether there [were] developments that raise[d] consumer protection concerns that [might] warrant further Bureau action."[14]

Who Was to Be Covered by the Rule

The CFPB rule was intended to apply to "providers of certain consumer financial products and services in the core consumer financial markets of lending money, storing money, and moving or exchanging money."[15] In particular, the rule would have applied to the following: (i) consumer credit services; (ii) automobile leasing; (iii) debt management or settlement services; (iv) providing directly to a consumer a consumer report, a credit score, or other consumer-specific information derived from a consumer file; (v) providing accounts subject to the Truth in Savings Act; (vi) providing accounts or remittance transfers subject to the Electronic Fund Transfer Act; (vii) transmitting or exchanging funds; (viii) accepting, or providing a product or service to accept, financial or banking data directly from a consumer to initiate a consumer payment or credit card or charge card transaction for a consumer; (ix) providing check cashing, check collection, or check guaranty services; and (x) debt collection.[16]

The rule would not have covered persons regulated by the Securities and Exchange Commission, persons regulated by a State securities commission as either a broker dealer or investment advisor, or persons regulated by the Commodity Futures Trading Commission, among others.[17] The rule also would not have applied to employers who offered covered financial products or services to their employees as an employee benefit,[18] persons excluded from the CFPB's rulemaking authority,[19] federal agencies, and any state or tribe under federal sovereign immunity law whose immunities had not been abrogated by the U.S. Congress.[20] Further, the CFPB rule would have excluded any Covered Providers that had provided products or services to no more than 25 consumers in the current and preceding calendar years.[21]

Implications

The CFPB rule was controversial; even if the Senate had not voted to overturn it before the CRA deadline, threatened court challenges might have derailed it.

The rule also presented some interpretive difficulties. For example, the rule applied only to arbitration agreements entered into on or after March 19, 2018. The official comments to the rule specified that if a Covered Provider "[m]odifie[d], amend[ed], or implement[ed]" the terms of a product or service that was subject to a pre-dispute arbitration agreement that pre-dated the Compliance Date, the product or service would not have been covered by the CFPB rule.[22] However, if a Covered Provider offered "a *new* product or service," the product or service would have been subject to the CFPB rule.[23] The line delineating a *modified* product or service from a *new* product or service might well have been difficult to draw in some cases. There might also thus have been an incentive for Covered Providers to characterize changes to products and services as "modifications," rather than "new" products or services.

As noted, under the CRA, now that the final rule has been overturned, the CFPB is prohibited in the future from issuing any new rule that is "substantially the same" as the overturned rule.

Endnotes

1. *See* Bureau of Consumer Financial Protection; Arbitration Agreements, 82 Fed. Reg. 33210 (July 19, 2017) (12 CFR Pt. 1040) ("FR Release").
2. *Id*. at 33280.
3. *Id*.
4. *Id*. at 33211.
5. FR Release, 82 Fed. Reg. at 33120.
6. 5 U.S.C. §§ 801-08.
7. Any day that the Senate gavels into session is a legislative day. Fridays, weekends and recess days do not count as legislative days.
8. The CFPB rule would have provided a limited exception for pre-packaged general-purpose reloadable prepaid cards, that were on store shelves as of March 19, 2018, when the providers were unable to contact consumers in writing. These providers would still have been bound by the class action waiver ban but would not

have needed to include the required language in the arbitration agreements with the customers.

9. 12 C.F.R. § 1040.4(a)(2)(i).
10. 12 C.F.R. § 1040.4(a)(2)(ii).
11. 12 C.F.R. § 1040.4(a)(2)(iv).
12. 12 C.F.R. § 1040.4(b)(2).
13. 12 C.F.R. § 1040.4(b)(1).
14. FR Release, 82 Fed. Reg. at 33210.
15. *Id*.
16. 12 C.F.R. § 1040.3(a).
17. 12 C.F.R. § 1040.3(b)(1)(i)-(iii).
18. 12 C.F.R. § 1040.3(b)(5).
19. 12 C.F.R. § 1040.3(b)(6).
20. 12 C.F.R. § 1040.3(b)(2)(i)-(ii).
21. 12 C.F.R. § 1040.3(b)(3).
22. 12 C.F.R. § 1040.4, cmt. 4-1(ii)(A).
23. *Id.*, cmt. 4-1(i)(A) (emphasis added). If a Covered Provider acquired or purchased a product or service that was subject to a pre-dispute arbitration agreement that pre-dated the Compliance Date, and the Covered Provider became a party to the agreement, the product or service would also have been covered by the CFPB rule. *Id.*, cmt. 4-1(i)(B).

Recent Trends in New York Partnership Law–Written, Oral, and Implied Partnerships, Fiduciary Duties, and Remedies

By Gerard V. Mantese and Emily S. Fields

> CAMERON: We'd love for you to work with us, Mark. I mean, we need a gifted programmer who's creative.
>
> TYLER: And we know you've been taking it in the shins.
>
> DIVYA: The women's groups are ready to declare a Fatwa, and this could help rehabilitate your image.
>
> MARK: Wow. You'd do that for me?
>
> DIVYA: We'd like to with you.
>
> CAMERON: Our first programmer graduated and went to work at Google. Our second programmer just got overwhelmed with school work. We would need you to build the site and write the code and we'll provide . . .
>
> MARK: I'm in.
>
> CAMERON: — the money. What?
>
> MARK: I'm in.
>
> TYLER: Awesome.[1]

In this scene from the film *The Social Network*, several students discuss forming a business relationship to create a social networking website. Despite this alleged agreement, Mark Zuckerberg, "Mark," allegedly delays working on their project to secretly create his own website, Facebook. Mark's website becomes wildly successful, and he excludes Cameron, Tyler, and Divya from its profits.[2]

Was this enough to form a partnership? New York law defines a partnership as "an association of two or more persons to carry on as co-owners a business for profit."[3] Partnerships may be formed by express, written agreements, which clearly identify and define the roles, rights, and duties of the parties. They also may be formed by oral agreement. Or, partnerships may be implied from the parties' conduct, even if the parties have never used the word "partner" or "partnership" to describe their relationship. Partnerships give rise to strict fiduciary duties.[4] Under the Partnership Law, partners are accountable to one another as fiduciaries.[5] The requirements for partnership formation permit courts to find that a partnership exists from the nature of the parties' relationship and therefore subject partners to liability for breach of fiduciary duties. In fact, parties may be subject to liability for breaching duties they may not necessarily know they owed to the other partners. Thus, it is important to understand the factors that courts analyze to determine whether a partnership exists.

Partnership Factors

New York courts examine four factors to determine whether a partnership exists. The presence or absence of a single factor is not dispositive.[6] Rather, courts will look at the entirety of the parties' relationship.[7] They look at the parties' intent (express or implied), whether the parties had joint control and management of the business, whether the parties shared in the profits and losses, and whether the parties combined their knowledge, skill, or property in their endeavors.[8]

In *Yuen v. Branigan*, the New York Supreme Court applied the partnership factors and held that the plaintiff pled sufficient facts as to the existence of an oral partnership agreement to defeat the defendants' motion for summary judgment.[9] The plaintiff sued for breach of fiduciary duties among other things, alleging that he entered into an oral partnership agreement with the defendants to operate a hedge fund.[10] Under the alleged agreement, the plaintiff became a "partner" of the hedge fund and received an equity interest.[11] The court noted several indicia of a partnership, including the defendants' holding the plaintiff out to the world as a partner,[12] the plaintiff's vested equity interest,[13] and the plaintiff's role as head of trading of defendants' hedge fund, which required the plaintiff's knowledge and skill.[14]

Similarly, in *Koether v. Sherry*, the plaintiff sufficiently pled the existence of a partnership to avoid summary judgment.[15] In *Koether*, the plaintiff alleged that he and the defendant agreed to use their shared expertise to develop a business and share in its profits.[16] The Kings County Supreme Court determined that the plaintiff adequately pled shared profits and losses (the essential element of a partnership), which was supported by documentary evidence.[17] The plaintiff also produced sufficient evidence

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to establish that he and the defendant jointly managed the business. This evidence included emails in which the parties discussed employee compensation and profit-maximizing strategies.[18] Given the parties' joint efforts to establish and manage the business over the course of their relationship, the court found that the plaintiff sufficiently alleged the existence of a partnership, giving rise to fiduciary duties.[19]

Fiduciary Duties

In *Meinhard v. Salmon*, Chief Judge Benjamin Cardozo elegantly described the fiduciary duties that partners owe one another, a standard which is still applied nearly 90 years later. Judge Cardozo wrote that,

> Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.[20]

Courts will enforce these duties with "uncompromising rigidity."[21] Partners owe their partners fiduciary duties, and courts take this obligation seriously. New York courts hold shareholders of closely held corporations,[22] managers of LLCs,[23] and trustees[24] to the same standard of fiduciary duties. Shareholders of closely held corporations, LLC managers, trustees, and partners owe strict fiduciary duties to the shareholders, members, beneficiaries, and partners of their respective enterprises.

Partners, and other fiduciaries, are obligated to act in the interests of their partners (rather than in their own interests) and with good faith, due care, and undivided loyalty, among other things.[25] They are required to make full disclosures of material facts, such as conflicts of interest and divided loyalty.[26] Under Partnership Law § 43, each partner is required to account to the partnership for any benefit received in any transactions connected with the partnership.[27]

This standard of conduct applies to partners regardless of how the partnership was formed. Therefore, parties who may be unaware that they are indeed partners of a partnership will also be held to this strict standard of conduct.

Breach of Fiduciary Duties

To establish a breach of fiduciary duty, the plaintiff must show that a fiduciary relationship existed, that the other party breached such duty, and that such wrongful conduct caused the plaintiff damage.[28] Therefore, if the plaintiff can establish an oral or implied partnership, the defendant is subject to liability for any misconduct that injured the plaintiff.

In *Frame v. Maynard*, the First Department held that the defendant breached fiduciary duties owed to the plaintiffs (his partners) when he failed to fully disclose information material to a specific transaction.[29] The defendant offered to acquire the plaintiffs' partnership interests in a particular piece of property for roughly $850,000.[30] The plaintiffs accepted the offer.[31] However, the defendant failed to fully disclose the actual value of the property at issue, which he recently had appraised for over $2 million.[32] The court found it "beyond dispute" that such a disclosure would have influenced the plaintiffs' decision to accept the offer, and so the defendant's failure to disclose constituted a breach of fiduciary duties.[33]

"In New York, partnerships may be formed without express agreements and may even by implied from conduct."

In *Pokoik v. Pokoik* (involving an LLC), the First Department held that the defendant breached fiduciary duties owed to the plaintiff.[34] The parties had entered into a settlement agreement, under which the plaintiff agreed to make payments of $2.2 million to certain properties in which they had an interest.[35] The company's accountant informed the defendant, the managing member of the LLC, that the transactions would result in a $750,000 tax liability.[36] To avoid a negative effect on himself, the defendant placed the entire tax burden on the plaintiff's shoulders.[37] The defendant did so without informing the plaintiff about the tax liability or that the plaintiff was the only member shouldering the burden.[38] The court determined that the defendant breached duties owed to the plaintiff.[39]

In another New York case, *Huang v. Sy*, the Second Department reaffirmed the lower court's holding that the defendant breached fiduciary duties.[40] The defendant engaged in self-dealing by making payments out of the partnership's funds to himself and entities he alone controlled, without obtaining consent from his partners.[41] The court found "no basis to disturb the Supreme Court's determination."[42]

Remedies for Breach

A breach of the fiduciary duties owed pursuant to Partnership Law § 43 is one of the events that triggers an innocent partner's right to an accounting. Partnership Law § 44 affords each partner the right to an accounting if: (1) he is excluded from partnership business or property; (2) he has such a right under an agreement; (3) his partner has violated § 43; or (4) the situation otherwise renders an accounting just and equitable.[43] In fact, the court may order a party to account for a breach of fiduciary duties where the relationship between the parties was never reduced to a writing, or even labeled a partnership.

Damages for breach of fiduciary duties include disgorgement of profits earned from the breach and damages from lost opportunities caused by the misconduct.[44] The court may award appreciation damages where the breach is the result of serious misconduct.[45] If possible, property transferred in a transaction that gives rise to a breach of fiduciary duties must be returned.[46] The court may also award interest for a breach of fiduciary duties.[47]

In *Frame v. Maynard*, the court ordered the defendant to disgorge the plaintiffs' share of the profits the defendant earned from the subject transaction, with interest.[48] The *Huang* plaintiffs were entitled to be restored to the position they were in before they joined the venture, with interest.[49]

Conclusion

In New York, partnerships may be formed without express agreements and may even be implied from conduct. Regardless of how the partnership is formed, the partners owe one another stringent fiduciary duties. Those in breach may be ordered to disgorge profits and pay damages for lost profits, among other remedies. It is imperative that parties engaged in business transactions understand the factors that courts analyze to determine whether a partnership in fact exists, as partnership duties are rigid and exacting.

Endnotes

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3. N.Y. P'ship Law § 10(1).
4. *Meinhard v. Salmon*, 249 N.Y. 458, 463-64 (1928).
5. N.Y. P'ship Law § 43.
6. *Fasolo v. Scarafile*, 120 A.D.3d 929, 930; 991 N.Y.S.2d 820 (N.Y. App. Div. 4th Dep't 2014).
7. *Id.*
8. *Hammond v. Smith*, 151 A.D.3d 1896, 1897; 57 N.Y.S.3d 832 (N.Y. App. Div. 4th Dep't 2017), *citing Griffith Energy Inc v. Evans*, 85 A.D.3d 1564; 925 N.Y.S.2d 282 (N.Y. App. Div. 4th Dep't 2011).
9. *Yuen v. Branigan*, 2015 NY Misc LEXIS 3252, at *26 (Sup. Ct. New York Co. 2015).
10. *Yuen*, 2015 NY Misc LEXIS 3252, at *1-2.
11. *Yuen*, 2015 NY Misc LEXIS 3252, at *4-5.
12. *Id.* at *25-26.
13. *Id.* at *26.
14. *Id.*
15. *Koether v. Sherry*, 40 Misc 3d 1237(A); 977 N.Y.S.3d 667 (Sup. Ct. Kings Co. 2013).
16. *Id.*
17. *Id.*
18. *Id.*
19. *Id.*
20. *Meinhard v. Salmon*, 249 N.Y. 458, 463-64 (1928).
21. *Id.* at 464.
22. *Brunetti v. Musallam*, 11 A.D.3d 280, 280; 783 N.Y.S.2d 347 (N.Y. App. Div. 1st Dep't 2004) ("The relationship between shareholders in a close corporation, vis-à-vis each other, is akin to that between partners and imposes a high degree of fidelity and good faith.").
23. *Kalikow v. Shalik*, 43 Misc. 3d 817, 824-25; 986 N.Y.S.2d 762 (Sup. Ct. Nassau Co. 2014) ("A partner, and by analogy, a [minority managing] member of a limited liability company, has a fiduciary obligation to others in the partnership or [LLC]…").
24. *Carbone v. Betz*, 101 A.D.3d 866, 868; 955 N.Y.S.2d 209 (N.Y. App. Div. 2d Dep't 2012).
25. *RSSM CPA LLP v. Bell*, 2017 N.Y. Misc LEXIS 40, at *31; 2017 NY Slip Op. 30020(U) (Sup. Ct. New York Co. 2017).
26. *Dubbs v. Stribling & Assocs.*, 96 N.Y.2d 337, 340; 752 N.E.2d 850 (2001).
27. N.Y. P'ship Law § 43(1).
28. *Pokoik v. Pokoik*, 115 A.D.3d 428, 429; 982 N.Y.S.2d 67 (N.Y. App. Div. 1st Dep't 2014).
29. *Frame v. Maynard*, 83 A.D.3d 599; 922 N.Y.S.2d 48 (N.Y. App. Div. 1st Dep't 2011).
30. *Id.* at 601.
31. *Id.*
32. *Id.* at 602.
33. *Id.*
34. *Pokoik v. Pokoik*, 115 A.D.3d 428; 982 N.Y.S.2d 67 (N.Y. App. Div. 1st Dep't 2014).
35. *Id.* at 429.
36. *Id.* at 429-30.
37. *Id.*
38. *Id.* at 430.
39. *Id.* at 432.
40. *Huang v. Sy*, 62 A.D.3d 660, 661; 878 N.Y.S.2d 398 (N.Y. App. Div. 2d Dep't 2009).
41. *Id.* at 661
42. *Id.*
43. N.Y. P'Ship Law § 44.
44. *Herman v. Herman*, 2017 NY Misc LEXIS 1862, at *8-9; 2017 NY Slip Op. 31034(U) (Sup. Ct. New York Co. 2017), citing *105 E Second St. Assoc v. Bobrow*, 175 A.D.3d 746, 746-47; 573 N.Y.S.2d 503 (N.Y. App. Div. 1st Dep't 1991).
45. *Id.*
46. *Id.* at * 9, citing *In re Estate of Rothko*, 43 N.Y.2d 305, 322; 372 N.E.2d 291 (1977).
47. *Id.* at *9.
48. *Frame v. Maynard*, 107 A.D.3d 582; 969 N.Y.S.2d 6 (N.Y. App. Div. 1st Dep't 2013).
49. *Huang v. Sy*, 18 Misc. 3d 1141(A); 859 N.Y.S.2d 903 (Sup. Ct. Queens Co. 2008), *aff'd*, *Huang v. Sy*, 62 A.D.3d 660; 878 N.Y.S.2d 398 (N.Y. App. Div. 2d Dep't 2009).

Update: Top Ten Environmental Due Diligence Considerations for Acquiring Companies, Assets, and Real Property Interests

By Christine A. Fazio, Christopher Rizzo, and Julie Weisman

Due diligence is a broad term that refers to the investigations that corporations typically carry out prior to acquiring other corporations, assets, or real estate. In complex mergers and acquisitions, corporations are wise to assemble a due diligence team that includes in-house staff, outside counsel, financial experts, and environmental consultants. The wide array of federal and state laws that have comprehensively regulated air, water, and land pollution since the 1970s make environmental due diligence essential.

Environmental due diligence is not just limited to corporate acquisitions. Often, developers will need an array of environmental and land use permits that will require considerable environmental due diligence, including on land that is leased or for easements associated with the development.

What follows are ten basic considerations for carrying out environmental due diligence.

1. Conduct Phase 1 environmental site assessments in compliance with ASTM standards

The first step in most due diligence projects should be the preparing of a basic environmental assessment to assess conditions at the plant, facility, storage units, other assets, and the land. Under the primary federal law governing liability for hazardous substances, as well as many of its state counterparts, financial responsibility for hazardous conditions may trail companies and property owners for many years—even after they've sold contaminated property. Additionally, the current owner of contaminated property may end up liable for hazardous conditions even if it did not cause or contribute to those conditions (or certainly may need to spend considerable legal fees to prove the landowner did not cause or contribute to the condition).[1]

The American Society for Testing and Materials, commonly referred to as ASTM, has established widely accepted protocols for carrying out environmental due diligence. If the Phase I inquiry turns up serious concerns, a Phase II environmental site assessment (which typically involves sampling and testing) may be necessary. Ask that the assessment also include some extras such as an examination for asbestos or lead in older buildings. These preliminary inquiries can help buyers establish liability defenses under federal law, even if they uncover certain contamination in the process. They are also a necessary first step in acquiring environmental insurance, which is often available to cover unknown liabilities.

2. Identify the environmental compliance officer at each facility

As part of due diligence, it makes sense to request permission to speak with the environmental compliance officer of each facility. If no one can tell you what environmental permits are in place, where spill reports are kept and whether any authorizations are about to expire, consider that a warning sign about how the facility, building or asset has been operated in the past.

3. Identify applicable environmental permits and transfer requirements

Many facilities have a host of environmental permits that will need to be transferred should the acquisition go forward. In particular, look for expiration dates and transfer requirements for each permit; in some cases, transfer requirements are described in state administrative procedures. This is a critical pre-acquisition task because some state regulators require *prior* notice to transfer air, water, and waste permits. Others provide generous grace periods in which to transfer permits to new owners.

Contracts for electricity or fuel might require either pre- or post-closing notices to the buyer or seller of the electricity or fuel, as well as the state's public utility commission. Thus, part of the due diligence review involves review of contracts, service agreements and possibly public utility regulations in order to understand all transfer requirements.

A company might have been the subject of an environmental enforcement action that resulted in a consent decree or order. Often, the provisions include very specific procedures and conditions for the transfer of an asset. Thus, in dealing with a federal consent order, it is very important to understand when and if to inform the U.S. Department of Justice or other federal agency. For expired or missing permits, a sale may be a good time to come clean with regulators.

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4. Look at local zoning

A buyer should also understand the local zoning for all assets to be purchased. Traditional zoning in the United States is premised on the strict separation of uses (industrial, commercial, and residential). The good news is that even if the local zoning prohibits the kinds of uses that are ongoing, they may be "grandfathered" because they pre-date the imposition of zoning controls. The bad news is that most municipalities, while allowing grandfathered uses to persist, prohibit any expansion or alteration of the grandfathered use. It is also important to review news articles for the area to determine if there are any pending community issues. For instance, a developer would not want to buy a lot with the intent to construct a 15-story building if there is a community movement to down-zone the area to allow only six-story buildings.

5. Work with a law firm that has access to local counsel or local environmental consultants who are best situated to know about quirky local permitting requirements

Land-use and environmental permitting requirements vary widely from state to state and city to city. Some states, like New Jersey, require state approval before the sale of any industrial facility; most states do not. Some counties require companies to obtain permits to store hazardous substances onsite; many others have no such requirement.

For complicated sites or acquisitions involving multiple locations, seek out consultants who have the ability to seek advice from local professionals.

6. Identify sale agreements and other contracts that might include indemnities that benefit past or future owners

If acquiring a corporate entity or real property, it is important to review the indemnification provisions of past contracts, which often have expiration dates. Also, keep in mind that some states require environmental indemnities to specifically mention environmental concerns or hazardous substances in order to successfully allocate liability; in other words—a generic indemnity from a seller to buyer (or lessor to lessee) may not transfer environmental liability.

If a seller holds a valid indemnity from a prior owner, this may be one of the best reasons to acquire the seller's corporate entity rather than just its assets. By acquiring the seller's corporate entity, the buyer may obtain the benefit of the indemnity, which the seller likely could not assign to the buyer in an asset sale.

7. Identify forthcoming regulations

Understanding possible new regulations that may be adopted by the U.S. Environmental Protection Agency (EPA) and states is essential to understand the risks of purchasing a new facility. For example, understanding pending regulations or policy initiatives of federal, state, and local governments is important to appreciate possible future costs to comply with new regulations.

Where there is a proposed regulation available for public comment, EPA and other federal agencies often prepare a Regulatory Flexibility Analysis or Regulatory Impact Statement that identifies the expected costs of the program. Thus, a refinery that is likely to be subject to a new EPA air toxic regulation will usually review the Regulatory Impact Statement to identify add-on controls and their costs.

One can also review trends on the U.S. Energy Information Administration website at http://www.eia.gov, which provides information on expected costs for the energy sector to comply with future regulations. Participating in industry trade associations or air and waste management associations is another way to keep abreast of new environmental rules.

8. Look at existing leases and easements

Leases routinely include broad and sometimes illogical prohibitions, such as on "storage of hazardous materials" at an industrial site. Identify such prohibitions before acquisition and, if problematic, ask the seller to obtain assurances from the owner that the lease terms do not prohibit the kinds of operations that are planned. A property might also contain an exclusive easement, such as for a utility line or future roadway, that could limit development on a portion of a property or may sever the property in such manner that it impacts the value of the land or ability for future development.

9. Be careful of commitments made in access agreements

Often developers in locating possible sites for a development project will want permission from the landowner to conduct environmental and cultural resource studies (particularly if federal or state permits or other approvals will be required). In order to conduct such on-site due diligence, a developer normally needs to enter into an access agreement with the landowner. Many landowners are concerned that if the developer starts digging holes on the property, petroleum product or other hazardous material may be discovered that would trigger the landowner to possibly have to undertake costly remediation. Thus, some landowners will include a section on hazardous materials that state that if the developer discovers hazardous materials on the premises, the developer must remediate the entire parcel and adjacent parcels. Signing such an agreement puts a developer at risk to having to spend considerable funds on remediating a pre-existing condition that it did not cause. Accordingly, review access agreements carefully before signing, including making sure there is no obligation to remediate if contamination is "discovered."

10. Consider incentives

Many states offer financial incentives for the use or redevelopment of brownfields, which is land whose use or development is complicated by the presence of hazardous substances—often an ideal location for a new power plant, manufacturing facility or solar panel array. Others states and cities offer financial incentives for environmentally sustainable buildings, solar panels, green roofs, and other desirable building characteristics. Many municipalities provide tax breaks for facilities siting or expanding into economic development zones.

Endnote

1. The primary reason is the 1979 Comprehensive Environmental Response Compensation and Liability Act (CERCLA), which states that any current owner or operator, any owner or operator at the time of disposal and any person that arranged for disposal, among others, shall be responsible for all costs of removal and remediation of hazardous substances. There are defenses to this liability, but the burden of proof will fall on the person asserting those defenses. For example, under CERLCA, a bona fide prospective purchaser is a buyer that conducts all appropriate inquiries prior to acquisition and complies with certain federal laws regarding any contamination that is uncovered (e.g., avoids exacerbating the conditions). 42 U.S.C. § 9601(40).

Mad Dogs and Englishmen: Part Deux

By C. Evan Stewart

One of the most insipid hit records of the 1960s was Roger Miller's "England Swings (Like a Pendulum Do)."[1] In an earlier edition of this august *Journal*, I detailed how differently our English "cousins" swing on the issue of witness preparation.[2] The Brits have been swinging again, this time in a different place, and lawyers with international, cross-border practices need to be aware and on guard.

Internal Investigations and the Privilege

As readers of the *Business Law Journal* know, many American lawyers and judges make numerous and significant mistakes when it comes to the application of the attorney-client privilege and attorney work product doctrine in the context of corporate investigations.[3] But who knew that the English judiciary could (and would) go their American brethren one "worse" (and more)?

The law in America has been pretty clear, at least since 1981. In that year, the U.S. Supreme Court strongly affirmed the privilege in the corporate setting in *Upjohn Co. v. United States*.[4] The *Upjohn* Court stressed the importance of there being "full and frank communications between attorneys and their clients," and that such communications were necessary to enable a lawyer to give "sound and informed advice." The Court concluded that the privilege "promote[s] broader public interests in the observation of law and administration of justice." As a consequence of those policies and interests, the Court barred disclosure to the Internal Revenue Service of corporate counsel's fact-oriented communications with employees regarding an investigation into questionable payments made to foreign government officials; and given an attorney's need to render "sound and informed advice," the Court specifically rejected prior precedent limiting the privilege to only certain employees (i.e., the "control group").[5]

Somewhat akin to the American distinction between the privilege and the attorney work product doctrine,[6] the British have three separate concepts under the general rubric of what is called the "Litigation Professional Privilege" that need to be understood. The first is the *legal advice privilege*; that doctrine applies to confidential communications between a lawyer and her client relating to the giving or receiving of legal advice. The second is the *work papers privilege*; that doctrine applies to lawyers' working papers where disclosure thereof might "betray" a lawyer's mental impression or legal advice. And the third is the *litigation privilege*; that doctrine applies to documents created (by lawyers and non-lawyers) where litigation exists—or where there is a "reasonable prospect" of litigation—*and* the documents were created solely or predominantly to deal with the litigation.[7]

The British Are Coming!

At issue in *The RBS Rights Issue Litigation*[8] was the fruit of a corporate internal investigation conducted in both England and the United States by Wilmer Hale in response to subpoenas issued to RBS by the SEC. Consistent with *Upjohn* protocols, the Wilmer Hale lawyers (i) interviewed a host of RBS employees (and former employees), (ii) gave those individuals appropriate Corporate Miranda Warnings,[9] (iii) told the interviewees to treat the sessions as confidential, and (iv) wrote up interview notes reflecting their "mental impressions." In subsequent civil litigation initiated in England, the plaintiffs sought the interview notes.

Justice Hildyard, of the English High Court of Justice (Chancery Division), ruled that the interview notes were discoverable. Following the controversial precedent of *Three Rivers District Council and others v. Governor and Company of the Bank of England (No 5)* ("information from an employee stands in the same position as information from an independent agent"),[10] he rejected RBS's invocation of the legal advice privilege, ruling that the interviewed individuals were not clients. Essentially adopting the control group approach, the Justice ruled that "only communications with an individual capable in law of seeking and receiving legal advice as a duly authorized organ of the corporation should be given the protection of legal advice privilege."

Hildyard also rejected the applicability of the work papers privilege because—irrespective of the "mental impressions" label in the interview notes—he was not persuaded that their disclosure would in fact "betray" Wilmer Hale's mental impressions or legal advice.[11] In order to render those two rulings, he declined RBS's request that the court apply *Upjohn* (or other relevant U.S. law) in ruling on the interview notes on the ground that an English court hearing a litigation matter in England should apply English law on privilege issues.[12] In so doing, Justice Hildyard recognized that the interview notes would have been protected from disclosure under U.S. law (i.e., *Upjohn*).

On the heels of *The RBS Rights Issue Litigation* decision (which was not appealed) came *The Director of the Serious Fraud Office v. Eurasian Natural Resources Corporation*.[13] Unlike the prior decision—which concerned a regulatory inquiry by a United States governmental agency, this mat-

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ter arose from the British government's Serious Fraud Office's (SFO) investigation into the Eurasian Natural Resources Corporation's (ENRC) business activities in Kazakhstan and Africa. Among other professionals, the Dechert law firm was hired by ENRC to conduct an internal investigation. Over an 18-month period, Dechert met frequently with SFO officials to update them on the status of its investigation. Then, in April 2013, Dechert was fired by ENRC; communications between the company and the SFO ceased, and shortly thereafter the SFO initiated a criminal investigation.

As part of the SFO's criminal investigation, it requested, *inter alia*, the documents generated by Dechert lawyers, including their notes of interviews of current and former ENRC employees. ENRC resisted producing these materials, citing the litigation privilege and the legal advice privilege. With one exception, however, Justice Andrews of the High Court of Justice (Queens Bench Division), rejected ENRC's privilege claims. With respect to the litigation privilege claim, Justice Andrews ruled that ENRC had not demonstrated that it was "aware of circumstances which rendered litigation between itself and the SFO a real likelihood rather than a mere possibility." This, of course, is a *very* different standard than the U.S. standard under Fed. R. Civ. P. 26(b)(3) for what constitutes "anticipation of litigation."[14]

As for the legal advice privilege claim, Justice Andrews made short work of that in the context of the interview materials, citing both *Three Rivers (No 5)* and Justice Hildyard's *RBS* opinion. As with those cases, the interviewed individuals were not authorized to seek or receive legal advice on behalf of ENRC. At the same time, however, the Justice ruled that five documents prepared by Dechert for the "specific purpose of giving legal advice to ENRC ['s corporate governance committee were] plainly privileged."[15]

What to Do (Deux)?

In light of the two English decisions, American lawyers performing internal investigations for multi-jurisdictional companies face some daunting issues. Obviously, following the *Upjohn* protocols correctly will not suffice in English courts.[16] So what can American lawyers do to have their international clients avoid the same fate as the clients of Wilmer Hale and Dechert?

One suggestion would be—at the onset of any international investigation (which may spawn offshore litigation)—(i) to make clear who is deemed to be in the corporate control group, and (ii) to make sure than any communications of significance and substance be between only those individuals and counsel.[17] *Another* suggestion would be to be very careful (i) on the taking of contemporaneous notes of interviews, and (ii) as to what is put in said materials. A *related* suggestion would be to *not* physically disseminate such materials to the corporate entity (or individuals therein); keeping such materials out of the hands of clients and retaining them as the work product of outside counsel (and in their files/computers located in the United States) is certainly a level of protection that has worked before in the face of determined governmental officials and litigants demanding disclosure.[18] *Another* suggestion would be to legend materials (as appropriate) consistent with the litigation privilege's "reasonable prospect" standard—as opposed to the Rule 26(b)(3) standard.[19] *Finally*, although a corporate entity cannot choose the place it gets sued, given these two English decisions, the more that lawyers can conduct investigations within the jurisdictional boundaries of the United States, the better chance that *Upjohn* protocols may in fact be honored.[20]

England and Conflicts

While we are highlighting our national differences, let us look at another area of the law where our British cousins have a slightly different take: conflicts of interest. This is a subject matter, to this author's mind, where modern-day (especially big firm) lawyers have not comported themselves with honor.[21] Recently, a major international firm (whose home base is New York) found its conduct under English scrutiny, with a *mixed* result.

On July 19, 2017, the United Kingdom's Solicitors Disciplinary Tribunal levied a fine of £250,000 ($324,061) against White & Case LLP and a fine of £50,000 ($64,812) against a partner of the firm, David Goldberg. These fines came on the heels of a 2014 decision of the High Court of England to disbar the firm and Goldberg from representing a Ukrainian client, Victor Pinchuk, in a commercial dispute with other firm clients: Ukrainian businessmen Igor Kolomoisky and Gennadiy Bogolyubov.[22]

While these amounts constitute the largest law firm/lawyer fines ever levied in England, they—at least to this observer—are not the most interesting aspect of the matter. What I find striking is the depth and breadth of the problem, in addition to the English court's antipathy to ethical structures frequently employed by U.S. lawyers (such as advance waiver provisions and ethical screens).

On the Pinchuk side of White & Case, there were *88* lawyers who billed their time (supported by *61* secretarial or other support staff); and on the Kolomoisky/Bogolyubov side of White & Case, there were *50* lawyers who billed their time (supported by *39* secretarial or other support staff). Not surprisingly, lots and lots of time was billed to each set of clients, with an obvious (and large) benefit to the firm's bottom line.

The High Court, per Justice Field, after a thorough vetting of what was done on behalf of both sets of clients, determined that a wide swatch of Messrs. Bogolyubov and Kolomoisky's confidential information had been imparted to White & Case, that the firm had "an unqualified [duty] to keep the information confidential and not, without the consent of [Messrs. Bogolyubov and Kolomoisky], to make use of it or to cause any use to be made of it by others otherwise than for [Messrs. Bogolyubov and Kolomoisky's] benefit."[23]

As for the firm's contentions that ethical screens and the geographical separation of many (but not all) of the scores of White & Case personnel served to wall off conflicts problems, Justice Field first reviewed prior English precedent that was highly skeptical of the efficacy of "Chinese Walls."[24] He then ruled—as an "evidential" matter—that White & Case had failed to demonstrate confidential client information had not in fact flowed between the two large internal firm groups.[25] This ruling came on the heels of prior determinations of Justice Field, in which he had been critical of ethical decisions made by the firm along the time continuum of its trying to represent the two sets of highly adverse clients.[26]

Given the foregoing, why does this author deem the determination by the Solicitors Disciplinary Tribunal a "mixed result"? Well, for one, the fines levied represent a mere fraction of all the lawyers (and others') time billed to (and presumably revenues accrued from) the two sets of adverse clients![27]

Endnotes

1. Smash Records (written by Roger Miller) (released November 1965) (U.S. *Billboard* Hot Adult Contemporary Tracks No. 1; U.S. *Billboard* Hot 100 No. 8; U.S. *Billboard* Hot Country Singles No. 3) ["England swings like a pendulum do; Bobbies on bicycles two by two; Westminster Abbey, the tower of Big Ben; The rosy-red cheeks of the little children."] Competing for the title of most insipid would, of course, be the fictional group, the Archies, and their "Sugar, Sugar" (Calendar) (written by Jeff Barry & Andy Kim) (released May 24, 1969; re-released July 1969 by Don Kirshner) (U.S. *Billboard* Hot 100 No. 1). Incongruously, "Sugar, Sugar" was played over-and-over again on the radio as we were driving all night on Thursday-Friday, August 14-15, 1969 to get to the Woodstock Music & Art Fair ("An Aquarian Exposition: 3 Days of Peace & Music").
2. *See Mad Dogs and Englishmen*, NY Business Law Journal (Summer 2013).
3. *See* C. E. Stewart, *The D.C. Circuit: Wrong and Wronger!*, NY Business Law Journal (Winter 2015); *see also* C.E. Stewart, *Attorney-Client Privilege: Misunderestimated or Misunderstood?*, New York Law Journal (Oct. 20, 2014).
4. 449 U.S. 383 (1981)
5. Although what the Court spelled out in *Upjohn* seems remarkably clear and easy to follow, some American judges (and lawyers) have nevertheless had trouble applying that jurisprudence. *See supra* note 3.
6. *See* C.E. Stewart, *Good Golly Miss Molly!: The Attorney Work Product Doctrine Takes Another Hit*, NY Business Law Journal (Winter 2012).
7. Unfortunately, the law in the United States on these latter two scores used to be clear, rejecting both a "reasonable prospect" test and "predominance" test; now the law is much less settled. *See* C.E. Stewart, *Caveat Corporate Litigator: The First Circuit Sets Back the Attorney Work Product Doctrine*, NY Business Law Journal (Summer 2010).
8. [2016] EWHC (3161) (Ch).
9. As I have repeatedly tried to make clear (*see, e.g.*, C.E. Stewart, *Thus Spake Zarathustra (And Other Cautionary Tales for Lawyers)*, NY Business Law Journal (Winter 2010)), these warnings are **not** *Upjohn* warnings.
10. [2003] QB 1556. *See also Astex Therapeutics Limited v. Astrazeneca* AB [2016] EWHC 2759.
11. *See West London Pipeline v. Total* [2008] EWHC 1729 (Comm); Sumitomo Corporation v Credit Lyonnais Rouse [2001] CP Rep 72. Nonetheless, in rejecting RBS's invocation of the work papers privilege he did suggest that the Upjohn Court's guidance on work product might well be sustained (in a different case): if you can show the "notes of the interviews as containing what [the lawyer] considered to be the important questions, the substance of the responses to them, [the lawyer's] beliefs as to the importance of these, [the lawyer's] beliefs as to how they related to the inquiry, [the lawyer's] thoughts as to how they related to other questions. In some instances they might even suggest other questions that I would have to ask or things that I needed to find elsewhere." Given the Justice's antipathy to the privilege claim, however, query whether a litigant could ever meet this standard.
12. *See Bourns Inc v. Raychem Corp* [1999] 3 All ER 154. RBS had urged the court to recognize a "newly fashioned rule"—that the "most significant relationship" vis-à-vis the creation of the interview notes was in the U.S. (presumably this was based upon the "touch base" standard employed by U.S. courts—*see, e.g.*, *Veleron Holdings, B.V. v. BNP Paribas SA*, 2014 WL 4184806, at *4 (S.D.N.Y. Aug. 22, 2014)). Hildyard declined to adopt RBS's "newly fashioned rule." One consequence of these two English decisions is that U.S. courts, in employing the "touch base" standard going forward, may well apply English Law to cross-border internal investigations, particularly those that do not follow *Upjohn* protocols.
13. [2017] EWHC 1017 (QB).
14. *See supra* notes 6 & 7. Justice Andrews also opined that the timing is different for anticipating civil vs. criminal litigation: there is "no inhibition on the commencement of civil proceedings" (so they can come at any time) versus criminal proceedings, which cannot commence until a later time—when there is a "sufficient evidential basis for prosecution."
15. As this article is being completed, there is no reported news about an appeal of Justice Andrews' decision.
16. And, as exemplified by the Kellogg Brown and Root embroglio, not all American lawyers know how to follow the *Upjohn* protocols. *See supra* note 3.
17. Of course, if your client finds itself in a jurisdiction that differs from U.S. and British standards, you may well have another set of problems altogether.
18. *See In re Murphy*, 560 F.2d 328 (8th Cir. 1977); C.E. Stewart, "Jumping on a Hand Grenade to Protect a Client," Federal Bar Council Quarterly (November 2009).
19. *See supra* notes 6 & 7. Lawyers creating documents outside the United States should also indicate (if appropriate) that said documents involve a U.S. matter. *See Wultz v. Bank of China*, 979 F. Supp. 2d 479, 492 (S.D.N.Y. 2014).
20. *See supra* note 12. And this is particularly true insofar as having American lawyers conduct the investigations; indeed, in-house European lawyers are not able to invoke the protection of the attorney-client privilege. *See Akzo Nobel Chemicals Ltd. v. European Comm'n*, Case C-550/07 P (Euro. Ct. Justice Sept. 14, 2010) (full text at http://op.bna.com/mopc.nsf/r?Open--jros-89cg88).
21. *See* C.E. Stewart, *The End of Conflicts of Interest? Courts Warm Up to Advance Waivers*, NYSBA: The Senior Lawyer (Fall 2015). As my law school Dean (and ethics guru) Roger Cramton once ruefully remarked: "[large New York firms] are some of the biggest risk-takers that I run into." *Id*.
22. *Georgian American Alloys, Inc. v. White & Case LLP* [2014] EWHC 94 (Comm). The amount sought in the civil litigation and a related arbitration was "not less than $2 billion." *Id*. at ¶ 42.
23. *Id*. at ¶¶ 79-81.
24. *Id*. at ¶¶ 75 & 88. He had previously cast significant doubt on the efficacy of advance waivers under English law. *Id*. at ¶ 17.
25. *Id*. at ¶¶ 84-87.
26. *Id*. at ¶¶ 17, 26, 33 & 51.
27. The financial net benefit to the firm thus perhaps justifying what Dean Cramton once lamented. See *supra* note 21.

Employment Law Update

New York City Shakes Up the Freelance Sector

By David S. Douglas

New York City has substantially altered the ground rules governing companies and individuals who utilize independent contractors. The Freelance Isn't Free Act—enacted in May and the first of its kind in the nation—imposes severe penalties on those who retain the services of independent contractors without written agreements. The Act also provides independent contractors who are not properly paid with strong remedies, including the right to recover double damages and attorneys' fees.

Written Contract

The new law requires that where an independent contractor is retained to perform services valued at $800 or more the agreement between the parties must be in writing. Hiring parties cannot avoid the written contract requirement by structuring their independent contractor relationships as a series of smaller value transactions. Rather, in assessing the value of the services at issue, the law takes into account the aggregate value of any arrangements between the parties over the course of the immediately preceding four months.

Payment

The Act makes clear that full payment must be made to the independent contractor either by the date that such payment is due under the parties' agreement, or, if the agreement does not set forth such a date, by no later than 30 days after the work under the contract is completed. The Act prohibits the hiring party from requiring as a condition of timely payment that the independent contractor accept less compensation than the contractually agreed-upon amount.

No Retaliation

Additionally, the Act bans retaliation, which it defines as any attempt by a hiring party to exert pressure on an independent contractor for purposes of convincing the independent contractor to forgo his or her rights under the Act.

Damages and Penalties

Where a hiring party violates any of these provisions, the independent contractor may sue and obtain a considerable recovery against the hiring party. Most notably, the Freelance Isn't Free Act gives the independent contractor the right to recover not only damages equal to twice the amount owed, but also attorneys' fees, remedies that previously had been available only to actual employees. A hiring party found to have retaliated against an independent contractor is further liable for damages that equal the total value of the underlying contract. The Act permits independent contractors to file complaints with the Office of Labor Standards as an alternative to commencing suit in court.

The Act also establishes a $250 penalty for entering into an independent contractor arrangement without a written contract where the independent contractor had requested it be in writing. Any hirer found to have repeatedly violated the Freelance Isn't Free Act's requirements may be subject to an additional civil penalty of up to $25,000 as part of a suit brought by New York City Corporation Counsel.

The Freelance Isn't Free Act governs the engagement of any person or organization as an independent contractor, where either the employer or independent contractor has ties to New York City. The law, however, does not apply to the retention of commission salespersons, lawyers, licensed medical professionals, or independent contractors who are performing work for government entities.

Anyone in the New York City area who has utilized or is considering utilizing the services of independent contractors (or anyone across the country looking to retain New York City-based independent contractors) should consult with an experienced employment attorney to analyze exactly how to structure these arrangements. Through careful consideration of written contract terms and payment provisions, and adherence to them, one should be able to avoid running afoul of the new restrictions that New York City has imposed, and at the same time maintain the added flexibility and economic benefits generally associated with engaging independent contractors.

David Douglas is a partner with the New York law firm Gallet, Dreyer & Berkey, focusing on commercial litigation, land use, and employment matters. **Pamela Gallagher** is an associate with the firm focusing on commercial and consumer residential disputes, and is a Delegate to the NYSBA House of Delegates.

New Regulations Clarify NY's Upcoming Paid Family Leave Benefits Law

By Pamela Gallagher

New York's Paid Family Leave Benefits Law, which takes effect on January 1, 2018, creates a new state insurance program funded by employee payroll deductions. The law requires all employers to permit New York employees to take a period of leave to bond with a new child, care for a family member with a serious health condition or address matters arising from an immediate family member being called to active duty in the United States Armed Forces.

The New York Workers' Compensation Board recently issued regulations clarifying eligibility and benefits requirements.

Eligibility

The New York Paid Family Leave Benefits Law applies to nearly all New York employees, whether full-time or part-time. All employees who are regularly scheduled for 20 or more hours per week are eligible for paid leave benefits after 26 weeks of employment. Employees who are regularly scheduled for fewer than 20 hours per week are eligible after 175 days worked, irrespective of the number of hours worked on a given day. Because the benefit is employee-funded, all employers, regardless of size, must offer paid family leave. The law does not provide leave for an employee's own health condition, but the employee may be entitled to leave or benefits under other programs, such as state disability insurance. Leave for one's own health condition under other programs does not reduce the benefits available for paid family leave. Employees do not have to exhaust other leave options such as sick leave or vacation before using paid family leave. While an employee may be permitted to use sick or vacation leave for full pay, the employer cannot require an employee to use this leave.

In combination with New York disability benefits, employees cannot take more than a combined total of 26 weeks in any 52-week period. One caveat is that leave taken by an employee due to his or her own serious health condition under the federal Family and Medical Leave Act (FMLA) is not "family leave" and does not reduce the amount of paid family leave for which an employee is eligible. For example, a new mother may elect to take Family Medical Leave under the federal FMLA for maternity benefits, followed by the new program's bonding leave. The difference is that the unpaid federal Family Medical Leave is for the mother's own condition, while the Paid Family Leave Benefits are for bonding with the child.

If foreseeable, the employee must provide the employer with 30 days' notice in advance of taking leave. If the employee fails to do so, the employer may file a partial denial of the paid family leave claim for up to 30 days. If the leave is not foreseeable, the employee must notify the employer as soon as possible.

Benefits

Under the new program, an employee can take up to 8 weeks per calendar year in 2018, increasing to 10 weeks in 2019 and to 12 weeks in 2021. When the employee returns to work at the end of the leave period, the employer has to restore the employee to his or her previous position or a comparable position.

An employee taking paid family leave will receive a percent of his or her regular wage during the leave, subject to caps. In 2018, the employee will receive 50 percent of the employee's regular weekly wage, capped at 50 percent of the state's average weekly wage. Based on 2016 figures, this calculates to a cap of $652.96, based on the state's current average weekly wage of $1,305.92. The percent of the employee wage and the percent of the cap both increase to 55 percent in 2019, 60 percent in 2020, and 67 percent in 2021. Because the cap is based on a percentage of the state's average weekly wage at that time, in future years the average weekly wage may be higher than the current $1,305.92.

This program is paid for by increased employee payroll deductions. For 2018, the amount to be deducted from employee payroll to pay for the program is 0.126% of an employee's regular weekly wage, capped at the statewide average weekly wage. For 2018, that calculates to a maximum of $1.65 per week. Employers were permitted to begin collection of the payroll deductions as of July 1 of this year, but employers are required to do so as of January 1, 2018. Going forward, the Superintendent of Financial Services will determine the following year's rate on September 1.

Additional Employer Requirements

Employers are required to post a notice concerning the benefits and to give employees written notice of the benefits within five business days after the employee takes such leave. Employers cannot take retaliatory action against employees who take leave.

For those who have more specific questions, the State has established a Paid Family Leave Helpline at 844-337-6303.

Inside the Courts

An Update From Skadden Securities Litigators

Class Representation

District of Massachusetts Denies Motion to Strike Class Representative

Henderson & Hershenson v. Bank of N.Y. Mellon Nat'l Ass'n, No. 15-10599-PBS (D. Mass. Sept. 25, 2017)

Judge Patti B. Saris denied the Bank of New York Mellon's (BNY Mellon) motion to strike putative class representative Ashby Henderson. BNY Mellon claimed that Henderson had inadequate knowledge of the case to serve as class representative, that she ceded control of the case to unfit class counsel and that her interests conflicted with the interests of the class. First, the court held that BNY Mellon should not have filed a motion to strike the class representative but should have opposed class certification because its motion to strike relied on evidence outside the pleadings, and the plaintiffs had already filed a motion for class certification. Instead, the court considered BNY Mellon's arguments as a partial opposition to the motion for class certification on the grounds that Henderson was an inadequate class representative. Although BNY Mellon argued that Henderson lacked sufficient understanding to serve as class representative, the court disagreed and noted that she explained "the essential nature of her claims, at least to the extent that is reasonable to expect from a layperson class representative in a complex financial case." Additionally, BNY Mellon alleged that Henderson ceded control to her attorney and did not represent the interests of the class. Again, the court disagreed. It held that Henderson did not exclusively rely on her counsel, that she understood that she and the other plaintiffs were represented by several attorneys and that she worked cooperatively with them.

Fiduciary Duties

Mergers and Acquisitions

Court of Chancery Applies *Corwin* to Dismiss Post-Closing Fiduciary Duty Claims

Morrison v. Berry, No. 12808-VCG (Del. Ch. Sept. 28, 2017)

Vice Chancellor Sam Glasscock III granted a motion to dismiss fiduciary duty claims asserted in connection with the sale of The Fresh Market to Apollo Management, L.P. In his decision, the vice chancellor noted that the case was "exemplary" of the "utility" of the doctrine adopted by the Delaware Supreme Court in *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015), which held that the business judgment rule is the appropriate standard of review for a post-closing damages action when a merger transaction that is not subject to the entire fairness standard of review has been approved by a fully informed, uncoerced majority of the target company's disinterested stockholders.

The plaintiff stockholder alleged that Fresh Market's founder, a director and 10 percent owner, sought out a private equity buyer for Fresh Market without the knowledge of the other eight members of the company's board of directors and reached a preliminary agreement with Apollo to roll over his shares. When Apollo made an unsolicited offer to acquire Fresh Market, the founder recused himself from the process, and the remaining board members formed a three-member special committee, hired a financial advisor and conducted a three-month auction process that included reaching out to 32 potential bidders. The process yielded five indications of interest and "several" offers.

In an attempt to argue that the stockholder vote was not fully informed, the plaintiff asserted several disclosure claims, including that (1) the Schedule 14D-9 failed to disclose that the sensitivities the company's financial advisor ran on management projections "included upside as well as downside sensitivities"; and (2) the Schedule 14D-9 was misleading because it did not fully describe the founder's role in the process and that the process was in fact a "sham." The court rejected both of these arguments, finding, among other things, that the complaint failed to allege that the disclosed projections represented "anything other than [the board's] best estimates," and that the plaintiff's description of the process as a "sham" was "not supported by the record." The court accordingly granted the motion to dismiss.

Court of Chancery Rejects Post-Closing Bad Faith Claims

Kahn v. Stern, No. 12498-VCG (Del. Ch. Aug. 28, 2017)

Vice Chancellor Sam Glasscock III granted a motion to dismiss a stockholder plaintiff's post-closing claims that the board of directors of Kreisler Manufacturing Corporation acted in bad faith in approving a sale of the company and certain "side deals" with insider directors, and in issuing disclosures in connection with the merger.

In connection with the transaction, the board formed a special committee consisting of two of the five members of the board, which, with the assistance of a financial advisor and outside legal counsel, conducted a sales process that included reaching out to 55 potential bidders. The process generated seven indications of interest and three offers. According to the plaintiff, two insider directors then negotiated "side deals" for themselves that included future employment with the surviving entity and a rollover of equity. In addition, the plaintiff challenged omissions in the information statement issued in connection with the transaction, including the failure to disclose management's projections used in the financial advisor's analyses. The plaintiff alleged, among other things, that (1) a majority of the board was interested in the transaction, and (2) a majority of the board acted in bad faith in approving the side deals and issuing the challenged disclosures.

The parties disputed the independence of only one director, who the plaintiff alleged "had a large, illiquid block of shares, favored a sale of the Company, had aligned himself with [an activist stockholder] who was agitating for a sale, and was excluded from the Special Committee." Rejecting this argument, the court noted that the director had not "received different or unique consideration" and observed that the complaint did not "allege that he faced a liquidity crisis or a particular exigent need that would necessitate a fire sale of his interest." The court also refused to draw an inference about the director's independence from the fact that he was not a member of the special committee.

The court also rejected the plaintiff's bad faith claims, observing that it "is a difficult standard to meet" and explaining that the allegations of the complaint did not support a reasonable inference that a reduction in the merger price allocable to the side deals made board approval inexplicable absent bad faith. Among other things, the court found that with respect to the side deals, "a potential rational business purpose exists: to incentivize proper management of the Company through and after the Merger."

With respect to the disclosure claims, the court observed that in a post-closing damages action with a majority disinterested and independent board, protected by an exculpatory charter provision, the plaintiff bore the burden to plead facts supporting an inference that the board acted in bad faith in issuing a materially deficient disclosure. The court explained that prior to a stockholder vote, "the decision to withhold management projections and other elements leading to the fairness opinion" was likely to "merit injunctive relief," but it ultimately found that, post-close, the complaint failed to allege facts supporting an inference that the board was participating in a "cover-up" or otherwise acted in bad faith in issuing the disclosures.

Derivative Claims

Court of Chancery Dismisses Derivative Claims Involving Alleged Overpayment in Asset Purchase

Chester Cty. Emps'. Ret. Fund v. New Residential Inv. Corp., No. 11058-VCMR (Del. Ch. Oct. 6, 2017)

Vice Chancellor Tamika Montgomery-Reeves granted a motion to dismiss stockholder derivative claims involving alleged overpayment for assets, finding that the plaintiff failed to demonstrate that demand was futile pursuant to Court of Chancery Rule 23.1.

The plaintiff, a stockholder of New Residential Corp., brought suit challenging a transaction between New Residential and Home Loan Servicing Solutions, Ltd. (HLSS), arguing that the director defendants caused New Residential "to overpay" for assets of HLSS in order to advantage other real estate assets of Fortress, an affiliate of New Residential's manager. The plaintiff alleged that Fortress was New Residential's controlling stockholder and that the transaction was not entirely fair.

The court reiterated the standard for pleading demand futility under *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), *overruled by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000), pursuant to which demand is futile only if a plaintiff alleges particularized facts to raise a reasonable doubt that either a majority of the directors are disinterested and independent, or the challenged transaction was otherwise the product of a valid exercise of business judgment.

With respect to director independence, the court concluded that the plaintiff failed to raise a reasonable doubt as to the impartiality of a majority of the board. Among other things, the court explained that assertions of "reputational harm," "receipt of indemnification and exculpation rights," "several years of social connections," donations to common charities and stale business dealings were insufficient to impugn the directors' independence or disinterestedness. The court also found that a director whose background of public service suggested he was of "less-than extraordinary means" did not support an allegation that such a director lacked independence or was interested because the board fees were material to him, since such a finding would discourage "regular folks" from board service—a result the court was "especially unwilling to facilitate."

The court also rejected the plaintiff's argument that because a controller was present, invocation of entire fairness "automatically" rendered demand futile. Declining to determine whether Fortress was in fact a controlling stockholder, the court found such an automatic excusal theory was "inconsistent with controlling authority'" in Delaware. Finally, the court concluded that the plaintiff failed to demonstrate that the asset sale between New Residential and HLSS implied a threat of a substantial likelihood of liability because the transaction was not so egregious that board approval amounted to bad faith. The court noted that complaints about the price paid for the assets were "precisely the type of 'Monday morning quarterbacking'" routinely found insufficient to excuse demand.

Insider Trading Claims

Second Circuit Affirms Dismissal of Short-Swing Profit Claims Against Hedge Fund Company

Morrison v. Eminence Partners II, L.P., No. 17-843-cv (2d Cir. Oct. 19, 2017)

The Second Circuit affirmed the dismissal of an investor's claim that a hedge fund company violated Section 16(b) of the Securities Exchange Act by allegedly obtaining "short-swing" profits from the sale of common stock in a national men's clothing company. Before the investor had filed his complaint, the clothing company had completed a corporate reorganization that resulted in shareholders exchanging the company's stock for shares in a holding company.

The district court had previously dismissed the investor's complaint for lack of statutory standing on the grounds that the investor did not hold stock in the issuer to which the short-swing trades pertained at the time he filed his complaint because he now owned stock of the parent holding company. The Second Circuit affirmed, determining that an investor must hold the security in the "issuer" to whom the short-swing profits would accrue at the time a complaint is filed. The court found that several exceptions to the general standing rule under Section 16(b) were inapplicable. The successor-issuer exception did not apply because the reorganized clothing company was not "merged out of existence" and remained a viable entity that itself had standing to bring a Section 16(b) claim for short-swing profits earned from purchases and sales of the company's securities. The fraud exception to standing also did not apply. The investor failed to allege plausible facts that the reorganization was a fraudulent effort to deprive him of statutory standing. The court determined that such an allegation was implausible because the company had completed the reorganization before the investor filed his Section 16(b) claim and it had announced the reorganization in a public filing well before the investor filed a Section 16(b) demand on the company.

Misrepresentations

SDNY Holds That Company's Conduct That Formed Basis of FCPA Violations Led to Material Misstatements and Omissions

In re VEON Ltd. Sec. Litig., No. 15-cv-08672 (ALC) (S.D.N.Y. Sept. 19, 2017)

Judge Andrew L. Carter Jr. granted in part and denied in part a motion to dismiss claims that VEON Ltd., an international telecommunications company, violated Sections 10(b) and 20(a) of the Securities Exchange Act.

The complaint was based substantially on statements included in a deferred prosecution agreement after VEON admitted violating the Foreign Corrupt Practices Act by paying bribes to gain market access in Uzbekistan. The court granted the motion to the extent that the complaint alleged that VEON's accurate financial reports and statements about sales and subscriber numbers were misleading. The court agreed with other courts that have held that "accurately reported income derived from illegal sources is non-actionable despite a failure to disclose the illegality."

In denying the motion in part, the court concluded that certain of VEON's statements were potentially misleading because they had put at issue "the topic of the cause" of its financial success. For example, VEON attributed its increase in mobile subscribers and revenues in Uzbekistan to its "sales and marketing efforts." The court concluded that because VEON had purported to identify a cause of its financial success, its failure to disclose that the illegal conduct had contributed to its success was actionable. The court also concluded that the plaintiffs adequately alleged scienter and loss causation.

Mortgage-Backed Securities

BNY Mellon Awarded Partial Summary Judgment on Claims Concerning 20 Residential Mortgage-Backed Securities Trusts

Phx. Light SF Ltd. v. Bank of N.Y. Mellon, No. 14-CV-10104 (VEC) (S.D.N.Y. Sept. 7, 2017)

In a case brought by investors in mortgage-backed securities, Judge Valerie E. Caproni of the U.S. District Court for the Southern District of New York granted partial summary judgment to the defendant BNY Mellon, the trustee of 27 securitization trusts. The plaintiffs alleged that BNY Mellon breached various contractual duties arising both before and after an "event of default"—including the duty of prudence that arose upon an event of default—in addition to violating the Trust Indenture Act (TIA) and negligently performing its contractual duties.

The court rejected the plaintiffs' argument that BNY Mellon breached its pre-event of default duty to investigate and provide notice of breaches of representations and warranties, and to enforce servicer Countrywide's repurchase obligations in connection with 16 trusts. Although the plaintiffs cited evidence that BNY Mellon knew of "systemic fraud" at Countrywide, that was insufficient to establish that BNY Mellon had "knowledge of any specific breach of any representation or warranty relative to any particular loan" in the Countrywide trusts. The court thus granted BNY Mellon summary judgment with respect to the pre-event of default breach of contract claims in connection with 16 trusts. For the other four trusts, in connection with which BNY Mellon received letters from certificateholders concerning material breaches of representations or warranties in specific loans, the court denied BNY

Mellon's motion for summary judgment, finding material facts in dispute.

With regard to the plaintiffs' post-event of default claims concerning five trusts in which an event of default was conceded, the court denied BNY Mellon's motion for summary judgment. The court held that whether BNY Mellon's issuance of a notice of an event of default, without further action, was sufficient to discharge its duty of prudence was a question of fact that could not be resolved on summary judgment. With regard to the remaining trusts, for which an event of default was not conceded, the court held that knowledge of an event of default—which triggered the duty of prudence—arose only upon written notice. Thus, BNY Mellon was entitled to summary judgment where there was no evidence that it had received written notice of an event of default, even if it had actual knowledge of that event. The plaintiffs' claims under the TIA, which relied on similar evidence, were also dismissed with respect to these trusts. The court denied the plaintiffs' cross motion for summary judgment on the claims concerning the duty of prudence, which required resolution of disputed issues of material fact.

The court also denied the plaintiffs' negligence claims, reasoning that they were barred by the economic loss doctrine and duplicative of the contract claims.

PSLRA—Pleading Standards

Third Circuit Holds Defendant Had No Duty to Disclose Loss of Distributor

Williams v. Globus Med., Inc., No. 16-3607 (3d Cir. Aug. 23, 2017)

The Third Circuit affirmed the dismissal of a putative securities fraud class action, holding that the plaintiffs failed to sufficiently allege that the challenged statements and omissions were false or misleading.

The defendant, a medical device company, uses independent distributors to sell its products. The defendant allowed its contract with one of its distributors to expire. The plaintiffs brought suit, alleging that the defendant omitted that it had lost a distributor in its historical statements and that the defendant made misleading forward-looking statements by issuing revenue projections that failed to account for the lost distributor.

The district court dismissed the plaintiffs' claims, and the Third Circuit affirmed. With regard to failing to disclose the expired contract in its historical statements, the court explained that corporations do not have an affirmative duty to disclose all information under the federal securities laws. So long as the omitted information was not necessary to prevent a defendant's statements from being misleading, the defendant was not liable for its failure to disclose information about the distributor. Here, while the defendants warned that the loss of an independent distributor could negatively impact its sales, the plaintiffs did not plead that the defendant's sales were adversely affected by the loss of the distributor or that a drop in sales was inevitable. Therefore, under the plaintiffs' own allegations, the defendant had no duty to disclose the loss of the distributor.

The court also dismissed the plaintiffs' claims based on the defendant's forward-looking revenue projections because those allegations hinged on the conclusory assertion that the projections incorporated sales figures from the lost distributor. However, because the plaintiffs did not cite contemporaneous sources to show that the defendant in fact incorporated sales figures from the distributor into its projections, the allegations failed to satisfy the specificity requirement of the Private Securities Litigation Reform Act pleading standard.

Eastern District of Michigan Dismisses Securities Fraud Claims Alleging Capital Expenditure and Customer Relationship Misstatements

USM Holdings, Inc. v. Simon, No. 15-14251 (E.D. Mich. Sept. 12, 2017)

The Eastern District of Michigan dismissed with prejudice securities fraud claims against the former officers of a target company arising from alleged misstatements in the diligence process and in the resulting merger agreement. The buyer brought suit against, among other defendants, the former CEO and chief financial officer of the target company, an automotive manufacturer. The buyer alleged that these defendants made misstatements regarding the state of the target's capital expenditures and the target's relationships with its two largest customers, in violation of Section 10(b) of the Securities Exchange Act and Rule 10b-5. The court dismissed these claims with prejudice, emphasizing the high bar of pleading fraud under the Private Securities Litigation Reform Act (PSLRA).

The buyer alleged that the target made material misstatements and omissions regarding the state of the target's capital expenditures on manufacturing machinery. The buyer set out three theories for these alleged misstatements: upkeep (alleging that the target had failed to maintain and repair its machinery as it represented during the course of diligence); forecast (alleging that a draft capital expenditure budget involved misleading figures); and failure to spend (alleging that the target failed to make certain capital expenditures prior to closing). The court rejected all three theories, each time noting the particularity in pleading required by the PSLRA. The court found that the buyer failed to plead facts regarding, for example, the officers' specific knowledge that certain machinery was in disrepair.

The buyer also alleged that the target made material misstatements and omissions regarding its relationship with its two largest customers because the target did not disclose ongoing contract disputes with these customers. The court again found that the buyer's pleadings failed to satisfy the PSLRA standard, emphasizing the need to allege detailed facts and figures regarding the disputes and even the method by which a party arrived at those facts and figures.

Scienter

Securities Fraud Class Action Based on Product Recall Allowed to Proceed

Godinez v. Alere Inc., No. 16-10766-PBS (D. Mass. Aug. 23, 2017)

Judge Patti B. Saris of the U.S. District Court for the District of Massachusetts denied a motion to dismiss a putative Section 10(b) securities fraud class action against medical device manufacturer Alere Inc., with respect to allegations that it failed to disclose the need to recall its INRatio blood-clotting measurement tool. Although Alere issued a recall of INRatio in July 2016, the plaintiffs alleged that Alere was on notice of problems with the product as early as 2014 and that a recall was sufficiently probable prior to July 2016 so as to require accrual or disclosure of an associated loss contingency under generally accepted accounting principles. For example, Alere's 2014 Form 10-K disclosed a partial recall of INRatio test strips, but, as the court found, did "not make the market fully aware of the failure rate associated with INRatio product malfunctions, necessitating the FDA's suggestion of a full recall." The court found that a number of alleged facts gave rise to a strong inference of scienter, including "the 2014 partial recall and correction, the high volume of consumer complaints, consumer injuries, and increased quality assurance staffing, the FDA's advice to prepare for a voluntary recall, and the timing of potentially lucrative merger discussions...(which could have been scuttled by disclosure of a likely recall), after which [the CEO and CFO] stood to receive a combined $29 million in change-in-control payments." The court accordingly allowed claims based on the recall to proceed to discovery.

The court dismissed all other allegations of fraud, including allegations that Alere failed to disclose weaknesses in internal controls related to revenue recognition. Although Alere was aware of internal control issues related to corporate taxation, the court found that "[p]laintiffs do not convincingly argue that an internal control problem in one accounting area puts a company or its senior management on notice of internal control problems in all other aspects of the company's accounting procedures." The court further rejected allegations that Alere failed to disclose certain billing improprieties in divisions subject to regulatory investigation, holding that "[t]he mere existence of an investigative subpoena...has limited probative value where there are no allegations that the issues being investigated were previously disclosed to senior management."

Securities Exchange Act

DC Circuit Affirms SEC Finding That Investment Banker Who Passed Along Statements From His Boss Was Liable for Securities Fraud

Lorenzo v. SEC, No. 15-1202 (D.C. Cir. Sept. 29, 2017)

On September 29, 2017, a two-judge majority of the D.C. Circuit upheld the Securities and Exchange Commission's (SEC) determination that investment banker Francis Lorenzo violated Section 17(a)(1) of the Securities Act, Section 10(b) of the Securities Exchange Act and Rules 10b-5(a) and (c) by passing along to investors statements made by Lorenzo's boss, holding that Lorenzo knew the statements were false and misleading when he sent them.

On October 14, 2009, Lorenzo, director of investment banking for a registered brokerage firm, emailed two potential investors several "key" points about Waste2Energy Holdings, Inc.'s (W2E) pending debenture offering. W2E had recently lost almost all of its value and was offering up to $15 million in convertible debentures. In his emails, Lorenzo forwarded information provided to him by his boss touting the highly attractive nature of the offering but omitted any mention of the devaluation of W2E's intangible assets. One of the emails noted it was being sent at the request of Lorenzo's boss, the owner of the brokerage firm, and the other email said it was being sent at the request of the owner and another broker. In both emails, Lorenzo signed his name and title at the bottom and urged the investors to call him with any questions.

On February 15, 2013, the SEC filed an action alleging Lorenzo violated Section 17(a)(1) of the Securities Act, Section 10(b) of the Securities Exchange Act and Rules 10b-5(a)-(c). An administrative law judge found the statements in the emails were false and that Lorenzo acted recklessly in passing them along to investors. The judge ordered Lorenzo to cease and desist from violating the various provisions, permanently barred him from participating in the securities industry and ordered him to pay a civil monetary penalty of $15,000.

Following an unsuccessful petition for review, Lorenzo appealed to the D.C. Circuit and argued that the statements were not false or misleading, he did not act with the requisite intent in forwarding them and he did not "make" the statements within the meaning of Rule 10b-5(b).

Judge Sri Srinivasan, writing for the majority, held that the statements were false and misleading and that Lorenzo acted extremely recklessly in sending them because, at the time he sent the emails, Lorenzo knew W2E did not have sufficient assets, was headed for financial ruin and his brokerage firm had not agreed to raise the additional monies needed to repay the debenture holders.

The court rejected the argument that merely sending the statements at the request of his boss was insufficient to establish liability. The court held that although Lorenzo's boss supplied the content of the statements, Lorenzo effectively vouched for them by passing them along in his role as director of investment banking and by inviting the investors to call him with any questions. The court, however, agreed with Lorenzo that he was not liable under Rule 10b-5(b), holding that Lorenzo did not make the challenged statements because his boss, not Lorenzo, retained ultimate authority over the statements.

In so holding, the court considered the U.S. Supreme Court's decision in *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. 135 (2011). In *Janus*, the Supreme Court held that an investment adviser who assisted in preparing a mutual fund's prospectuses did not "make" the statements in the prospectuses as required under Rule 10b-5(b) because the adviser did not have "ultimate control" over the statements' content and dissemination. Like the adviser in *Janus*, the court held that Lorenzo did not have "ultimate control" over the statements in the emails because Lorenzo's boss: (1) asked him to send the emails; (2) supplied the content; and (3) approved the emails for distribution.

Relying on *Janus*, Lorenzo argued that because he did not "make" the statements at issue, he should not be liable under the other securities fraud provisions. The court held that the conduct at issue in *Janus* materially differed from Lorenzo's conduct. In *Janus*, the adviser drafted false statements that an independent entity chose to disseminate in its own name, and the adviser's role in drafting the statements was unknown to the investors who received the statements. The court held that, unlike in *Janus*, the investors were aware of Lorenzo's role in the matter because he sent the emails from his account and under his name, in his capacity as director of investment banking.

"Relying on Janus, *Lorenzo argued that because he did not 'make' the statements at issue, he should not be liable under the other securities fraud provisions."*

Eastern District of Virginia Holds That Liability Under Section 14(a) Securities Exchange Act Requires Only Proof of Negligence, Not Fraud or Reckless Disregard

Knurr v. Orbital ATK Inc., No. 1:16-cv-1031 (E.D. Va. Sept. 26, 2017)

On September 26, 2017, the U.S. District Court for the Eastern District of Virginia denied the defendants' motion to dismiss claims under Section 14(a) of the Securities Exchange Act, holding that the plaintiffs sufficiently alleged the defendants acted negligently in issuing a misleading proxy statement.

In 2015, defendant Orbital ATK, an aerospace and defense company, acquired another aerospace and defense company. Before the merger, the target entered into a multiyear contract with the U.S. Army. A year after the transaction closed, Orbital restated its financial statements to correct information concerning the target's contract with the Army and to clarify that the costs associated with the contract would exceed Orbital's revenues over the life of the contract.

The plaintiffs sued, alleging the defendants violated Section 14(a) of the Securities Exchange Act and Rule 14a-9.

A central issue in dispute was the state of mind required to establish liability under Section 14(a). The defendants argued that the plaintiffs must plead and prove that the defendants acted with fraudulent intent or reckless disregard for the truth. The plaintiffs argued that they need only plead and prove the defendants acted negligently.

The court agreed with the plaintiffs. It noted that the U.S. Supreme Court and the Fourth Circuit have expressly declined to rule on the state of mind required to establish liability under Section 14(a). Looking first to the plain text of the statute, the court observed that neither Section 14(a) nor Rule 14a-9 refers to a state of mind. The court then looked to the statutory context and noted that where Congress intended to impose an intentionality requirement, it used terms like "manipulative," "deceptive," "device" or "contrivance" to describe the requisite state of mind.

The court also considered Supreme Court case law noting that terms like "device," "scheme" and "artifice" connote knowing and intentional practices. The court held that because Section 14(a) does not use such terms, the drafters of the statute must have intended the standard to be negligence. The court also remarked that a majority of the circuits to address the issue have held that Section 14(a) requires only a showing of negligence, not intentionality.

The defendants argued that even if negligence is the standard, the PSLRA requires the plaintiffs to plead facts giving rise to a "strong inference" of negligence in order to state a claim. The court declined to address the issue, concluding that even if the PSLRA applies to Section 14(a) claims, the plaintiffs' complaint alleged sufficient facts to support a strong inference that the defendants were negligent in issuing the challenged statements because the plaintiffs alleged ample facts suggesting the defendants could have discovered the massive losses associated with the contract if they had conducted proper due diligence.

Securities Fraud Pleading Standards

Ninth Circuit Reverses Dismissal of Securities Fraud Action, Holds Statements Regarding FDA Warning Letter Were Materially Misleading

In re Atossa Genetics Inc. Sec. Litig., No. 14-35933 (9th Cir. Aug. 18, 2017)

The Ninth Circuit reversed in part the dismissal of a putative securities fraud class action, holding that certain statements regarding a Food and Drug Administration (FDA) warning letter and FDA clearance of a medical device were materially false or misleading.

The defendant developed and marketed products used to detect precancerous conditions. The FDA sent a warning letter to the defendant, stating that one of its devices—the MASCT system—was not being used for the purpose for which it was cleared, and that another one of its tools—the ForeCYTE Test—required independent clearance. Several months later, the FDA ordered the defendant to recall both the MASCT system and ForeCYTE Test. After the defendant disclosed the recall order to investors, its share price dropped over 46 percent.

The district court dismissed the plaintiffs' claims, concluding that all of the challenged statements were either not false or immaterial. The Ninth Circuit reversed in part.

First, the court held that the plaintiffs sufficiently pleaded that the defendant's statements describing the ForeCYTE Test as FDA-cleared were materially false. Citing an analyst report giving the defendant a "BUY" rating based in part on the defendant's "approved" products, the court concluded that the approval status of the ForeCYTE Test significantly altered the total mix of information that investors would consider.

Second, the court held that the defendant's Form 8-K filing giving notice of the FDA's warning letter was materially misleading because it reflected only a subset of the FDA's concerns and omitted the rest, leading to the reasonable inference that the FDA raised no concerns other than those disclosed.

Finally, the court held that opinion statements made by the defendant's CEO were misleading. Applying *City of Dearborn Heights Act 345 Police & Fire Retirement System v. Align Technology, Inc.*, 856 F.3d 605 (9th Cir. 2017), the court concluded that the CEO omitted facts concerning his knowledge of the FDA's letter that would conflict with what a reasonable investor would take away from his challenged statement.

Central District of California Holds That Anonymous Blog Post Based on Publicly Available Information Can Be Material and Constitute a Corrective Disclosure

In re Banc of Cal. Sec. Litig., no: SACV 17-00118 AG (DFM) (C.D. Cal. Sept. 6, 2017)

Judge Andrew J. Guilford denied the defendant's motion to dismiss a putative securities fraud class action, finding that the plaintiffs sufficiently alleged that the anonymous short-seller blog post that caused the company's stock to drop 29 percent was both material and a corrective disclosure.

The plaintiffs' allegations were based largely on a blog post claiming that an individual who was convicted of securities fraud had connections to the defendant company's CEO and that the company failed to disclose those connections in certain public statements. The blogger later revealed the sources of his post—sources that were publicly available.

The court rejected the defendant's argument that the information contained within the blog post was immaterial as a matter of law because it was based on publicly available sources. The court agreed with the plaintiffs' distinction "between situations where information is readily and easily available to investors, and situations where the information is only discoverable by combing through and analyzing hundreds of legal and agency documents." The court rejected the defendant's loss causation arguments on the same grounds, finding that the blog post could have revealed the truth behind the defendant's omissions, even though it was based on publicly available information. The court cited the sharp stock drop as evidence that the market had not previously known about the alleged connections between the man convicted of securities fraud and the defendant company's CEO.

SLUSA Pre-Emption

Ninth Circuit Holds Dismissals Pursuant to SLUSA Are Jurisdictional and Therefore Must Be Without Prejudice

Hampton v. Pac. Inv. Mgmt. Co., No. 15-56841 (9th Cir. Aug. 24, 2017)

The Ninth Circuit affirmed the dismissal of a putative securities fraud class action but joined the Third Circuit in holding that dismissals pursuant to the Securities Litigation Uniform Standards Act (SLUSA) are based on lack of subject matter jurisdiction, not a decision on the merits, and therefore must be without prejudice.

The plaintiff brought claims for breach of contract and breach of fiduciary duty under Massachusetts law. The district court dismissed the claims with prejudice, holding that the claims were barred under SLUSA because SLUSA does not permit a plaintiff to file a putative class action in federal court based on state law, where the plaintiff alleges a material falsehood or omission connected to the purchase or sale of federally regulated securities.

The Ninth Circuit affirmed the district court's dismissal of the plaintiff's claims but vacated the portion of the district court's order that dismissed the claims with prejudice. Circuit courts are split on whether motions to dismiss based on SLUSA pre-emption should be brought under Federal Rule of Civil Procedure 12(b)(1), for lack of subject matter jurisdiction, or 12(b)(6), for failure to state a claim. Dismissals under Rule 12(b)(1) must be without prejudice because a court without subject matter jurisdiction cannot decide the merits of a case. Dismissals under Rule 12(b)(6), on the other hand, are judgments on the merits of a case and thus may be with prejudice.

The court held that dismissals under SLUSA are jurisdictional and that motions to dismiss based on SLUSA pre-emption must be brought under Rule 12(b)(1). While the panel acknowledged that the Ninth Circuit has previously affirmed district court decisions dismissing cases based on SLUSA pre-emption under Rule 12(b)(6), it determined that these decisions carried no precedential weight because jurisdiction in those cases was assumed by the courts and the parties.

Statute of Limitations

SDNY Dismisses Putative Class Claims Brought by Investors in a Multinational Power Management Company

In re Eaton Corp. Sec. Litig., No. 16-cv-5894 (JGK) (S.D.N.Y. Sep. 20, 2017)

Judge John G. Koeltl dismissed putative class claims against a multinational power management company and two senior executives brought under Section 20(a) and Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder. In a consolidated class action complaint, the putative class plaintiffs alleged that, in a series of conference calls and meetings, SEC filings and press statements in connection with a merger, the defendants materially misled and thereby harmed investors about whether the company could spin off or divest its vehicle business, and if so, what the tax consequences would be. The plaintiffs alleged that the first of these misstatements occurred on May 21, 2012, and that the last occurred on November 13, 2013.

The plaintiffs claimed that the defendants misled investors by claiming that there was nothing in the deal from a tax perspective that would prevent the company from divesting its vehicle business. The plaintiffs claimed that the truth was revealed during a July 29, 2014, call, when the company admitted that it was not possible to do any tax-free spin-off for five years. The plaintiffs filed an initial complaint on July 22, 2016, alleging a class period from November 13, 2013 (the date of the last purportedly misleading statement), through July 29, 2014. They filed a consolidated class action complaint on January 13, 2017, alleging an expanded class period from May 21, 2012 (the date of the first purportedly misleading statement), through July 29, 2014. The plaintiffs claimed that the executives intentionally misled investors, as evidenced by the tens of millions of dollars in company stock they sold during the class period.

The defendants argued that the claims of the extended class members were time-barred by the two-year statute of limitations for securities fraud claims and that the statements were not materially misleading because the company did not spin off its vehicle business and did not intend to. Regarding the statute of limitations, the plaintiffs contended that the claims of the extended class members were not time-barred because they related back to the date of the initial filing on July 22, 2016. The court, following the "persuasive" reasoning of *Wilder v. News Corp.*, No. 11 Civ. 4947 (PGG), 2015 WL 5853763 (S.D.N.Y. Oct. 7, 2015), sided with the defendants, finding that the new class members' claims did not relate back to the filing of the original complaint because the consolidated class action complaint did not satisfy Federal Rule of Civil Procedure 15(c)(1)(C). Under that rule, an amended pleading with new parties may relate back to the original complaint if the omission of the new parties in the original complaint was a mistake about the identity of the omitted parties. The court noted that "the plaintiff does not attempt to argue that the failure to include the purported class members who purchased Eaton securities prior to November 13, 2013...was the result of a mistake in identity" and found the claims of the new class members were time-barred.

Similarly, regarding materiality, the court sided with the defendants, finding that their omission of the tax consequences was not materially misleading because they "were under no duty to disclose the hypothetical tax consequences of a potential spin-off" that the defendants said the company had no interest in pursuing. The court noted that the "defendants ... made clear from the day the merger was announced that there were no plans to spin off [the company's] automotive business." The court therefore concluded that "the theoretical tax consequences of a hypothetical transaction that was never planned and never occurred is not material, and the defendants were under no duty to disclose them." Finally, regarding scienter, the court found that, although the defendants sold a lot of stock during the class period, their stock transactions were consistent with those in the periods immediately before and immediately after the class period.

Anti-Money Laundering and Privacy: Are They Interrelated or in Conflict? A Comparison Between the U.S. and the E.U.[1]

By Davide Szép

Anti-money laundering and privacy regulations are intrinsically interrelated, for the mere fact that AML (Anti-Money Laundering) controls imply the utilization by companies of the personal data of their clients. This could bring about issues when companies are located in more than one country and/or geographic area, in particular with regard to privacy laws, that can vary as a result of differences in underlying principles and in the ways that personal data are treated in different jurisdictions.

This article analyzes how such differences may hamper the implementation of a consistent group-wide AML compliance program, and what should be done to better integrate privacy and anti-money laundering regulations in multinational groups.

The scope of this article is limited to financial institutions, and the geographic focus is on the United States and the European Union. Therefore, two layers of comparison are set forth. A first layer regards the differences in privacy regulation between the U.S. and the E.U., and the differences in AML regulation between the U.S. and the E.U. A second layer concerns the relationship between AML and privacy regulations in each of the two regions.

I. Overview on Financial Privacy Regulation

A. In the U.S.

The U.S. Constitution does not explicitly provide for a right to privacy. However, some "areas of privacy" can be found in the Bill of Rights, and in particular in the First Amendment (freedom of speech), the Third Amendment (privacy of the home), the Fourth Amendment (protection of financial records from warrantless seizure), Fifth Amendment (privileges against self-incrimination), and the Ninth Amendment (rights not dealt with in other amendments).

What is relevant for the purposes of this article is the "privacy area" contained in the Fourth Amendment:

> The right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated, and no Warrants shall issue, but upon probable cause, supported by Oath or affirmation, and particularly describing the place to be searched, and the persons or things to be seized.[2]

Privacy is widely recognized to have been first advocated as a right in the U.S. in an article entitled "The Right to Privacy," published in 1890 in the *Harvard Law Review*.[3] The article was written by Louis Brandeis and Samuel Warren.[4] The authors describe privacy as "the right to be let alone,"[5] referring to European concepts of honor and reputation.

Almost a century later, in 1973, the U.S. created a template of Fair Information Practice Principles (FIPPs), i.e., guidelines that represent widely accepted concepts concerning fair information practice and the use of automated data systems (e.g., the fact that consumers should be given notice of an entity's information practices before any personal information is collected from them).[6]

Notwithstanding such principles, the U.S. Supreme Court has traditionally been reluctant to recognize a right to privacy in the financial industry, as one can see in the following three cases.[7]

In *California Bankers Association v. Shultz*,[8] *a* privacy challenge was brought to the Bank Secrecy Act of 1970 (BSA),[9] the first statute regulating Anti-Money Laundering. Banks were required by the BSA to keep copies of all checks over a certain amount. The plaintiffs argued that the BSA's records requirements made banks agents of the government in surveillance of citizens, hence requiring a "seizure" of the records of customers in violation of the Fourth Amendment to the U.S. Constitution. However, the Court rejected this argument, holding that the recordkeeping requirements did not violate the Fourth Amendment since the bank owned the records of transactions to which it was itself a party.

In *United States v. Miller*,[10] it was held that "[t]he lack of any legitimate expectation of privacy concerning the information kept in bank records was assumed by Congress in enacting the Bank Secrecy Act [. . .]. The depositor takes the risk, in revealing his affairs to another, that the information will be conveyed by that person to the Government."[11]

Finally, in *Fisher v. United States*,[12] the Court stated that the records held by third parties (in a case regarding whether an IRS summons to a taxpayer's lawyer re-

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questing the delivery of the taxpayer's financial records that had been drafted by the taxpayer's accountant was subject to the privilege against self-incrimination provided for in the Fifth Amendment) were not protected by privacy rights. The Court asserted that the Fifth Amendment protected against "compelled self-incrimination, not [the disclosure of] private information."[13] Although not argued by the petitioners, the Court dealt also with the Fourth Amendment, stating that there was no expectation of privacy because the accountant had drafted the records, and hence the records belonged to the accountant.[14]

The above holdings highlight the way personal data are treated in the U.S.: data ownership is not vested in the individual, but rather in the holder; hence, the entity that holds them also owns them.[15]

Two years after the last two decisions, and in particular as a reaction to the discretion left to government authorities by *United States v. Miller*—discretion that the IRS was increasingly taking advantage of—the Right to Financial Privacy Act of 1978 was passed. The main aim of the statute was to fill the gap left by the ruling in *Miller* that a bank customer has "no standing under the Constitution to contest government access to financial records."[16]

The 1978 Act requires, *inter alia*, that (1) the financial records asked for be reasonably described, (2) the government use certain means to obtain them (e.g., subpoena, court order, etc.), and (3) before releasing the financial records, the bank receive a certification that the government agency has abided by the applicable provisions of the 1978 Act.[17]

The 1978 Act did not prove very effective because it contained a number of exceptions and limitations that still allow the financial institution wide discretion. For instance, (1) the act requires notice to the customer; however, such notice may be postponed if it would potentially make the customer destroy evidence or intimidate witnesses; (2) grand jury subpoenas are exempt from the notice provisions; (3) the supervisory authorities of financial intermediaries (both federal and state) are not subject to the 1978 Act when performing their supervisory functions; (4) in circumstances of imminent danger, and upon submission to the court of a statement justifying such circumstances, any government agency can obtain the records before complying with the notice provisions; and (5) suppression of financial records obtained in violation of the 1978 Act is not possible as a remedy, in that the right of privacy set forth in the Act is only statutory—not common-law based—and hence only civil penalties can be enforced.

> The most salient feature of the Act is the narrow scope of the entitlements it creates. Thus, it carefully limits the kinds of customers to whom it applies, and the types of records they may seek to protect. A customer's ability to challenge a subpoena is cabined by strict procedural requirements. […] the statute is drafted in a fashion that minimizes the risk that customers' objections to subpoenas will delay or frustrate agency investigations.[18]

B. In the E.U.

Data protection in Europe originated in France and Germany, mainly to safeguard the aristocracy from intrusions of the press. In particular, Germany was the first country to define such principles as the right to personality, connecting individual freedom with the right to have control over one's public persona.[19] After World War II, the right to personality became an integral part of the privacy culture of Europe,[20] and in 1950 the European Convention on Human Rights (ECHR) defined some parameters of privacy, also providing for some exemptions "in the interests of national security, public safety or the economic well-being of the country, for the prevention of disorder or crime, for the protection of health or morals, or for the protection of the rights and freedoms of others."[21]

During the 1960s, as governmental and private entities were storing and transferring increasing amounts of data, some European countries issued privacy regulations specific to certain industries (e.g., health and education).[22] However, this brought about regulatory asymmetries, as a result of which the Council of Europe's Convention for the Protection of Individuals with regard to Automatic Processing of Personal Data adopted the recommendations issued by the OECD in 1980 regarding the standardization of the collection and processing of data.

European countries did not implement such recommendations until 1995, when Directive 95/46/EC (the so-called "Data Protection Directive")[23] was issued. Anti-money laundering and counter-terrorism financing were included in the Directive among the derogations for the storage and transfer of data in the "public interest."[24] However, in 2015 the Data Protection Directive was replaced by E.U. Regulation 2016/679 (the so-called "General Data Protection Regulation"), to harmonize data protection regulation all over the European Union.[25] The 2015 Regulation does not fully exempt anti-money laundering and counter-terrorism financing—as the 1995 Directive did—but still preserves the legitimacy of collecting and transferring in the public interest, yet with an additional safeguard: the consent of the concerned data subject.[26]

II. Overview of Anti-Money Laundering Regulation

A. In the U.S.

Money laundering is the process through which the original ownership and control of proceeds obtained via illegal activities are disguised by making such proceeds appear to have derived from a legitimate source.[27]

The first piece of legislation to criminalize money laundering in the U.S. was the Bank Secrecy Act of 1970, followed, 16 years later, by the Money Laundering Control Act. Such laws—based on the concept that almost all profit-driven criminal activity is done in cash, and as part of an effort to destroy drug cartels—introduced know-your-customer (KYC) rules, which, however, at that time were restricted to acquiring the name and address of the client in order to either file a Currency Transaction Report (CTR), buy certain monetary instruments, or perform a wire transaction.[28]

In 1992, the Annunzio-Wiley Anti-Money Laundering Act extended the reporting obligations by adding the filing of Suspicious Activity Reports (SARs) in case the transactions carried out by a customer were not consistent with his, her, or its risk profile and gave rise to suspicions of a violation of law.[29]

Treasury. Nevertheless, policies, procedures, and controls need to be in place, as well as procedures to guarantee the confidentiality of such information.[31] However, the client is not notified that private financial data has been released or obtained, and this trumps previous contrary provisions of the Right to Financial Privacy Act of 1978 and the Gramm-Leach-Bliley Act.

The Bank Secrecy Act, as amended by the USA PATRIOT Act, requires that financial institutions establish anti-money laundering compliance programs to detect and report certain transactions and suspicious activity to FinCEN.[32] The minimum elements that such programs must contain are (1) policies, procedures, and controls, (2) designation of a compliance officer, (3) ongoing training, and (4) an audit, in order to have an independent review of the program.

> *"Money laundering is the process through which the original ownership and control of proceeds obtained via illegal activities are disguised by making such proceeds appear to have derived from a legitimate source."*

After the terrorist attacks of September 11, 2001, a different type of illicit activity, connected to—but different from—money laundering, needed to be more strictly regulated and criminalized: terrorist financing. As opposed to money laundering, in which the source of the proceeds—i.e., what is sought to be concealed—is necessarily an illegal activity, and the ultimate use of the funds is lawful, with terrorist financing the source of those proceeds does not necessarily have to be unlawful, the focus being on their intended purpose, which is illegal by definition. The USA PATRIOT (Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism) Act of 2001 addressed those issues. What is relevant for present purposes is Title III, the International Money-Laundering Abatement and Anti-Terrorism Financing Act, which extends the KYC obligation by requiring this acquisition of additional information about the client, including verifying the identity of that client, maintaining records about his or her identity, and checking into whether the person appears on any governmental list of (suspected) terrorists or terrorist organizations.[30]

Moreover, the USA PATRIOT Act § 314(a) provided for exceptions to certain financial privacy rules, allowing the government to ask, through FinCEN, for information about persons for which there is reason to suspect that they are engaging in money laundering or terrorism. The USA PATRIOT Act § 314(b) allows for the sharing of information among financial institutions regarding persons suspected to be involved in money laundering or terrorism, upon notice provided to the U.S. Department of the

Supervisory authorities can review an AML program, and, if they find that it is deficient, they can use enforcement tools, such as civil regulatory actions or referral to the U.S. attorney for criminal prosecutions. To avoid or lessen such penalties (and to avoid the spotlight a court challenge would generate), the financial institution may enter into a deferred prosecution agreement or a consent order that are both subject to minimal or no judicial review. This provision raises issues because it means that third parties are reviewing the private financial information of the client and forwarding it to the government, without notifying the client, and without anyone speaking on behalf of the account holders. The government can overcome potential challenges by the client just by showing that the information is relevant to an ongoing investigation. The most controversial issues in this area arise with regard to the customer information in a SAR, since the law prohibits notifying the client that his or her private information has been forwarded to the government.[33]

B. In the E.U.

In 1991 Europe adopted its First Anti-Money Laundering Directive (Council Directive 91/308/EEC, implemented by the member states two years later) to prevent the use of financial institutions for purposes of money laundering, and to assure that financial and economic transactions function properly. The First Anti-Money Laundering Directive required (1) financial institutions to perform due diligence controls before entering into any business relationship, (2) financial institutions to maintain for at least five years the documents collected for due diligence purposes, (3) international cooperation between financial institutions and regulators, and (4) less strict confidentiality rules when disclosing to the supervisory authorities suspected money laundering transactions, granting special protection to financial institutions that breached confidentiality rules by making such disclosure.

Ten years later, the Second Anti-Money Laundering Directive (Directive 2001/97/EC of the European Parliament and of the Council of the European Union of 4 December 2001) amended and updated the first one by including the 40 recommendations issued by the Financial Action Task Force (FATF) in 1989. The Second Directive expanded the definition of money laundering, included more underlying offenses, such as corruption, and included currency exchanges, money transmitters and investment firms within its scope of application.[34]

The Third Directive, Commission Directive 2006/70/EC of 1 August 2006, considered the FATF's revised recommendations of 2003. The Third Directive included so-called "designated non-financial businesses and professions" (such as lawyers, notaries, accountants, real estate agents, casinos) within its scope of application, as well as all providers of goods when payments are made in excess of €15,000 ("Obliged Entities"). Moreover, as a result of the terrorist attacks of September 11, 2001, and of Madrid, the Third Directive made the anti-money laundering regime of the European Union much stricter. The Directive Required the Obliged Entities to identify and verify the identity of customers (through Customer Due Diligence—CDD) and beneficial owners, to monitor their financial transactions, and to report suspicions of money laundering to the relevant Financial Intelligence Units (FIUs). The directive also introduced enhanced due diligence requirements for clients qualifying as Politically Exposed Persons (PEPs).

The Third Directive has been replaced by the Fourth Anti-Money Laundering Directive, Directive (E.U.) 2015/849 of the European Parliament and of the Council of 20 May 2015. The main changes brought about by the Fourth Directive are the following:

(1) a more risk-based approach to CDD, which would not allow simplified due diligence just because a counterparty is based in a country included in the member state's list of "equivalent" third countries, but which would also take into account the industry's risk level;

(2) expansion of the definition of PEP to include domestic, foreign, and international organization PEPs (the rule applies also to, e.g., directors of state-owned enterprises and members of the judiciary);

(3) addition of tax crimes to the underlying offenses for money laundering; and

(4) a lowered threshold to trigger anti-money laundering procedures (from €15,000 to €7,500, with the possibility that member states could set even lower thresholds.[35]

However, the most relevant change for purposes of this analysis is the requirement that financial institutions implement privacy protections in their AML compliance operations:

> Member states shall require obliged entities that are part of a group to implement group-wide policies and procedures, including data protection policies and procedures for sharing information within the group for AML/CFT purposes. Those policies and procedures shall be implemented effectively at the level of branches and majority-owned subsidiaries in member states and third countries.[36]

The inclusion of data protection in the 2015 Fourth Anti-Money Laundering Directive shows that the financial services industry (starting from the implementation date of the Directive) will no longer be able to rely on the exceptions set forth in Directive 95/46/EC, first, and then in the General Data Protection Regulation, as discussed in part I.B. above.[37]

III. The Relationship Between Anti-Money Laundering and Privacy Regulations in the U.S. and in the E.U.: Differences and Attempts at Harmonization: The FATF Recommendations

Financial data in the U.S. belongs to the holder, rather than to the person that the data refer to. Therefore, this property-based model gives financial institutions control over their service agreements. Once an individual signs up for certain services with a financial institution, his or her data automatically belong to the financial institution unless the individual informs the company otherwise.

"Once an individual signs up for certain services with a financial institution, his or her data automatically belong to the financial institution unless the individual informs the company otherwise."

Privacy law in the U.S. is very flexible and business-friendly; however, it is also fragmented, and this can create overlaps. Also, firms have to respond to different regulators according to their products and the states in which they do business. All of this can lead to inconsistent application of the law and unclear enforcement.[38] For example, ten state constitutions specifically mention some privacy rights,[39] 26 states have certain rules mandating destruction of data, and many have data breach notification rules.[40] All laws on financial data protection in the U.S. have restrictions of access for data collected and processed in investigations.[41] However, unlike the E.U., U.S. anti-money laundering regulation does not require financial institutions to implement data protection rules in their AML compliance policies and procedures.

On the other hand, the E.U. model keeps data ownership strictly attached to the individual the data refer to, almost like a human right. Moreover, once an individual signs up for services, he or she can agree or disagree to have the financial institution use his or her data for purposes other than the provision of the services he or she signed up for.

Although the U.S. and the E.U. thus differ in data protection regulation, they are similar as far as anti-money laundering regulation is concerned, since the latter was developed as part of an effort by the G7[42] to fight money laundering in drug trafficking.

Both regimes are dispersed. The U.S. regime is dispersed because, as discussed above, financial institutions are governed by different regulators according to their function. In fact, they can be regulated by the Securities and Exchange Commission, Federal Reserve, Federal Deposit and Insurance Corporation, Office of the Comptroller of the Currency, National Credit Union Administration, as well as by state authorities. The E.U. regime is dispersed because its main legislative tool, i.e., directives, needs to be implemented by each member state, by definition allowing for discretion.

In order to *"set standards and promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system,"*[43] the G7 summit that was held in Paris in 1989 created the Financial Action Task Force on money laundering. FATF was originally comprised of the G7 member states, the European Commission, and eight other countries. In 1991 and 1992 its membership was expanded to 28 members, in 2000 to 31 members, and since then it has expanded to 37 members. FATF initially issued 40 Recommendations to cover anti-money laundering measures, and added nine more after the attacks of September 11, 2001, in order to incorporate terrorist financing. These nine additional Recommendations were merged into the original 40.

The Recommendations are broad in order to address differences among market practices and states/countries, and this leads to variances among national legislations; however, *"the FATF produced shared operational and definitional foundations whose differences are trivial compared to those found among transatlantic privacy regimes."*[44]

The FATF Recommendations can be analyzed by an appraisal of U.S. and E.U. anti-money laundering and privacy legislations so as to highlight the differences between such regimes and the consequent obstacles in implementing consistent compliance programs in multinational groups. Three Recommendations are significant in that respect.

A. FATF Recommendation 1: Risk-Based Approach

Recommendation 1 states that "Countries should apply a risk-based approach to ensure that measures to prevent or mitigate money laundering and terrorist financing are commensurate with the risks identified."

A risk-based approach—rather than a rules-based approach—helps multinational financial institutions make their compliance programs more consistent. However, a risk-based approach allows for some discretion on the company's side in assessing levels of risk and the relevant control. Therefore, this exposes financial institutions to scrutiny from regulators that will evaluate how financial institutions have assessed risk.[45] In certain instances, this could bring about a "technology or methodology race,"[46] in which supervisory authorities make the methodologies utilized by the various financial institutions compete with each other. This can be positive for the whole industry because it could lead financial institutions to stay up-to-date with the latest best practices.

As said, the risk-based approach brings uniformity to the compliance programs of multinational firms, but problems arise when one juxtaposes the AML risk-based approach with the E.U. data protection regime, which is rules-based and has very few exceptions.[47] Moreover, as also already indicated, the U.S. regime does not require privacy concerns to be included in anti-money laundering programs. These differences constitute obstacles to the implementation of consistent AML compliance programs in multinational financial institutions.

B. FATF Recommendation 2: Cooperation with Financial Intelligence Units and Law Enforcement Agencies

The USA PATRIOT Act § 314(a)[48] allows U.S. and foreign law enforcement agencies to submit information requests to FinCEN. FinCEN then figures whether the request is related to money laundering or terrorist financing, and then notifies the financial institutions of the request. Financial institutions are then mandated to make a search of client accounts and transactions, and they have to provide a response within two weeks, but only if they have positive matches. If the Law Enforcement Agencies want to check the information related to a match, they have to use "*appropriate legal means,*" and information concerning such requests cannot be disclosed to foreign branches or affiliates.[49]

The above-described process brings the USA PATRIOT Act §314(a) somewhat in line with the principles underlying E.U. privacy regulation (which favors specific, rather than massive, requests).[50] However, the fact that the lists of suspected subjects held by the government or by financial institutions are not consistently updated if an investigation is dropped or a prosecution is declined, for example, is not in line with European data protection concerns.

In the E.U., financial institutions must "*respond fully and speedily to enquiries from their Financial Intelligence Units or from other authorities, in accordance with their national law.*"[51] However, such national laws may have inconsistencies,[52] which make it more complicated for multinational groups to comply with all relevant regulations, since they need to know what can and cannot be disclosed to regulators in each jurisdiction in which they operate.

Besides that, the main obstacles for multinational financial institutions—with regard to cooperation with Financial Intelligence Units and Law Enforcement Agencies—trying to implement consistent group-wide anti-money laundering compliance programs, are the following:

(1) while the Fourth Anti-Money Laundering Directive requires financial institutions headquartered in the E.U. and operating in the U.S. to implement SARs and data-sharing programs with E.U. criteria as regards anti-money laundering, the E.U. data that are stored in the U.S. can be acquired by U.S. regulators (through, e.g., subpoenas, Foreign Intelligence Surveillance Act requests, and National Security Letters).[53] However, financial institutions cannot disclose that SAR investigations are being carried on (and are protected against civil law suits),[54] and, with the exception of certain individuals in the compliance department, no one–including the individuals the investigations refer to–can be notified about such actions;[55]

(2) U.S. regulators can keep the data regarding their investigations from 2 to 75 years, and this is longer than allowed by E.U. laws;[56]

(3) U.S. regulators can also seize data from foreign accounts. In fact, the USA PATRIOT Act § 319(b) states that the Attorney General or the Secretary of the Treasury can "*issue a summons or subpoenas to any foreign bank that maintains a correspondent account in the U.S. for records relating to such accounts, including records outside the U.S. relating to the deposit of funds into the foreign bank.*"[57]

C. FATF Recommendation 18: enterprise/group data sharing (SARs)

The discrepancies between the U.S. and the E.U. regimes in this area are some of the greatest hindrances to the implementation of a consistent group-wide AML compliance program for multinational financial institutions.

In the E.U., anti-money laundering prevention is based on a territoriality principle, i.e., a financial institution has to abide by the AML rules of the country in which the office is located. As a consequence, a group with offices in more than one E.U. member state is required to comply with the regulations of more than one E.U. member state.[58] However, the General Data Protection Regulation permits data-sharing among "a group of undertakings or institutions affiliated to a central body," even though based in different countries, provided that the country with which the information is shared has adequate privacy protections. However, despite attempts at harmonization by the E.U., regulatory differences remain among E.U. member states, and as no guidance is provided by the E.U. to deal with them, this is left to the member states.[59]

In the U.S., the data regarding SARs and the relevant investigations cannot be shared by the depository institution with the group. U.S. financial institutions can share the information regarding the existence of a SAR with the controlling companies, but they cannot share that information with their affiliates and (foreign) branches (however, the information related to the fact underlying a SAR can be shared both ways under certain conditions).[60] Foreign branches can share information regarding SARs and the relevant investigations only with their controlling company.[61]

The impossibility for U.S. financial institutions to share SARs with foreign branches is a great obstacle to the implementation of consistent group-wide anti-money laundering programs in financial institutions with a presence in both the U.S. and the E.U.

Some commentators maintain that FinCEN should recognize FATF countries as having appropriate AML standards for quality reporting within a group, and allow disclosure of SARs information among those countries provided that regulated confidentiality agreements are in place (the E.U. has recognized the U.S. AML regime as adequate to allow European firms to share data with U.S. branches and affiliates). However, the U.S. authorities probably believe that such a solution could be dangerous because no foreign AML law may be up to U.S. standards.[62]

IV. Conclusions

This analysis suggests that E.U. financial privacy regulation is more extensive than in the U.S. (although the U.S. is stricter with regard to confidentiality of SARs), and the inclusion of data protection in the Fourth Anti-Money Laundering Directive is just one of the most recent examples of this.

This inclusion is a sign of how privacy concerns permeate the European Union regime. Such concerns reflect the very dissimilar underlying principles and sensibilities to privacy in the U.S. and the E.U., which differ because the prevailing legal and social values of the respective societies differ. In the E.U., privacy is viewed as an aspect of dignity—as the right to control the information disclosed about oneself–while in the U.S. it is viewed as an aspect of freedom, especially against the government—as the right to liberty from intrusions by the state.[63] "*American anxieties thus […] tend to be anxieties about maintaining a kind of private sovereignty within [one's] own walls.*"[64]

This is probably the underlying reason why in the E.U., when one subscribes to online services from a bank, for example, he or she has the option to consent or not consent to the bank's using his or her data for purposes other than the provision of the services he or she signed up for, while in the U.S., once one signs up for services, his or her data belong to the bank.

This is possibly also the cause of the more extensive "interferences" of E.U. privacy regulation in the financial industry, and these fundamentally different sensibilities are the reason for the lack of legal guidance on how to deal with the regulatory discrepancies. Since these discrepancies originate from such rooted cultural differences, there is not going to be much legal guidance for banks to rely on in trying to deal with them in the near future.

Therefore, multinational financial institutions should themselves set their own harmonization standards and take the opportunity to establish best practices, by interacting with regulators.

First, in order to implement robust AML controls in line with E.U. data protection law such as the Fourth Anti-Money Laundering Directive, multinational companies should set policies and procedures that include the European rules on privacy law and indicate how to share information within the group for AML and CTF purposes, and such policies and procedures should also be applied consistently to branches and majority-owned subsidiaries in third countries.

One does not know, yet, what such policies and procedures will look like. In fact, although the deadline for implementation of the Fourth Directive was June 27, 2017, member states are either late in the transposition process, or in transposing the Directive they have set further deadlines for corporations to draft the policies and procedures.[65]

The rationale of the requirement is ensuring that corporations with branches/subsidiaries in countries with less onerous AML and/or privacy requirements comply with the E.U. standard of AML and data protection regulation. However, in the case of the U.S., if on one hand, as described above, the country has a looser privacy regulation than the E.U. does, its regulation of AML/CTF is probably stricter than elsewhere. Hence, multinational companies with a presence in both the U.S. and the E.U. should probably—regardless of where their headquarters are—adhere to U.S. AML/CTF regulation and E.U. data protection regulation.

Nevertheless, in certain instances that might be much easier to say than to do, especially when some elements of one regulatory area (e.g. anti-money laundering) for the U.S. are not easily compatible with elements of the same regulatory area for the E.U., or vice-versa (e.g., as stated earlier, the fact that the AML regime is risk-based while the European privacy regime is rule-based, or the fact that there are inconsistencies with regard to cooperation with Financial Intelligence Units and Law Enforcement Agencies), or when for the same element there is no uniformity even among different states in the U.S. or different countries in the E.U.

Therefore, in order to manage the above problems and obtain a better integration between privacy and anti-money laundering regulations, as well as between each of those regulations in the U.S. and in the E.U., respectively, corporations should implement some organizational changes, such as:

(1) creating compliance teams that integrate professionals in the areas of privacy, information technology, and anti-money laundering/counter-terrorism financing;

(2) creating specific positions to coordinate the above three areas and to facilitate communication among them;[66]

(3) providing compliance employees with training in all of the above areas, as well as in investigative intelligence techniques; and

(4) conducting risk assessments at the group level, taking into account both anti-money laundering and data protection from a legal, technical, and operational perspective.[67]

Endnotes

1. This article analyzes the situation as of the date of submission to NYSBA, i.e., Aug. 15, 2017.
2. U.S. Const. amend. IV.
3. Louis. D. Brandeis & Samuel. D. Warren, *The Right to Privacy*, 4 Harv. L. Rev. 193 (Dec. 15, 1890).
4. The former later became U.S. Supreme Court Justice and used the language of the article to express his dissent from the majority holding in *Olmstead v. United States* (277 U.S. 438 (1928)), in which the Court held that the use of wiretapped private telephone conversations, obtained by federal agents without judicial approval and subsequently used as evidence, did not constitute a violation of the defendant's rights provided for in the Fourth and Fifth Amendments. *See* Robert Olejar, *Anti-Money Laundering v. the Right to Privacy*, 251 N.J. Law. 56 (Apr. 2008).

5. Brandeis & Warren, *supra* note 3, at 193.

6. *See* Sec'y Advisory Comm. on Automated Pers. Data Sys., U.S. Dep't of Health, Educ. & Welfare, Records, Computers, and the Rights of Citizens 53–64 (1973). Europe—as will be pointed out hereinafter—was the first to implement a privacy regime; the U.S. was the first to create the above-mentioned FIPPs, which influenced the work of the OECD and Council of Europe.

7. Olejar, *supra* note 4, at 57.

8. 416 U.S. 21, 33–34 n.7 (1974).

9. *See id.*; 31 U.S.C. §§ 5311–5332 (2001); 31 C.F.R. § 103 (2010).

10. 425 U.S. 435 (1976).

11. *Id*. at 442–43.

12. 425 U.S. 391 (1976).

13. *Id*. at 401.

14. *See id*. at 411.

15. Michelle Frasher, *Multinational Banking and Conflicts Among U.S.-E.U. AML/CTF Compliance & Privacy Law: Operational & Political Views in Context* 10 (SWIFT Inst., Working Paper No. 2014-008, 2016).

16. H.R. Rep. No. 95-1383, at 34 (1978), *reprinted in* 1978 U.S.C.C.A.N. 9273, 9306.

17. *See* 12 U.S.C. §§ 3402, 3403(b).

18. *SEC et al. v. Jerry T. O'Brien, Inc., et al.*, 467 U.S. 735, 745 (1984).

19. *See* James Q. Whitman, *The Two Western Cultures of Privacy: Dignity versus Liberty*, 113 Yale L.J. 1151, 1180–89 (Jan. 1, 2004).

20. *See* Corinna Coors, *Headwind from Europe: The New Position of the German Courts on Personality Rights after the Judgment of the European Court of Human Rights*, 11 German L.J. 527, (2010); *see also* Helge Dedeck & Martin J. Schermaier, *German Law*, *in* Elgar Encyclopedia of Comparative Law 349–370 (Jan M. Smits ed., Edward Elgar Publishing 2nd ed. 2012).

21. Convention for the Protection of Human Rights and Fundamental Freedoms art. 8, Nov. 4, 1950, E.T.S. No. 1.

22. *See* Gloria González Fuster, The Emergence of Personal Data Protection as a Fundamental Right of the E.U. (Springer 2014).

23. Directive 95/46/EC, of the European Parliament and of the Council of 24 October 1995 on the Protection of Individuals with Regard to the Processing of Personal Data and on the Free Movement of Such Data, 1995 O.J. (L 281) 31.

24. *See id.* at 34–37 (Recitals 30, 32, 34, 35, 36, 45, 58); *see also id.* at 40–41, 46 (Sections II, III, and Art. 26 on derogations).

25. It is easier to bring harmonization through a regulation because, as opposed to a directive—which needs to be implemented by each member state, and, thus, allows for discretion and asymmetries—the former is immediately effective as is and does not allow implementation autonomy of member states.

26. *See* Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the Protection of Natural Persons With Regard to the Processing of Personal Data and on the Free Movement of Such Data, and Repealing Directive 95/46/EC, 2016 O.J. (L 119) 1, 7–8 (Recital 40: "In order for processing to be lawful, personal data should be processed on the basis of the consent of the data subject concerned or some other legitimate basis, laid down by law, either in this Regulation or in other Union or Member State law as referred to in this Regulation, including the necessity for compliance with the legal obligation to which the controller is subject or the necessity for the performance of a contract to which the data subject is party or in order to take steps at the request of the data subject prior to entering into a contract.").

27. *What Is Money Laundering?*, Int'l Compliance Ass'n, https://www.int-comp.org/careers/a-career-in-aml/what-is-money-laundering/ (last visited Aug. 15, 2017).

28. *See* 31 C.F.R. § 103.28 (2010).

29. *See* 31 U.S.C. § 5318(g) (2001).

30. *See* 31 U.S.C. § 5318(1) (2001).

31. *See* Frederick E. Curry III, *Anti-Money Laundering: A New Sense of Urgency*, Deloitte Transactions and Business Analytics, LLP (Dec. 3, 2014) http://slideplayer.com/slide/4716626/.

32. *See* 31 U.S.C. §§ 310, 5318(h) (2001).

33. Olejar, *supra* note 4, at 61.

34. *History of the European Union Anti-Money Laundering and Financing of Terrorism Directives*, Anti-Money Laundering Forum, http://www.anti-moneylaundering.org/Europe.aspx (last visited Aug. 15, 2017).

35. Jennifer Hanley-Giersch, *Europe's Upcoming Fourth AML/CFT Directive*, p. 58, http://files.acams.org/pdfs/2015/Europes_Upcoming_Fourth_AML_CFT_Directive.pdf (last visited Sept. 9, 2017).

36. *See* Art. 45, Fourth Anti-Money Laundering Directive.

37. Frasher, *supra* note 15, at 3.

38. *Id.*

39. I.e., Washington, South Carolina, Montana, Louisiana, Illinois, Hawaii, Florida, California, Arizona, Alaska. *See Ninth Circuit Partially Reinstates California Financial Privacy Law's Affiliate Sharing Opt Out Provisions*, WILMERHALE (2008), https://www.wilmerhale.com/pages/publicationsandnewsdetail.aspx?NewsPubId=89594.

40. *US State Data Breach Charts*, BAKERHOSTETLER https://www.bakerlaw.com/files/Uploads/Documents/Data%20Breach%20documents/Data_Breach_Charts.pdf (last visited Sept. 9, 2017).

41. Fair Credit Reporting Act of 1970 15 USC §§ 1681(b), 1681(u), 1681(v), Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 12 U.S.C. § 5468, Gramm-Leach-Bliley Act of 1999 15 USC § 6802, Right to Financial Privacy Act of 1978 12 USC §§ 3412, 3420.

42. Composed of Japan, Canada, Italy, Germany, France, United Kingdom, and United States.

43. *See* FATF website: http://www.fatf-gafi.org/about/ (last visited Sept. 9, 2017).

44. Frasher, *supra* note 15, at 17.

45. *See Guide to US Anti-Money Laundering Requirements: Frequently Asked Questions*, 6th ed., Protiviti, https://www.protiviti.com/sites/default/files/united_states/insights/guide-to-us-aml-requirements-6thedition-protiviti_0.pdf (last visited Sept. 9, 2017).

46. Unger Brigitte et al., *How to Dodge Drowning in Data? Rule- and Risk-Based Anti-Money Laundering Policies Compared*, *Review of Law and Economics*, 953-85 (Vol. 5 2009).

47. Frasher, *supra* note 15, at 18.

48. 31 CFR §1010.520 (Information Sharing between Federal Law Enforcement Agencies and Financial Institutions); 31 CFR §1010.540 (Voluntary Information Sharing among Financial Institutions); FinCEN 314(a) Factsheet.

49. *Law Enforcement Information Sharing with the Financial Industry*, FinCEN, https://www.fincen.gov/statutes_regs/patriot/pdf/leinfosharing.pdf (last visited Sept. 9, 2017).

50. *See* the General Data Protection Regulation, Recital 24(c): public authority requests "*should always be written, reasoned and occasional and should not concern the entirety of a filing system or lead to the interconnection of filing systems.*"

51. *See* Fourth Anti-Money Laundering Directive, Recital 57, Art. 42.

52. Even the names of the reports to be filed can change according to the jurisdiction: *e.g.*, Currency Transactions Reports (CTRs), Unusual Transaction Reports (UTRs), Suspicious Activity Reports (SARs), Suspicious Transaction Reports (STRs); *see* Frasher, *supra* note 15, at 20.

53. Francesca Bignami, *The US Legal System on Data Protection in the Field of Law Enforcement. Safeguards, Rights and Remedies for E.U. Citizens*, 2015 http://www.europarl.europa.eu/RegData/etudes/STUD/2015/519215/IPOL_STU%282015%29519215_EN.pdf (last visited Sept. 9, 2017); *see also* 31 CFR §1010.670 (Summons of Subpoenas of Foreign Bank Records; Termination of Correspondent Relationship).

54. The Annunzio-Wiley Anti-Money Laundering Act and the USA PATRIOT Act § 351 protect financial institutions from civil liability.

55. Charles Doyle, *National Security Letters in Foreign Intelligence Investigations: Legal Background*, Congressional Research Service (Jul. 30, 2015), https://fas.org/sgp/crs/intel/RL33320.pdf.

56. Rachel Levinson-Waldman, *What the Government Does with Americans' Data*, Brennen Center for Justice at New York University School of Law, (2013) https://www.brennancenter.org/sites/default/files/publications/Data%20Retention%20-%20FINAL.pdf

57. Daniele Canestri, *Fourth E.U. AML Directive: What Is Missing? Section 319 PATRIOT Act and the new E.U. AML Directive*, *European Journal of Crime*, Criminal Law and Criminal Justice, 23/3, 2015.

58. *Compliance with the Anti-Money Laundering Directive by Cross-Border Banking Groups at Group Level*, Staff Working Paper, EUROPEAN COMMISSION (2009), http://ec.europa.eu/internal_market/company/docs/financial-crime/compli_cbb_en.pdf.

59. Frasher, *supra* note 15, at 35.

60. *See* 31 CFR § 1020.320(e)(ii)(A)(2).

61. FinCEN et. al., *Interagency Guidance on Sharing Suspicious Activity Reports with Head Offices and Controlling Companies* (2006), https://www.fincen.gov/sites/default/files/guidance/sarsharingguidance01122006.pdf; FinCEN et al., *Sharing Suspicious Activity Reports by Depository Institutions with Certain US Affiliates* (2010), https://www.fincen.gov/sites/default/files/shared/fin-2010-g006.pdf.

62. *The Clearing House LLC Guidance on SAR and Underlying Data Sharing*, TCH 2015.

63. Robert C. Post, *Three Concepts of Privacy*, 89 GEO. L.J. 2087 (2001).

64. Whitman, *supra* note 19, at 1162.

65. This might be also a strategy. In fact, sometimes member states introduce their own implementing legislation only after the newest Directive on the same topic (in this case, the Fifth Anti-Money Laundering Directive) is discussed and settled by the E.U. Parliament. The Fifth AML Directive is expected to be issued in the fourth quarter of 2017; however, certain aspects of the Fourth AML Directive have already been implemented by certain member states (*e.g.*, Ireland, with its so-called Beneficial Ownership Regulations 2016, that went into effect on Nov. 15, 2016).

66. *Annual Privacy Governance Report 2016*, International Association of Privacy Professionals and Ernst&Young, https://iapp.org/media/pdf/resource_center/IAPP-2016-GOVERNANCE-SURVEY-FINAL2.pdf (last visited Sept. 9, 2017). The report shows that finance and privacy employees do not often work together, and the majority of professionals in privacy work in legal departments, often isolated from the operations departments.

67. Frasher, *supra* note 15, at 53-54.

Client Update
LabCFTC Primer: The CFTC's Views on Regulation of Virtual Currencies

By Byungkwon Lim and Gary E. Murphy

LabCFTC, an initiative launched by the U.S. Commodity Futures Trading Commission (CFTC) in May 2017, recently issued its Primer on Virtual Currencies (the "Primer").

The Primer summarizes a number of points that are generally consistent with the market's current understanding of the CFTC regulatory landscape. It provides a good overview of the development of the CFTC's claim to jurisdiction over certain transactions in virtual currencies. It also provides an opportunity to take stock of open issues that have not yet been resolved by the CFTC.

Background on Virtual Currencies

After providing a brief introduction to virtual currencies (including Bitcoin in particular) and the features of blockchains, the Primer points out that:

- Bitcoin and other virtual currencies have been determined by the CFTC to be commodities.
- The CFTC has jurisdiction over virtual currency transactions if they involve derivatives or if there is fraud or manipulation involving a virtual currency traded in interstate commerce.
- Outside of instances of fraud or manipulation, the CFTC does not generally oversee spot or cash market exchanges and transactions involving virtual currencies that do not utilize margin, leverage or financing.

Virtual Currencies as Commodities

The Primer reiterates the CFTC's view that the definition of "commodity" in the Commodity Exchange Act (the "CEA") is broad and includes "all services, rights and interests…in which contracts for future delivery are presently or in the future dealt in." The CFTC first found that Bitcoin and other virtual currencies are commodities in 2015.

Coinflip

From March 2014 to August 2014, Coinflip, Inc. and its CEO, Francisco Riordan, operated an online trading facility called Derivabit that designated numerous put and call options on Bitcoin as eligible for trading on the Derivabit platform. The CFTC found that such activity constituted the operation of a facility for the trading or processing of "swaps" (as defined in section 1a(47) of the CEA) without registration under the CEA and the CFTC regulations as a swap execution facility (SEF) or designated contract market (DCM). The CFTC also found that, because Bitcoin and virtual currencies are commodities, Coinflip violated sections of the CEA and the CFTC regulations that prohibit a person from offering to enter into, entering into, confirming the execution of or otherwise conducting any activity related to any commodity option transaction without meeting certain additional requirements.

TeraExchange

In the TeraExchange matter, the CFTC issued an order holding that TeraExchange LLC, a provisionally registered swap execution facility (SEF), had actively arranged two offsetting non-deliverable forwards based on Bitcoin and U.S. dollars, which constituted both wash trades and prearranged trades in violation of the CEA. The CFTC found that, in doing so, Tera violated its obligation under the CEA and the CFTC regulations to enforce rules prohibiting wash trading and prearranged trading on its SEF platform.

Bitcoin is certainly a commodity subject to the CEA, particularly in light of the CME's planned listing of Bitcoin futures for trading. The issue is whether all cryptocurrencies should be treated as commodities. Altcoin and Litecoin, which have no functionality other than as a store of value and a purported medium of exchange, are commodities, even if no futures on either of them are currently traded. Ethereum tokens (ETH) started out, and are actively used, as utility tokens to power smart contracts on the Ethereum protocol, but they are actively traded and purchased and held in many instances by those who have no plan or intention of using them to put any smart contracts on the Ethereum protocol. In other words, ETHs are utility tokens as well as virtual currencies, and the CFTC certainly treats them as commodities. The same can be said about Ripple tokens (XRP).

A more difficult question is whether a utility token or security token that has functionality other than as a store of value or medium of exchange should be treated as a

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commodity if a large number of investors hold it as an investment. In addition, given the evolution of ETH from a pure utility token to a combination of utility token and virtual currency, a pure utility token may evolve into a virtual currency and may be regarded as a commodity. In that case, it is not clear at what point such a token will be considered as a commodity. It is possible that the CFTC may ultimately take the view that all blockchain tokens are commodities since the early buyers of tokens are almost invariably investors.

Permitted Activities

While clearly not exhaustive, the Primer provides several examples of activities involving virtual currencies that are permitted under the CEA and CFTC regulations. Permitted activities include:

- The listing of a Bitcoin swap for trading by "eligible contract participants" on a SEF.

  The CFTC uses TeraExchange as an example of such a permitted activity. Although TeraExchange consented to an order by the CFTC in 2015 instituting sanctions for its failure to enforce wash trading and prearranged trading rules (as discussed above), it is used by LabCFTC here as an example of a permitted listing of Bitcoin swaps for trading on a registered (or provisionally registered) SEF platform by eligible contract participants.

- The establishment of a derivatives exchange as a DCM listing binary options based on a Bitcoin price index for trading by customers, including retail customers.

  With respect to the establishment of a derivatives exchange as a DCM, the Primer points to NADEX (the North American Derivatives Exchange Inc.). NADEX listed binary options based on the Tera Bitcoin Price Index for trading on its DCM from November 2014 to December 2016.

- The listing of digital currency options by a registered SEF for trading and the clearing and settlement of transactions in such options through a derivatives clearing organization (DCO).

  In this last category, the Primer provides the example of LedgerX. In July 2017, LedgerX, LLC became registered as a SEF and as a DCO, and it intends to list digital currency options for trading by eligible contract participants. The CFTC's order of registration as a DCO indicates that LedgerX is permitted to clear fully collateralized digital currency swaps and that a contract cleared by LedgerX will be considered fully collateralized if LedgerX holds, at all times, funds sufficient to cover the maximum possible loss a counterparty could incur upon liquidation or expiration of the contract, in the form of the required payment.

Prohibited Activities

The Primer also provides several examples of prohibited activities, including:

- Price manipulation of a virtual currency traded in interstate commerce.
- Pre-arranged or wash trading in an exchange-traded virtual currency swap or futures contract.
- Trading of a virtual currency futures or option contract or swap on a U.S. domestic platform or facility that has not registered as a SEF or a DCM.
- Certain schemes involving virtual currencies marketed to retail customers, such as off-exchange financed commodities transactions with persons who fail to register with the CFTC.

LabCFTC does not call out specific names here. But the references to pre-arranged or wash trading and trading of options on an unregistered domestic platform seem to line up well with the TeraExchange and Coinflip matters discussed previously.

LabCFTC's references to price manipulation may relate to statements made by one or more CFTC Commissioners as far back as 2014. For example, former Commissioner Mark Wetjen indicated in an article in 2014 that the CFTC would have authority to bring enforcement actions against anyone who attempts to manipulate a virtual currency.

Bitfinex

The Primer's reference to schemes involving virtual currencies marketed to retail customers is based on the Bitfinex matter. Bitfinex was, at the time, a British Virgin Islands company that was not registered in any capacity with the CFTC. Bitfinex was operating an online platform for exchanging and trading virtual currencies. Unlike Coinflip and TeraExchange, which both involved derivatives, Bitfinex did not list or permit the trading of derivatives (such as futures, options or swaps). Rather, Bitfinex facilitated spot transactions in virtual currencies.

The Bitfinex platform permitted users, including those who did not meet the definition of eligible contract participant or eligible commercial entity, to borrow funds from other users on the platform in order to trade Bitcoins on a leveraged, margined or financed basis. The CFTC found that during the relevant period, Bitfinex did not "actually deliver" Bitcoins to the traders who purchased them because the purchased Bitcoins either were held in Bitcoin deposit wallets that Bitfinex owned and controlled until such time as outstanding loans and fees were paid in full or were held in multi-signature wallets established by a third party over which Bitfinex retained control of the private keys until such time as outstanding loans and fees were paid in full. The CFTC also concluded that Bitfinex's accounting for individual customer interests in its own database was insufficient to constitute "actual delivery."

The CFTC's conclusion regarding absence of "actual delivery" is significant because that is the basis for the CFTC's enforcement action against Bitfinex. Section 2(c)(2)(D) of the CEA provides that an agreement, contract or transaction in any commodity that is (i) entered into with, or offered to, a person that is not an eligible contract participant (or eligible commercial entity) and (ii) entered into, or offered, on a leveraged or margined basis, or financed by the offeror, the counterparty or a person acting in concert with the offeror or counterparty on a similar basis, must be executed and effected on a DCO. However, any such agreement, contract or transaction that results in "actual delivery" of the commodity within 28 days from execution is exempt from such provisions, so long as it is not a swap, future or option.

Because the trading platform managed by Bitfinex was not a registered DCO and, as noted above, the CFTC concluded that there was no actual delivery of Bitcoin in a financed transaction executed on such platform, Bitfinex violated section 2(c)(2)(D) of the CEA. The CFTC also found that Bitfinex violated the CEA by failing to register as a futures commission merchant in connection with the solicitation or acceptance of orders for, and the acceptance of money in connection with, retail commodity transactions.

Implications for Virtual Tokens and Icos

Primer references the recent report of the Securities and Exchange Commission (SEC) regarding the DAO (the "DAO Report"). The DAO is an example of a Decentralized Autonomous Exchange, which is a virtual organization embodied in computer code and executed on a blockchain or other type of distributed ledger. Investors in the DAO exchanged ETHs for virtual "DAO Tokens" to fund projects in which the investors would share in anticipated earnings. The DAO Tokens could be resold on web-based platforms.

The SEC determined that DAO Tokens are securities under the federal securities laws. In reaching that conclusion, the SEC employed a facts-and-circumstances test originally set forth in the U.S. Supreme Court decision in *SEC v. W.J. Howey Co.*

In the Primer, LabCFTC states that there is no inconsistency between the SEC's analysis in the DAO Report concluding that certain virtual tokens (or the arrangements pursuant to which they are offered or issued) are securities and the CFTC's determination that virtual currencies are commodities and that virtual tokens may be commodities or derivatives contracts depending on the particular facts and circumstances. As the SEC and the CFTC both have from time to time asserted jurisdiction over a particular financial instrument and they share jurisdiction over certain financial instruments (such as mixed swaps), this statement is not a surprise. Some blockchain tokens will definitely fall under the dual jurisdiction of the CFTC and SEC.

Virtual Currency Risks

The Primer closes with a summary of risks of virtual currencies, which primarily seems to be aimed at potential investors in virtual currencies and similar investments. These include operational risks, cybersecurity risks, speculative risks and fraud and manipulation risks.

Operational Risk

The Primer points out that many of the virtual currency platforms are not subject to the supervision that applies to regulated exchanges. For example, if a platform engages in only certain spot or cash market transactions and does not utilize margin, leverage or financing, such platform may be subject to federal and state money transmission and anti-money laundering laws, but it is not required to follow any of the rules that would apply to the operation of a regulated exchange.

The Primer also notes that some virtual currency platforms may be missing critical system safeguards and customer protection-related systems. As such, customers could lose some or all of their virtual assets.

Cybersecurity Risk

LabCFTC notes that some platforms may commingle customer assets in shared accounts (whether at a bank for fiat currency or a digital wallet for virtual currency), and this may affect whether or how a customer can withdraw currency. The Primer also notes that depending on the structure and security of a digital wallet, some accounts may be vulnerable to hacks, which could result in the theft of virtual currency.

Speculative Risk

The Primer indicates that the virtual currency marketplace has been subject to substantial volatility and price swings, and an individual or coordinated group trading a large amount of virtual currency at once could affect the price. The Primer also notes that periods of high volatility with inadequate trading volume may create adverse market conditions, leading to harmful effects such as customer orders being filled at undesirable prices.

LabCFTC also points to the fact that some advertisements may seem to promise guaranteed returns, and notes that this can be a common tactic with fraudulent schemes.

Fraud and Manipulation Risk

The Primer asserts that unregistered virtual currency platforms may not be able to protect adequately against market abuses by other traders. In this regard, LabCFTC points out that recent news articles discuss potential "spoofing" activity and other manipulative behavior that can affect prices negatively.

The Primer also asserts that some virtual currency platforms may be selling virtual currency directly from the platform's own account. Such transactions may give the platform unfair advantages and sometimes could resemble fraudulent "bucket shop" schemes.

Finally, LabCFTC notes that there is a risk of Ponzi schemers and fraudsters seeking to capitalize on the current attention focused on virtual currencies. Although the Primer does not give specific examples, we note that the CFTC recently issued a press release announcing the filing of its first anti-fraud enforcement action involving Bitcoin. In this action, the CFTC charges a Brooklyn-based company and its CEO with operating a Bitcoin Ponzi scheme in which they fraudulently solicited monies from investors, purportedly for placement in a pooled commodity fund making Bitcoin investments. The CFTC alleges that, in fact, the trading strategy was fake, purported performance reports were false and payouts to investors actually consisted of other customers' misappropriated funds. The press release includes a statement by James McDonald, the CFTC's Director of Enforcement, that part of the CFTC's continued commitment to facilitating market-enhancing FinTech innovation "includes acting aggressively and assertively to root out fraud and bad actors in these areas."

Unresolved and Developing Points

Another Look at Bitfinex

The Primer was silent on some unresolved points. For example, the Bitfinex matter made it clear that the CFTC intends to assert jurisdiction over certain retail commodity transactions that involve financing, leverage or margin and which do not result in actual delivery of the underlying virtual currency within 28 days. Although the CFTC determined that actual delivery had not occurred in the Bitfinex scenario, the CFTC did not explicitly set forth circumstances that would constitute actual delivery.

This raises questions as to what constitutes actual delivery of Bitcoin or other virtual currencies. For example, does actual delivery occur when ownership of the virtual currency is changed on a third party's books, or only when a transfer happens on the blockchain? If the latter, what constitutes the completion of a transfer on the blockchain in light of the complexities of cryptographic key management? These key questions remain unresolved. But CFTC Commissioner Brian Quintenz recently indicated in remarks at a trade conference that "the CFTC is working very hard to provide a suitable response to that question."

The Bitfinex order suggests that one approach would be to require that the virtual currency be transferred to a deposit wallet for which the recipient controls the private key(s). However, representatives for industry participants have identified potential weaknesses with this approach as the sole determinant of delivery. For example, there is no inherent attribute of the blockchain that defines how a private key may be used to authorize or effect a transaction. Instead, private keys are a tool used by the parties to effectuate the parties' contractual agreements when they choose to transfer property using the blockchain.

Coinbase Flash Crash

The Primer also made no mention of an apparent investigation into a June 2017 flash crash on Coinbase's GDAX platform.

Although neither Coinbase nor the CFTC has made the letter public, unofficial sources indicate that the CFTC recently sent a letter to San Francisco-based Coinbase Inc. requesting information about a June 21, 2017 incident on its GDAX platform. On June 21, ETH crashed from $317.81 to $0.10 in milliseconds, before quickly recovering. The crash occurred when a single sell order of approximately $12.5 million initiated a domino effect.

Unofficial sources suggest that among the areas of focus of the CFTC is the role that leverage might have played in this flash crash. Coinbase indicates on its website that it is registered as a money services business with the Financial Crimes Enforcement Network (FinCen) and is licensed to engage in money transmission in most U.S. jurisdictions, but Coinbase currently holds no registrations with the CFTC. Given the CFTC's willingness to assert jurisdiction over spot market transactions that involve leverage, it would not come as a surprise if the CFTC uses this as an opportunity to reinforce or expand its jurisdictional claim.

Wrapping Up

Although the Primer did not make any new or unsurprising statements regarding the regulatory treatment of virtual currencies, it is useful as a summary of the current state of regulation. It is also indicative of the increased regulatory focus on virtual currencies and related instruments.

As recent events and CFTC commentary suggest, virtual currencies are likely to be a hot topic for regulators in the coming months and years.

Ask the Professor: What Is the Impact of the Recent Ninth Circuit Case of *Paul Somers v. Digital Realty Trust, Inc. et al.* on the Dodd-Frank's Anti-Retaliation Provision Involving Whistleblowers?

By Professor Ronald Filler

Several recent whistleblower cases have addressed whether the anti-retaliation provision established by the Dodd-Frank Act[1] requires the whistleblower to make both an internal disclosure regarding the alleged wrongful act and to directly contact the Securities and Exchange Commission (SEC) with respect to that disclosure, or whether only one such action, that is, either an internal disclosure or a disclosure directly to the SEC, will suffice to protect the whistleblower against any possible retaliation from the employer.[2] This article will analyze the history of the laws and regulations involving whistleblowers in general and the impact of the *Somers* case in particular.

A. Introduction

Whistleblower protections were initially added by the Sarbanes-Oxley Act (SOX). Section 21F of the Securities Exchange Act of 1934 ("'34 Act"), which was added by the Dodd-Frank Act, involves whistleblower's incentives and protections.[3] The law prohibits an employer from taking any retaliatory actions against a whistleblower who makes any such report against the company. SEC Rule 21F states, in essence, that no person may take any action to impede an individual person from communicating with SEC staff about a possible securities law violation.[4] Section 748 of the Dodd-Frank Act added a similar whistleblower provision with respect to the Commodity Exchange Act.[5] CFTC Part 165 is comparable to SEC Rule 21F.[6] The SEC has been, by far, the more aggressive agency in bringing retaliatory actions against firms which prohibit or even impede employees who may become whistleblowers. As noted in more detail below, several recent cases brought by the SEC reflect this more aggressive stance.[7]

The SEC adopted its whistleblower rules by a 3-2 vote on May 25, 2011.[8] The SEC has also granted some large rewards to whistleblowers. One such recent award totaled $20,000,000.[9] In addition, on May 22, 2017, the CFTC approved amendments to its Whistleblower's Rules that will, among other things, strengthen the anti-retaliation protections for whistleblowers and enhance the process for reviewing whistleblower claims.[10]

B. The Ninth Circuit Case in *Somers*

The Ninth Circuit has issued a very important case recently involving the securities laws, namely the *Salman* case, which ultimately led to the U.S. Supreme Court issuing its opinion upholding the Ninth Circuit's opinion.[11] On March 8, 2017, the Ninth Circuit rendered its decision in *Somers* and held that the Dodd-Frank Act's anti-retaliation provision "should be read to provide protections to those who report internally as well as to those who report to the SEC."[12] The Ninth Circuit had upheld the district court's denial of the Defendant's Motion to Dismiss the Dodd-Frank claim, followed precedent from the Second Circuit and rejected precedent from the 5th Circuit. The court held that Congress did not intend to limit protection to whistleblowers who disclose information directly to the SEC but also intended to protect those who were fired after making internal disclosures of alleged unlawful activity.[13] The Fifth Circuit was the first circuit to interpret the Dodd-Frank Act's definition of a whistleblower and required an actual disclosure to the SEC.[14] The Second Circuit followed, applying *Chevron* deference to the SEC regulations, and held that the SEC regulation interpreted the new Dodd-Frank Act's whistleblower section to extend protection to all who make disclosures of suspected violations, whether the disclosures are made internally or to the SEC.[15]

Somers thus resulted from an addition to the Dodd-Frank Act that was intended to extend protection to those who made disclosures under SOX.[16] The Ninth Circuit upheld the lower court's decision that denied Defendant's Motion to Dismiss. The Court interpreted the intent of the whistleblower sections in both the Dodd-Frank Act and

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SOX and concluded "the SEC regulation correctly reflects congressional intent to provide protections for those who make internal disclosures as well as to those who make disclosures to the SEC."[17] Accordingly, both disclosures are not required to protect the whistleblower.

The Plaintiff, Paul Somers, was employed as a Vice President at Defendant, Digital Realty Trust, Inc. and had made several reports to senior management regarding possible securities law violations by the Defendant.[18] The Defendant then terminated Somers before he could issue any disclosure to the SEC.[19] Somers sued Digital Realty, alleging violations of various state and federal laws, including Section 21F of the 34 Act (i.e., the Whistleblower Law).[20] As noted above, the district court dismissed Defendant's Motion to Dismiss the Dodd-Frank claim.[21]

The Ninth Circuit decision provided a discussion of SOX, the Enron Corporation collapse and the intent of Congress to require public companies to "maintain internal compliance systems that include procedures for employees to anonymously report concerns about accounting or auditing matters" and to provide "protections to . . . 'whistleblower' employees in the event that companies retaliate against them.'"[22] It then stated: "Sarbanes-Oxley expressly protects those who lawfully provide information to federal agencies, Congress or 'a person with supervisory authority over the employee.'"[23] The court also noted that the Dodd-Frank Act provided "new" incentives and employment protections for whistleblowers by adding Section 21F to the '34 Act.[24] It then stated: "Section 21F defines a whistleblower as, 'any individual who provides, or 2 or more individuals acting jointly who provide, information relating to a violation of the securities laws to the Commission, in a manner established by rule or regulation, by the Commission.'"[25]

Section 21F also provides anti-retaliation protections and states:

> No employer may discharge, demote, suspend, threaten, harass, directly or indirectly, or in any other manner discriminate against, a whistleblower in the terms and conditions of employment because of any lawful act done by a whistleblower—(i) in providing information to the Commission in accordance with this section, (ii) in initiating, testifying in, or assisting in any investigation or judicial or administrative action of the Commission based upon or related to such information; or (iii) in making disclosures that are required or protected under (SOX, the Dodd-Frank Act) or any regulation promulgated by the Commission.[26]

The Ninth Circuit noted that subdivision (iii) was the issue before the court. Section (iii) gave whistleblowers the necessary protection if they had made any "required or protected" disclosures under SOX, the Dodd-Frank Act and other relevant laws.[27] The court then noted that subdivision (iii) was a last-minute addition that was added after the bill went through Committee, and therefore no legislative history explained its purpose.[28] The court was therefore required to interpret congressional intent by its actual wording. It then reasoned, as the Second Circuit did in *Berman*, that SOX and Section 21F added by the Dodd-Frank Act do not require an express disclosure to the SEC; otherwise, an auditor (or even an employee) must await a company response before he or she could report such disclosure to the SEC.[29] Citing the Second Circuit's decision in *Berman*, the Ninth Circuit then stated:

> [S]ubdivision (iii) would be narrowed to the point of absurdity; the only class of employees protected would be those who had reported possible securities violations both internally and to the SEC, when the employer—unaware of the report to the SEC—fires the employee, solely on the basis of the employee's internal report.[30]

The Ninth Circuit then reasoned that employees would most likely report either internally or to the SEC, but the anti-retaliation provisions would have no merit if the employee was fired after the internal report.[31] It then concluded that "subdivision (iii) of Section 21F should be read to provide protections to those who report internally as well as to those who report to the SEC."[32] It then stated that the SEC regulation, adopted pursuant to Section 21F, provides broad protections to whistleblowers from any anti-retaliation provisions adopted under any of the subdivisions (i), (ii) and (iii).[33]

C. Other SEC Actions Taken Via the Anti-Retaliation Rules

As noted above, the SEC has been quite aggressive recently in connection with anti-retaliation actions taken by employers. Two recent enforcement cases, NeuStar and Sand Ridge Energy, reflect these SEC enforcement actions.[34]

In *NeuStar, Inc.*, the SEC accepted an Offer of Settlement from the company.[35] The SEC cited the legislative history of Section 21F of the Dodd-Frank Act and its own Rule 21F-17, which provides in part: "(a) No person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement."[36]

The SEC noted in its Release that NeuStar had entered into voluntary severance agreements with employees who were leaving the company.[37] These severance agreements included language not acceptable to the SEC which stated: "I (employee) agree not to engage in any communication that disparages, denigrates, maligns or impugns NeuStar or its officers, directors, shareholders, investors, potential investors, partners . . . to regulators (including but not limited to the Securities and Exchange Commission) . . . "[38]

The severance agreement then required the employee to acknowledge that a breach of this clause "would cause irreparable injury and damage to NeuStar."[39] The SEC noted that at least 246 NeuStar employees had signed this severance agreement and required NeuStar to:

1. Amend the Severance Agreement provision noted above;[40]
2. Notify every NeuStar employee that signed the older version of the severance agreement and provide them with a link to the SEC Order and a statement that NeuStar does not prohibit former employees from communicating with the SEC; and
3. Pay a fine of $180,000 to the SEC.[41]

The SEC took even stronger action in *SandRidge Energy.*[42] SandRidge Energy and 24 affiliates had filed petitions for relief under Chapter 11 of the Bankruptcy Code on May 16, 2016.[43] Once again, as in NeuStar, the SEC Order cited Section 21F and Rule 21F-17.[44] The SEC Order also cited Section 21F(h)(1) which prohibits, in part, an employer from taking retaliatory actions, either directly or indirectly, against a whistleblower who makes a report protected under SOX.[45] The SEC Order then noted that Sand Ridge Energy had entered into separation agreements with approximately 546 employees who were leaving the company that stated in part:

> [A] former employee may not . . . at any time in the future voluntarily contact or participate with any governmental agency in connection with any complaint or investigation pertaining to (SandRidge), and may not be employed or otherwise act as an expert witness or consultant in any similar paid capacity in any litigation, arbitration, regulatory or agency hearing or other adversarial or investigatory proceeding involving (SandRidge).[46]

The separation agreement also required employees to agree "not to make any independent use of or disclose to any other person or organization, including any governmental agency, any of (SandRidge's) confidential, proprietary information unless the employee obtained (SandRidge's) prior written consent" and to agree not to "defame, disparage or make statements or disparaging remarks which could embarrass or cause harm to SandRidge's name and reputation . . . ."[47]

What distinguished *SandRidge* from *Neustar* was that a whistleblower had notified senior management of his disagreement over a period of two-and-a-half years regarding the company's process in calculating its oil and gas reserves.[48] This whistleblower then strongly disagreed with a draft report regarding an internal audit at SandRidge and was later terminated by SandRidge.[49] The SEC Order required SandRidge to:

1. Cease and desist from committing any future violations of Section 21F of the '34 Act and Rule 21F-17; and
2. Pay a fine of $1,400,000 to the SEC.

Both of these cases, *NeuStar* and *SandRidge*, settled in December 2016. Three other noteworthy whistleblower cases were settled by the SEC, two just a few months before *NeuStar* and *SandRidge*.[50]

A Risk Alert issued by the SEC's Office of Inspections and Examinations (OCIE) in October 2016 clearly reflected the SEC's intent to review compliance by investment advisers (IA) and broker-dealers (BD) with respect to its Rule 21F.[51] In connection with such examinations, OCIE noted that it would analyze a variety of agreements and documents used by IAs and BDs to ensure compliance with Rule 21F-17, including (1) compliance manuals, (2) codes of ethics, (3) employment agreements, and (4) severance agreements.[52] It was the language in severance agreements that led to the *NeuStar* and *SandRidge* cases. In reviewing such documents and agreements, OCIE further stated that it will assess whether any such documents or agreements contain any language that may contribute to or cause a violation of Rule 21F-17.[53] OCIE then confirmed that any such violations of Rule 21F-17 by a SEC registrant would be referred to the SEC's Division of Enforcement.[54]

D. Conclusion

One would assume that SEC enforcement cases and whistleblower rewards will continue under the Trump Administration despite all the efforts made to date, and projected for the future, regarding financial regulatory reforms. The whistleblower program provides important and timely information and evidence to the SEC with respect to potential or even actual violations of the federal securities laws. The same can be said with respect to the CFTC. The need to protect whistleblowers against any retaliation, as provided by Section 21F of the '34 Act, is still an important goal. The SEC must continue to bring such enforcement cases against companies that try to hinder any such disclosures by their employees, internally or to the SEC, involving violations of the federal securities laws or to retaliate against them if they do. It will be interesting to see if the SEC's Division of Enforcement takes a more lenient approach involving protecting whistleblowers. The same can be said with respect to the CFTC's Division of Enforcement. The fact that it issued a new press release on May 22, 2017, that enhances its whistleblower program is a pretty good indication regarding its priorities to help whistleblowers. I just hope that these whistleblower programs will remain strong and defiant now and in the future.

Endnotes

1. The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010). The Dodd-Frank Act extended protections to whistleblowers first offered under the Sarbanes-Oxley Act, 15 U.S.C. §78u-6(h)(1)(A)(iii). Section 21F of the '34 Act was added by Section 922 of the Dodd-Frank Act.
2. *See, e.g.*, *Asadi v. G.E. Energy (USA), LLC,* 720 F.3d 620 (5th Cir. 2013).
3. 18 U.S.C. 1514A; *see also* 15 U.S.C. § 78u-6(h)(1)(A)(iii); 15 U.S.C. § 78u-6(a)(6).
4. *See* Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, 17 C.F.R. § 240 (2011) *available at* http://sec.gov/rules/final/2011/34-64545.pdf; *See* 17 C.F.R. §240.21F-17 (2011).
5. Section 748 of the Dodd-Frank Act added Section 23 to the CEA.
6. The CFTC Rules on its whistleblower program were added in August 2011.
7. *See infra* Section C.
8. 17 C.F.R. § 240.
9. *See SEC Issues $20 Million Whistleblower Award*, U.S. Sec. Exch. Comm'n (Nov. 14, 2016), https://www.sec.gov.news/pressrelease/2016-237.html.
10. *See CFTC Strengthens Anti-Retaliation Protections for Whistleblowers and Enhances the Award Claims Review Process*, U.S. Commodity Futures Trading Comm'n (May 22, 2017), http://www.cftc.gov/PressRoom/PressReleases/pr7559-17. These new amendments establish a claims review process to consider and issue a Preliminary Determination as to whether an award claim should be granted or denied. A fact sheet was also provided in connection with this press release.
11. *See Ask the Professors—Will the Recent Supreme Court Case in Salman Result in More CFTC Enforcement Actions Charging Insider Trading?*, 37 Fut. Deriv. L. Rep. Issue 3 (March 2017), by Professor Ronald Filler and Professor Jerry Markham.
12. *Somers v. Dig. Realty Tr., Inc.,* 850 F.3d 1045, 1050 (9th Cir. 2017).
13. *Id.* at 1046.
14. *Id.* at 1047 (*citing Asadi v. G.E. Energy (USA), LLC,* 720 F.3d 620, 621 (5th Cir. 2013)).
15. *Id.* (citing *Berman v. Neo@Ogilvy LLC,* 801 F.3d 145,155 (2d. Cir. 2015)).
16. 15 U.S.C. § 78u-6(h)(1)(A)(iii).
17. *Somers*, 850 F.3d at 1047.
18. *Id.*
19. *Id.*
20. *Id.*
21. *Id*. The district court conducted an extensive analysis and review of the statutory text provided by SOX and the Dodd-Frank Act as well as the procedural and practical implications of harmonizing the narrow definition of "whistleblower" with the broad protections of the anti-retaliation provisions. *Somers v. Dig. Realty Tr. Inc.*, 119 F. Supp. 3d 1008, 1100–1105 (N.D. Cal. 2015).
22. *Somers*, 850 F.3d at 1048 (citing 15 U.S.C. § 78-j-1(m)(4); 18 U.S.C. § 1514A(a)).
23. *Id.*
24. *Id.*
25. *Id.* (quoting 15 U.S.C. § 78u-6(a)(6)).
26. *Id.* (quoting 15 U.S.C. § 78u-6(h)(1)(A)).
27. *Id.* at 1048–49.
28. *Somers*, 850 F.3d at 1049.
29. *Id.*
30. *Id.* (citing *Berman*, 801 F. 3d at 151–52).
31. *Id.*
32. *Id* at 1050.
33. *Id.*
34. *See* Office of Compliance Inspections and Examinations, Examining Whistleblower Rule Compliance, National Exam Program Risk Alert, U.S. Sec. Exch. Comm'n (vol. VI, issue 1, Oct. 24, 2016).
35. *In re NeuStar, Inc.,* Securities Exchange Act of 1934 Release No. 79593, File No. 3-17736 (Dec. 19, 2016), *available at* https://www.sec.gov/litigation/admin/2016/34-79593.pdf.
36. *Id.* at 2 (Section A of the SEC Order).
37. *Id.* (Section B of the SEC Order).
38. *Id.*
39. *Id* at 3.
40. *Id.* NeuStar's Severance Agreement now reads: "In addition, nothing herein prohibits me from communicating, without notice to or approval by NeuStar, with any federal governmental agency about a potential violation of a federal law or regulation."
41. *Id.* at 3–4 (Sections III and IV of the SEC Order).
42. *In re Sand Ridge Energy, Inc.*, Securities Exchange Act of 1934 Release No. 79607, File No. 3-17739 (Dec. 20, 2016), *available at* https://www.sec.gov/litigation/admin/2016/34-79607.pdf.
43. *Id.* at 2.
44. *Id.*
45. *Id.*
46. *Id.* at 3
47. *Id.*
48. *Id.* at 5.
49. *Id.* at 5–6.
50. *See In re KBR, Inc.*, Securities and Exchange Act of 1934 Release No. 34-74619, File No. 3-16466 (Apr. 1, 2015), *available at* https://www.sec.gov/litigation/admin/2015/34-74619.pdf; *In re* Health Net, Inc., Securities and Exchange Act of 1934 Release No. 78590, File No. 3-17396 (Aug. 16, 2016), *available at* https://www.sec.gov/litigation/admin/2016/34-78590.pdf; *In re* BlueLinx Holdings Inc., Securities and Exchange Release No. 78528, File No. 3-17371 (Aug. 10, 2016), *available at* https://www.sec.gov/litigation/admin/2016/34-78528.pdf.
51. *See supra* notes 5, 34.
52. *Id.*
53. *Id.*
54. *Id.*

The Supreme Court's Dodd-Frank Dilemma: Should Internal Whistleblowers Be Protected?

By Grace E. Nealon

I. Introduction

Whistleblowers who report information regarding the violation of federal securities laws provide an invaluable public service, often at the expense of their personal and professional interests. Section 78u-6 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") created the whistleblower protection program, which is carried out by the U.S. Securities and Exchange Commission (SEC).[1] Congress created the whistleblower program to incentivize persons with specific, timely, and credible information regarding securities law violations to bring this information to the SEC's attention.[2] The whistleblower protection program has been called a "game changer" by Mary Jo White, former Chair of the SEC, who said the program provides "a source of valuable information to the SEC to further its mission of protecting investors while providing whistleblowers with protections and financial rewards."[3] Dodd-Frank offers whistleblowers protection from retaliation, confidentiality assurances, and monetary awards.[4] There are two types of whistleblowers: external reporters who report wrongdoing outside of their organization, and internal reporters who report wrongdoing to the appropriate authority within their organization. While other modern whistleblower statutes relating to financial crimes offer protection from retaliation to whistleblowers who report wrongdoing internally, it is uncertain whether Dodd-Frank will offer protection from retaliation to these types of whistleblowers.[5]

II. Circuit Split

Federal Circuit Courts divide on the question of what reporting requirements a whistleblower must meet in order to receive anti-retaliatory protections under Dodd-Frank. In *Asadi v. G.E. Energy United States, L.L.C.*, the Fifth Circuit held that, in order to qualify for anti-retaliatory protections under 15 U.S.C. § 78u-6(h)(1)(A)(iii), an individual must report information directly to the SEC.[6] The Circuit's strict interpretation does not extend the Dodd-Frank anti-retaliatory provisions to persons who report federal securities law violations internally. The Fifth Circuit justified its narrow interpretation of the statute with the isolated reading of the definition of whistleblower in 15 U.S.C. § 78u-6(a)(6), despite the interplay between the definition and § 78u-6(h)(1)(A)(iii) of the statute.[7] The court held that § 78u-6(h)(1)(A)(iii) did not create tension with the definition in § 78u-6(a)(6) because § 78u-6(h)(1)(A)(iii) would cover a whistleblower who simultaneously reported to the SEC and his or her employer.[8]

15 U.S.C. § 78u-6(a)(6) defines a whistleblower as "any individual who provides . . . information relating to a violation of the securities laws to the Commission, in a manner established, by rule or regulation, by the Commission."[9] However, 15 U.S.C. § 78u-6(h)(1)(A)(iii) prohibits an employer from discharging or discriminating against a whistleblower who "mak[es] disclosures that are required or protected under the Sarbanes-Oxley Act of 2002 . . . and any other law, rule, or regulation subject to the jurisdiction of the Commission."[10] Providing information to a person with supervisory authority over the employee is expressly covered by 18 U.S.C. § 1514A(a)(1)(c) of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"); thus, internal reporting is a fully protected activity under Sarbanes-Oxley.[11]

The Second Circuit reached a different conclusion after considering the tension between the definition and the types of whistleblowers contemplated in the anti-retaliatory provision. The court found that not only would the scope of § 78u-6(h)(1)(A)(iii) be severely limited if it required internal reporters to make a simultaneous report to the SEC, but also that certain whistleblowers, including auditors and attorneys, would likely not be protected because they are not permitted to report wrongdoing to the SEC until after they have reported the wrongdoing to their employer.[12] The court deemed the tension sufficiently ambiguous to oblige the court to follow *Chevron* and defer to SEC Rule 21F-2(b)(1).[13] Since SEC Rule 21F-2(b)(1) does not require an individual to report securities law violations directly to the SEC in order to be entitled to protection from retaliation, the Second Circuit held that an individual may report wrongdoing internally and still receive anti-retaliation protection under Dodd-Frank.[14]

Chevron is a two-part test used to determine whether to grant deference to a government agency's interpretation of a statute which it administers.[15] Step One asks whether Congress has spoken directly to the precise question at issue. If Congress has spoken directly to that issue, the unambiguously expressed intent of Congress must be followed.[16] If the statute is silent or ambiguous with respect to the specific issue, the court moves to Step Two of *Chevron,* which asks whether the agency's answer is based on a permissible construction of the statute.[17] If Congress has left a gap for the agency to fill, this is considered a delegation of authority to the agency and the agency's interpretation must be "given controlling weight unless [the interpretations] are arbitrary, capricious, or manifestly contrary to the statute."[18]

The SEC promulgated Rule 21-F-2 to describe two different types of whistleblowers.[19] Section 240.21F-2(a),

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the first definition of whistleblower, which is limited to the award and confidentiality provisions of Section 21F, requires the individual to submit information to the SEC in accordance with the reporting requirements of § 240.21F-9.[20] In order to meet the reporting requirements of § 240.21F-9, the individual must submit his or her information either "(1) [o]nline, through the Commission's website . . . ; or (2) [b]y mailing or faxing a Form TCR . . . to the SEC Office of the Whistleblower."[21] In contrast, § 240.21F-2(b) deals exclusively with the prohibition against retaliation and does not require the individual to meet the reporting requirements of § 240.21F-9.[22] This definition indicates that, regardless of whether the individual qualifies for a monetary award, an individual is protected from employer retaliation if he or she provides information "in a manner described in Section 21F(h)(1)(A) of the Exchange Act (15 U.S.C. 78u-6(h)(1)(A))." Thus, the definition includes individuals who report internally because § 78u-6(h)(1)(A) includes disclosures protected by Sarbanes-Oxley and Sarbanes-Oxley protects employees who internally report wrongdoing to a person with supervisory authority over them.[23]

"Dodd-Frank's whistleblower program has had a 'transformative impact' on the SEC's enforcement abilities because the information from the whistleblowers allows the SEC to bring high-quality enforcement actions with fewer resources."

III. The Supreme Court Grants Certiorari in *Somers v. Digital Realty Trust*

This circuit split will soon be addressed by the Supreme Court after the Ninth Circuit followed the Second Circuit in *Somers v. Digital Realty Trust, Inc.*[24] In *Somers,* the employee made several reports to senior management regarding possible securities law violations made by the company.[25] Somers was terminated before he could report the possible violations to the SEC.[26] The Ninth Circuit held that the uncertainty created by the use of the word "whistleblower" in the anti-retaliatory provision compelled deference to the SEC's interpretation; thus, Somers' activity was protected.[27]

On June 26, 2017, the Supreme Court of the United States granted certiorari to Digital Realty Trust's petition arising out of the Ninth Circuit's decision.[28] The petitioner framed the question as "[w]hether the anti-retaliation provision for 'whistleblowers' in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 extends to individuals who have not reported alleged misconduct to the Securities and Exchange Commission and thus fall outside the Act's definition of a 'whistleblower.'"[29]

If the Supreme Court follows the Fifth Circuit and relies on the definition of whistleblower in isolation, then individuals who are terminated after reporting wrongdoing to their employer will not be protected under Dodd-Frank. Due to the insufficiencies of Sarbanes-Oxley, this means these individuals will likely not have any cause of action against their employer. This interpretation would not only be an enormous deterrent for reporting wrongdoing internally, but it would also attenuate the intended effect of Dodd-Frank's anti-retaliation protections. "Definitions are, after all, just one indication of meaning—a very strong indication, to be sure, but nonetheless one that can be contradicted by other indications."[30]

IV. Guideposts for the Court: Evaluating Policies Regarding Whistleblowers Under Dodd-Frank

Individuals who are terminated after reporting securities law violations to their employer should be afforded a cause of action under Dodd-Frank because Sarbanes-Oxley does not offer adequate protection for internal reporters. Sarbanes-Oxley only offers 180 days for an individual to file a complaint, whereas Dodd-Frank offers anti-retaliation protection for up to six years.[31] Daniel Berman, the whistleblower in the Second Circuit case on this issue, reported his information to the government six months after his termination but missed protection under Sarbanes-Oxley because of the short statute of limitations.[32]

Dodd-Frank's whistleblower program has had a "transformative impact" on the SEC's enforcement abilities because the information from the whistleblowers allows the SEC to bring high-quality enforcement actions with fewer resources.[33] These enforcement actions have led to the collection of over $504 million in sanctions with more than $346 million in disgorgement and interest distributed to investors.[34] The implications of not offering Dodd-Frank anti-retaliatory protections to whistleblowers who report internally would be detrimental to the success of the SEC's whistleblower program. Anti-retaliatory protection is the most important part of Dodd-Frank's whistleblower protections because people are significantly more likely to report wrongdoing when offered protection from retaliation, whereas money is not as significant a factor in a person's decision to report wrongdoing.[35] While we might wish that altruism would be enough to motivate whistleblowers, the legitimate threats of termination, litigation, and reputational harm create enormous disincentives to reporting wrongdoing.[36] In order to protect the livelihood of individuals who risk their professional success for the greater good, there must exist a cause of action for individuals who report wrongdoing internally.

Additionally, internal reporting is a better policy for the whistleblower, the government, the company, and the company's shareholders. Going outside of one's organization to report wrongdoing raises conflicting obligations that do not arise with internal reporting.[37] By signing an employment contract, employees typically assume a duty to avoid harming their employer's interest which conflicts with the employee's legal obligation not to be complicit in illegal activity if the employee becomes aware of a potential securities law violation.[38] Reporting externally can harm the employer's interest in many ways; for example, the employee's disclosure may lead to the exposure of sensitive information or it may damage the employer's public reputation, which often happens even if the employee's accusations turn out to be false.[39] If the company's public reputation is harmed by inaccurate accusations, shareholders are harmed as well. If employees are required to report externally, they will always be forced to choose between their duty to the public and their duty to their employer.[40]

Allowing the employee to report potential wrongdoing internally allows the company to conduct an internal investigation and self-report any wrongdoing. Internal reporting also protects the company and the shareholders from unnecessary harm if the employee's report of potential wrongdoing turns out to be a false alarm. Incentivizing internal reporting will likely encourage companies to self-report, which is consistent with current federal policies. The federal government has several policies that encourage companies to self-report wrongdoing, such as the Department of Justice's (DOJ) pilot program for the Foreign Corrupt Practices Act (FCPA).[41]

On April 5, 2016, the DOJ introduced a pilot program for business organizations that discover that individuals within the organization have not complied with the FCPA.[42] A business organization that complies with the requirements of the pilot program may be able to pay a reduced fine or avoid prosecution altogether.[43] When deciding whether to decline prosecution or reduce fines, the DOJ considers four factors: "(1) the company's voluntary self-disclosure, (2) the company's cooperation with the [DOJ], (3) the company's remediation, and (4) the company's disgorgement of ill-gotten profits."[44] In order to qualify for full mitigation under the pilot program, a company must voluntarily self-disclose, fully cooperate with a DOJ investigation, and remediate internal controls and compliance programs.[45]

The first year of the FCPA pilot program resulted in seven declination letters whereby the DOJ publicly declined to prosecute companies that complied with the pilot program's requirements despite the companies' FCPA violations. For example, in 2015, the U.S. company Nortek discovered that several employees of the company's Chinese subsidiary, including the managing director, accounting manager, and customs liaison officer, had likely violated the anti-bribery provisions of the FCPA when they made or approved at least 400 improper payments and gifts to foreign officials in exchange for preferential treatment.[46] Not only did the company violate the anti-bribery provisions of the FCPA, but Nortek's internal accounting controls failed to recognize that employees of Nortek's subsidiary inaccurately recorded the payments and gifts in Nortek's books and records, which would likely violate the accounting provisions of the FCPA.[47] Nortek participated in the pilot program and the DOJ decided to decline prosecution of the company. In a declination letter dated June 3, 2016, the DOJ indicated that its decision not to prosecute Nortek was based on several factors, including: Nortek's prompt voluntary self-disclosure; the thorough investigation undertaken by the company; the company's "fulsome cooperation" by identifying all individuals involved in the misconduct and by revealing all facts relating to the misconduct; the company's full remediation, which required terminating the employment of all five individuals involved in the China misconduct; and disgorgement to the SEC.[48]

"Allowing the employee to report potential wrongdoing internally allows the company to conduct an internal investigation and self-report any wrongdoing."

This pilot program is a reflection of the willingness of companies to self-report wrongdoing, even when disgorgement is required. It also indicates that the government's goals can still be served without expensive, adversarial investigations. Taxpayers are better served when companies cooperate with the government in this way because fewer resources need to be expended in order to remedy the company's wrongdoing. Incentivizing internal reporters may encourage companies to self-report their wrongdoing, which would be consistent with the goal of remediating illegal conduct at the lowest cost to taxpayers.

V. Conclusion

In the near future, the Supreme Court will decide whether internal reporters are protected by Dodd-Frank. As a matter of statutory interpretation, the tension between 15 U.S.C. § 78u-6(a)(6) and § 78u-6(h)(1)(A)(iii) of the statute creates uncertainty as to Congress' intent behind the anti-retaliatory provision; thus, the court is obligated to follow *Chevron* and defer to the SEC's interpretation of whistleblower in § 240.21F-2(b), which offers protection to whistleblowers who report internally. As a matter of policy, internal reporting should be covered by Dodd-Frank because Sarbanes Oxley does not offer sufficient protection. Additionally, internal reporting is a better policy to protect the interests of employees and encourage companies to self-report to the government.

Endnotes

1. 15 U.S.C. § 78u-6 (2012).
2. *See* U.S. Sec. & Exch. Comm'n, SEC Whistleblower Program Surpasses $100 Million in Awards (Aug. 30, 2016), https://www.sec.gov/news/pressrelease/2016-173.html.
3. *Id.*
4. Brent J. Fields, *Interpretation of the Sec's Whistleblower Rules Under Section 21f of the Securities Exchange Act Of 1934*, U.S. Sec. & Exch. Comm'n 3 (Aug. 4, 2015), https://www.sec.gov/rules/interp/2015/34-75592.pdf.
5. *See* 12 U.S.C. § 5567 (2012) (covering employees who provide (or caused to be provided) information relating to a violation of the Consumer Financial Protection Act to the employer, the Consumer Financial Protection Bureau, or a state, local, or federal government authority or law enforcement agency); *see also* 18 U.S.C. § 1514A(a)(1)(c) (2012) (covering employees who provide (or caused to be provided) information that the employee reasonably believes constitutes a violation of 18 U.S.C. §§ 1341, 1343, 1344, 1348, or any rule or regulation of the SEC, or any provision of Federal law relating to fraud against shareholders, when the information or assistance is provided to or the investigation is conducted by (1) a Federal regulatory or law enforcement agency, (2) any Member of Congress or any committee of Congress, (3) a person with supervisory authority over the employee.
6. *Asadi v. G.E. Energy United States, L.L.C.*, 720 F.3d 620, 630 (5th Cir. 2013).
7. *Id.* at 627.
8. *Id.* at 627–28.
9. 15 U.S.C. § 78u-6(a)(6) (2012).
10. 15 U.S.C. § 78u-6(h)(1)(A)(iii) (2012).
11. 18 U.S.C. § 1514A(a)(1)(c); *See also* Stephen M. Kohn, *Sarbanes-Oxley Act: Legal Protection for Corporate Whistleblowers*, Nat'l Whistleblower Ctr., http://www.whistleblowers.org/index.php?option=com_content&task=view&id=27 (last accessed Nov. 28, 2017).
12. *Berman v. Neo@Ogilvy LLC*, 801 F.3d 145, 151–52 (2d Cir. 2015) (first citing 15 U.S.C. § 78j-1; then citing 15 U.S.C. § 7245).
13. *Berman*, 801 F.3d at 155.
14. *Id.*
15. *Chevron, U.S.A., Inc. v. NRDC, Inc.*, 467 U.S. 837, 842–43 (1984).
16. *Id.*
17. *Id.* at 843.
18. *Id.* at 843-44.
19. 17 C.F.R. § 240.21F-2 (2017).
20. § 240.21F-2; *see also* Fields, *supra* note 4 at 4–5.
21. 17 C.F.R. § 240.21F-9 (2017).
22. § 240.21F-2(b); *see also* Fields, *supra* note 4 at 4–5.
23. 18 U.S.C. § 1514A(a)(1)(c); § 240.21F-2(b).
24. *Dig. Realty Tr., Inc. v. Somers*, 137 S. Ct. 2300, 198 L. Ed. 2d 723 (2017).
25. *Somers v. Dig. Realty Tr., Inc.*, 850 F.3d 1045, 1049 (9th Cir. 2017).
26. *Id.* at 1047.
27. *Id.* at 1050.
28. *Dig. Realty Tr.,* 137 S. Ct. at 2300, 198 L. Ed. 2d at 723.
29. Brief for Petitioner, *Dig. Realty Tr., Inc. v. Somers* (No. 16-1276), 2017 WL 1488628 at *1.
30. Antonin Scalia & Bryan A. Garner, Reading Law: The Interpretation of Legal Texts 228 (2012).
31. Filing Whistleblower Complaints under the Sarbanes-Oxley Act, Occupational Safety & Health Admin., https://www.osha.gov/Publications/osha-factsheet-sox-act.pdf (last accessed Nov. 28, 2017); *see also* Jill L. Rosenberg & Renée B. Phillips, *Whistleblower Claims Under the Dodd-Frank Wall Street Reform and Consumer Protection Act: The New Landscape,* N.Y. State Bar Ass'n 10, https://www.nysba.org/Sections/Labor_and_Employment/Labor_PDFs/LaborMeetingsAssets/Whistleblower_Claims_Under_Dodd_Frank.html (last accessed Nov. 28, 2017).
32. *Berman*, 801 F.3d at 149.
33. U.S. Sec. & Exch. Comm'n, *supra* note 2.
34. *Id.*
35. Dr. Eileen Taylor & Matt Shipman, *Protections, Not Money, Can Boost Internal Corporate Whistleblowing*, NC State University (Mar. 2, 2015), https://news.ncsu.edu/2015/03/taylor-reporting-2015/; *see also* Cynthia P. Guthrie & Eileen Z. Taylor, *Whistleblowing on Fraud for Pay: Can I Trust You?*, Soc. Sci. Research Network (Dec. 15, 2016), https://ssrn.com/abstract=2555712 (finding that when the threat of retaliation is high, monetary incentives do not significantly influence a person's decision to report wrongdoing).
36. Christine Sgarlata Chung, *A Lament for Whistleblowers*, Forum on Fin. Mkt. Regulation (July 25, 2016), http://financialmarketregulation.org/2016/07/a-lament-for-whistleblowers.
37. *Id.* at 191
38. *Id.* at 189.
39. *Id.* at 189–90.
40. *Id.* at 190 (citing Michael Davis, *Some Paradoxes of Whistleblowing*, 15 Bus. & Prof. Ethics J.
41. Andrew Weissmann, *The Fraud Section's Foreign Corrupt Practices Act Enforcement Plan and Guidance*, U.S. Department of Justice (Apr. 5, 2016), https://www.justice.gov/criminal-fraud/file/838416/download.
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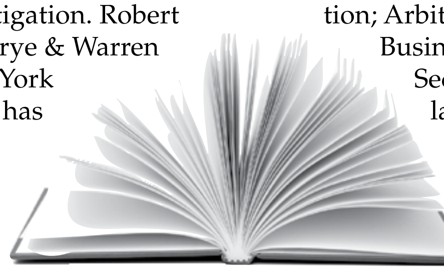
43. *Id.*
44. Christine Sgarlata Chung, *The Foreign Corrupt Practices Act: A Primer and Recent Developments*, Forum on Fin. Mkt. Regulation (Jul. 18, 2016), http://financialmarketregulation.org/2016/07/the-foreign-corrupt-practices-act-a-primer-and-recent-developments/.
45. *Id.*
46. *Id.*
47. *Id.*
48. Daniel Kahn, *Re: Nortek, Inc.*, U.S. Dep't of Justice (Jun. 3, 2017), https://www.justice.gov/criminal-fraud/file/865406/download.

BOOK REVIEW
Business and Commercial Litigation in Federal Courts, Fourth Edition
Reviewed by John P. McCahey

Business and Commercial Litigation in Federal Courts has been updated and expanded in its fourth edition. That treatise, whose first edition was released in 1998 to positive reviews, now consists of 14 volumes (the first edition had six) with 153 chapters (more than double those in the initial edition). The publication is the result of a joint venture between Thomson Reuters and the American Bar Association Section of Litigation. Robert L. Haig, a litigation partner at Kelley, Drye & Warren LLP and a respected leader of the New York bar, is the treatise's Editor-in-Chief and has been its driving force from conception.



Business and Commercial Litigation in Federal Courts was written to be a step-by-step practice guide from beginning to end of a commercial or business dispute litigated in a federal court. The phases of litigation covered begin with the initial investigation and assessment of a case before its commencement and continue through to the preparation of pleadings, parties, third-party practice, remedies, discovery, motions, settlement, experts, trial, judgment and appeal. These phases in many instances are broken down and addressed in separate chapters. Attorneys looking for guidance in the area of discovery, for example, can turn to the following chapters: Discovery Strategy and Privileges; Depositions; Document Discovery; Discovery of Electronically Stored Information; Interrogatories; and Requests for Admissions. They can also consult the following chapters when preparing for trial: Jury Selection; Motions in Limine; Trial Strategy and Advocacy; Effective Trial Performance; Opening Statements; Presentation of the Case in Chief; Cross-Examination; Evidence; Final Arguments in Jury and Bench Trials; and Jury Conduct, Instructions, and Verdicts.

In addition to its comprehensive treatment of a litigation's procedural aspects, the treatise devotes 68 chapters to those areas of substantive law that are often at issue in a commercial or business dispute. These chapters include those on Securities; Banking; Contracts; Sale of Goods, Employment Discrimination; Insurance; Patents; Trademarks; ERISA; RICO; and Warranties. The treatise also offers instructive chapters on other topics a federal litigator may face or find useful beyond those of procedural and substantive law, including Litigation Avoidance and Prevention; Crisis Management; Litigation Technology; Litigation Management by Law Firms; Ethical Issues in Commercial Cases; and Civility.

All of the chapters mentioned above were included in the treatise's third edition and have been updated in the fourth edition as appropriate to bring them current. In addition, the fourth edition has been expanded to include 25 new chapters on topics relevant to commercial and business litigation. These chapters consist of the following: Civil Justice Reform; Cross-Border Litigation; Mediation; Arbitration; Social Media; Marketing to Potential Business Clients; Teaching Litigation Skills; Securitization and Structured Finance; Regulatory Litigation; Health Care Institutions; Telephone Consumer Protection Act; Mass Torts; Aviation; Joint Ventures; Fiduciary Duty Litigation; Advertising; Media and Publishing; Fraud; International Trade; Civil Rights; Public Utility; Declaratory Judgments; Negotiations; Effective Trial Performance; and Fashion and Retail.

The fourth edition is the work of 296 "principal authors," many of whom have been with the treatise since its first edition. They include past and present members of the judiciary and numerous prominent practitioners from across the country, all of whom were recruited by Mr. Haig to contribute to the treatise due to their experience and recognized expertise in the areas on which they write. It is noteworthy that these distinguished (and busy) members of the bar have devoted substantial time and effort to this publication without compensation or reimbursement. All royalties from the treatise—which Mr. Haig reports have been "substantial" —go to the American Bar Association Section of Litigation.

Mr. Haig and the authors have combined to produce a work both of high quality and great utility to the bar. While the manner and organization of presentment is not completely uniform throughout the 153 chapters—perhaps not surprising given both the number of authors and the diverse subjects covered—there are elements common to all chapters. Each chapter provides an overview of law and procedure applicable to its topic in lucid fashion, with citations to relevant cases and statutes. Cross-references to relevant sections of other chapters are included in the footnotes where appropriate. Strategic choices and preliminary issues the litigator and client may face in the course of a litigation are highlighted and

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advice provided. Finally, "Practice Aids" helpful to the litigator are found at the end of each chapter, and typically include one or more practice checklists, suggested forms and proposed jury instructions.

Two of the chapters added to the fourth edition reflect both the old and new of a business and commercial dispute. Chapter 130 (Fraud) begins with an overview of the issues, including strategy and pleading requirements, that should be considered by a party before making a fraud claim. The elements of a fraud claim, including those of a failure to disclose or one of fraudulent inducement, are explained together with examples of what federal courts have accepted or rejected as sufficient evidence of those elements. Other topics covered include fraud-based statutes (including the Securities Exchange Act and RICO) and the circumstances to which they apply, a plaintiff's remedies for fraud (including the measure of monetary damages), and defenses potentially available in response to a fraud claim. The chapter concludes with numerous checklists, pleading and discovery forms, and jury instructions for both a plaintiff and defendant in a fraud action.

Several media platforms, including Facebook and Twitter, permit the user the ability to publicly disclose details of his or her life. As shown in Chapter 67 (Social Media), social media can impact upon a commercial or business litigation in numerous ways. It may, for example, reveal critical information going to the credibility of an adverse witness at trial or a potential juror's bias. These and other relatively new issues and challenges that social media present in litigation are explained in the chapter's discussion of the following: (1) discovery of social media, including under the Federal Rules of Civil Procedure; (2) admissibility at trial of social media under the Federal Rules of Evidence; (3) use of social media in jury research and selection; (4) an employer's potential liability for its employee's use of social media; and (5) ethical issues social media may present to attorneys. The chapter concludes with form discovery requests and deposition questions. It, as do the treatise's other chapters, provides an informative gateway to the topic covered.

Included in the fourth edition is a separate Appendix that provides an index as well as tables of all laws and rules, cases, and forms found in the text. That Appendix and the text will be updated annually. The publication also comes with a CD-ROM that contains the jury instructions, forms and checklists set forth in the text.

The fourth edition of *Business and Commercial Litigation in Federal Courts* continues to be a valuable resource for federal court litigators.

Committee Reports

Report of the Section Chair

I cannot believe that my tenure as Chair of the Business Law Section is already half-over! The Section is going strong and I want to share a few highlights since the last issue of the *Business Law Journal*.

Fall Section Meeting

The Business Law Section held its Fall Meeting on October 13, 2017, in mid-town Manhattan. "Financial Regulation and Deregulation: What's Next," an all-day program, spearheaded by Program Chair Peter LaVigne, focused on the changes in the financial services landscape since the 2016 election. It was well-attended and we received considerable positive feedback.

Keynote speeches were given by Department of Financial Services Superintendent Maria Vullo and Executive Deputy Attorney General for Economic Justice Manisha Sheth. Each of them emphasized the State's focus on protecting New York consumers, regardless of any changes in financial services regulation at the federal level.

There were interactive panels on the Impact of FinTech Innovations on the Delivery of Financial Services, the Future of Financial Services Regulation, Securities Regulation, Deregulation and Enforcement, and Changes in Banking Regulation in the new Administration. Panel speakers included federal and state government legal officials, in-house lawyers, private practitioners and academics.

A webcast is available. Please send an email to sbugos@nysba.org for further information.

Annual Meeting

The next Business Law Section meeting will take place in New York City on Wednesday, January 24, 2018, during the NYSBA Annual Meeting taking place at the New York Hilton. We will again be partnering with the Corporate Counsel Section to present a joint CLE program the morning of the 24th, with a luncheon to follow. Committees will be meeting that afternoon.

A New Bar Foundation Fund

I am most excited to be announcing that the Business Law Section has established a new restricted fund within the New York Bar Foundation. The Business Law Section Small Business Support Fund will provide financial support for programs that provide legal advice and assistance to military veterans, minorities and other underserved New York residents seeking to establish their own small business enterprises in the State. Elsewhere in this issue you will find more information on the Fund. Kudos to longtime Section member Stuart Newman for developing the idea and shepherding it through the establishment process (see the inside front cover of this issue for additional information). To donate, please visit www.tnybf.org/donation and note your gift is in honor of the Business Law Section Small Business Support Fund. Or send a check to: The New York Bar Foundation, 1 Elk Street, Albany, NY 12207.

If you have any questions about the Section or its Committee and programs, please feel free to reach out to me at Kathleen.scott@nortonrosefulbright.com.

Kathleen Scott, Section Chair

Banking Law Committee

The Banking Law Committee held a meeting on October 12, 2017 at the law offices of Norton Rose Fulbright US LLP, in conjunction with the Fall meeting of the Business Law Section. The Committee was addressed by Trevor Goering, CEO and co-founder of Gotham Security, who specifically presented on the Equifax data breach and all aspects of how it happened, its impact, and next steps. As October was National Cybersecurity Awareness month and the Equifax breach affected well over 140 million consumers, this was a very timely presentation. Mr. Goering, assisted by Ms. Blake Pearlstein, COO and co-founder of Gotham Security, was able to offer a detailed analysis of the various components of the breach. Those in attendance walked away with a chilling sense of how vulnerable all our data really is to the "Dark Web" and other nefarious criminal elements. A copy of the presentation was made available via Community to all members of the Banking Law Committee.

Tanweer Ansari, Chair

Bankruptcy Law Committee

The Bankruptcy Law Committee met on May 12, 2017, as part of the Section's Spring meeting. At the meeting, Nick and Jim Rigano of Rigano LLC presented a CLE seminar entitled: "How The Bankruptcy Code Can Help with Sale of an Environmentally Contaminated Property." The presentation was entertaining and informative and it was well-received by the members.

Matt Spero, Chair

Corporations Law Committee

No report submitted.

Derivatives and Structured Products Law Committee

The Derivatives and Structured Products Committee has held five CLE seminars since this summer. They were: (i) Legal Technology in the Derivatives and Structured Products Markets: Current State and Where We Are Headed—A Discussion Through the Lens of Margin Reform, hosted by Mayer Brown; (ii) Update on the Hague Securities Convention and recent CFTC initiatives, in particular Project KISS, hosted by Morgan Lewis; (iii) An examination of the Final QFC Rules from a Derivatives and Structured Products Perspective, hosted by Sullivan & Cromwell; (iv) MiFID II, current state and cross-border implications, hosted by Linklaters; and (v) CFTC enforcement developments, including the new advisory on self-reporting and CFTC regulation of virtual currencies, hosted by Skadden Arps.

As with all our recent meetings, members who cannot attend in person are able to participate for CLE credits via teleconference. Lunch was also provided, compliments of each firm. The meetings continue to be well-attended with very active participation by our members, and our topic selections are based on current issues and market trends. We have also chosen topics by popular demand as we try to make the committee user friendly and accessible.

We want to take this opportunity to thank all the firms that have volunteered to host us throughout 2017 and to once again thank them for the effort they exert in the preparation for our meetings, including conference calls, developing the topic for the program as well as the issuing of CLE credits and logistical items such as obtaining security clearance for each attendee to their respective facility. Much appreciation for all the hands that help make our meetings popular and successful.

Rhona Ramsay, Chair
Ruth Arnould, Vice Chair

Franchise, Distribution and Licensing Law Committee

For further information regarding the Committee and its activities or to share feedback and suggestions, please contact Committee Chair Justin M. Klein (justin@marksklein.com).

Justin M. Klein, Chair

Insurance Law Committee

No report submitted.

Legislative Affairs Committee

The Legislative Affairs Committee monitored a variety of bills in the 2017 legislative session and circulated information for comment within the Section. After a very active 2016 session, this year's legislative session was relatively quiet. The Committee participated in Section discussions on topics of interest for possible further development, including limited liability companies and the Uniform Voidable Transactions Act. The Committee's charter document was worked on in more detail to define its mission and responsibilities more clearly. The Committee continued to work closely with NYSBA's governmental relations staff and to maintain contact with counterpart committees in other Sections.

Mike de Freitas, Chair

Mergers and Acquisitions Committee

An initial organizational meeting of the new Mergers and Acquisitions Committee was held at Orrick, Herrington & Sutcliffe on October 12, 2017 in conjunction with the Section's Fall Meeting. At the outset of the meeting, the Chair asked its new members to help shape the coming agenda and focus of this new Committee. An active discussion ensued focusing on future meeting topics, speakers and areas of focus. The many excellent suggestions are presently being evaluated and future meetings and programs are being planned. As a new Committee, we look forward to further growth in membership and involvement from all concerned.

James Rieger, Chair

Not-For-Profit Corporations Law Committee

Our committee held a meeting on September 14, and in addition to other committee business, we had a presentation from Ken Cerini, of the accounting firm of Cerini & Associates, LLP, on the topic "Nonprofit Accounting: What Lawyers Need To Know." Ken is the managing partner of Cerini & Associates, and is the executive responsible for the administration of the firm's not-for-profit and educational providers practice group.

On November 30, in cooperation with the Trust & Estates Law Section (in particular, we thank Marion Fish for her partnership) and with co-sponsorship from the Business Law Section, our committee presented an all-day CLE at the State Bar Center in Albany. The program was entitled "New York Not-For-Profit Organizations Practice Symposium: From Basics to Hot Topics." The program was designed to address a variety of levels of skill and experience. In-person attendance was excellent, and there was robust attendance via webcast, as well.

Mike de Freitas, Josh Gewolb, Mike Cooney, Fred Attea and David Goldstein of our committee were among the presenters. There were additional presenters from around the State, as well as from Washington, D.C. James Sheehan, Charities Bureau Chief, and Donna Cole-Paul, Chief of the Charities Bureau Transactions Section, attended and presented at the invitation of our committee. Their presentations were particularly well-received. The program will be archived and will be available for on-demand purchase and viewing.

Our next committee meeting is scheduled for January 24, 2018 as part of the Association's annual meeting.

David Goldstein, Chair

Public Utility Law Committee

No report submitted.

Securities Regulation Committee

The Committee has had a busy and productive Fall schedule. In September, Richard Grossman and Gabrielle Wolf of Skadden, Arps, Slate, Meagher & Flom LLP presented on "Shareholder Activism: What Public Companies Need to Know," and Anna Pinedo of Morrison & Foerster discussed "The Securities and Exchange Commission and a Fiduciary Standard" (the SEC's original charge under Dodd-Frank to consider the standard of care applicable to broker-dealers, a study on the topic by the SEC, recent statements by SEC representatives regarding the Department of Labor Fiduciary Rule and actions we might anticipate). In October, Committee Chair Anastasia Rockas moderated a program on "Securities Regulation, Deregulation and Enforcement" at the NYSBA Business Law Section Fall Meeting on "Financial Regulation and Deregulation: What's Next." The panelists were Robert Colby, Chief Legal Officer, Financial Industry Regulatory Authority (FINRA); Katherine Milgram, Chief, Investor Protection Bureau, Office of the New York State Attorney General; and Daniel S. Kahl, the Associate Director and Chief Counsel for the Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission (SEC).

In November, the Committee hosted a great panel on "Blockchain, Tokens and Smart Contracts: Recent Legal Developments." The panel consisted of Stuart Levi from Skadden, Matthew O'Toole from Potter Anderson & Corroon LLP, and Dan Kahan from Morrison & Foerster LLP. Committee member Edward Eisert of Orrick, Herrington & Sutcliffe moderated the panel. Additionally, the Private Investment Funds Subcommittee held a program entitled "Countdown to MIFID." Speakers included Joe Morrissey of Seward & Kissel and Dale Gabbert of Simmons & Simmons.

In December, a group from Ballard Spahr presented an update on AML obligations of broker dealers.

At this writing, the Committee has scheduled a session in January, at which litigators from Skadden will be presenting a program on recent securities litigation and regulatory enforcement updates. We are also currently scheduling additional programs for the remainder of the year, including new updates on Regulation A+ and the DOT's recommendations for capital markets, among others, and we always welcome suggestions and requests from the members.

Anastasia Rockas, Chair
Kelley Basham, Secretary

Technology and Venture Law Committee

In June the Technology and Venture Law Committee met at the offices of Reitler Kailas & Rosenblatt LLC in New York City for an informal "wine and cheese" event which provided a great opportunity for attendees to socialize, network and learn from each other's experience and areas of expertise. The Committee also held a meeting in October at the offices of Reitler Kailas & Rosenblatt LLC. The topic of the meeting was "SAFEs v. Convertible Notes: Who Wins, Who Loses, and What Are the Differences?" The topic was very well received and a lively discussion ensued among the attendees. Ideas for related topics to be discussed at the next meeting were suggested.

Mikhail Mann, Committee Member
(Peter Rothberg, 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.

Manuscripts are to be submitted to:

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