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Inside

CORPORATE COUNSEL SECTION
30th YEAR

A publication of the Corporate Counsel Section of the New York State Bar Association

Message from the Chair

Once again the changing of the guard is upon us. This past year has been exceptional for our Section, which is only fitting as we have been celebrating our 30th anniversary. The Executive Committee worked tirelessly to create a more dynamic Section, including launching our presence on Facebook and LinkedIn, expanding our Diversity Internship Program, bringing our voice to the House of Delegates, improving and increasing our membership events and providing unsurpassed CLE opportunities, most notably our 4th Corporate Counsel Institute with a stellar panel of speakers, at a great venue and covering intriguing topics. We also had three stellar issues of *Inside*, with more substance than ever before including videos from *Inside* authors that are now posted on our NYSBA website. Leading the Section in all this fantastic activity has been an honor and it is with the utmost confidence and excitement that I turn the reins over to Dave Rothenberg, Chair for 2012, so that he can continue this great work.

While all that the Corporate Counsel Section does is meaningful, I want to mention one project in particular that I am very excited about and on which I will continue to work during Dave's tenure. Our Section, in conjunction with NYSBA President Vincent Doyle's initiative, has embarked on a Diversity Challenge. We

Inside

Editors: Janice Handler and Allison B. Tomlinson

SPECIAL ISSUE: WELCOME TO MY (REGULATED) WORLD

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have established a Diversity Challenge Committee and in conjunction with the Executive Committee designed a Plan of Action both to encourage diversity in its many forms and enhance the experience of diverse individuals within our Section and the legal profession generally by creating opportunities for greater interaction among all individuals and focusing on the specific needs and qualities of all individuals.

As part of the challenge, we have established three initiatives: (i) establish and promote a restricted fund within the New York Bar Foundation that will provide an annual grant to a non-profit organization for a Summer diversity internship for a first or second year law student with a $6,000 stipend; (ii) expand the Section's existing Kenneth G. Standard Diversity Internship Program to focus on its growing alumni base (now approaching 50 past interns) by, among other things, developing a mentor program and (iii) improve the experience of our existing diverse membership through more targeted programs, better promotion of the work of the Section and the solicitation of feedback on how our Section can better promote diversity. By now you should have received more detailed information about these initiatives and the work we have been doing. Our program is well under way and we are very excited about how these initiatives will shape our Section in the coming years. We are looking for feedback and assistance on the project from members of the Section and I urge you to reach out to me or any member of the Executive Committee if you want to become more involved.

I thank you for the privilege of having led our Section this past year and I look forward to continuing to contribute in the years ahead.

Greg Hoffman

Inside Inside

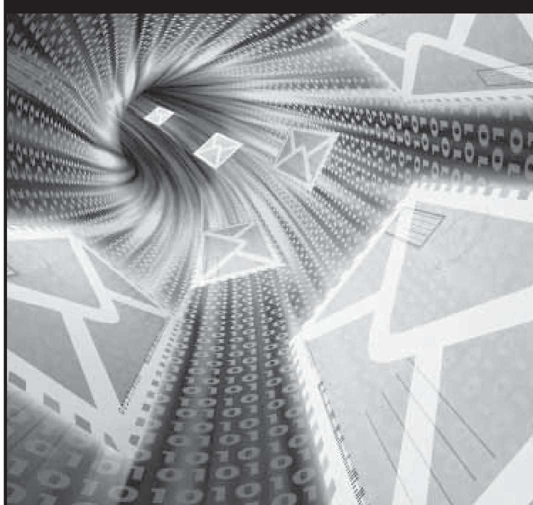
I tell my Corporate Counseling students that what law school is all about is cases, cases, cases. But what real life- and in-house lawyering is all about is regulations, regulations, regulations. It is essential when embarking on a corporate career to ascertain what agencies will be your business partners and what is the regulatory scheme that governs your industry.

It can make a huge difference. At one point in my in house career with a food company, we had a safety issue with a premium we were offering with a purchase, a glass container that had the unfortunate tendency to explode when heated. Since our usual stock in trade was food, I didn't know that glass containers were governed by an entirely different agency (Consumer Product Safety Commission rather than FDA) and much more stringent timetables for recall than FDA required. Fortunately somebody informed me before our deadline for reporting was past—but it was a close call.

We want to help our readers avoid such self-inflicted wounds, so in this issue we bring you all things regulatory. Whether you are in the business of banking, consumer goods , insurance, investment advising, or simply promoting your product through social media, there is something in this issue to enlighten you We also tell you how to advertise using a celebrity, how the tentacles of Dodd-Frank can embrace (or smother) you, and how to avoid environmental liability in the EU. And **all** employers will be interested in new anti-wage theft laws that impose new burdens on wages and hours bookkeeping. Enjoy this issue—and stay away from exploding glass containers.

Janice Handler

Request for Articles



If you have written an article and would like to have it considered for publication in *Inside*, please send it to either of its editors:

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Articles should be submittted in electronic document format (pdfs are NOT acceptable), and include biographical information.

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Dare to Compare: Know Your Options When Confronted with Deceptive Advertising

By Laurence Beckler

In today's competitive economic environment, consumers are bombarded daily by advertisements which tout a certain product as "Number One in Its Field" or "Better Than Any Other Product on the Market." Although such advertisements seem commonplace, comparative advertising is a relatively recent phenomenon used to extol the virtues of a certain product in comparison with a competing product in the same market. When used properly, comparative advertising is considered an important tool in promoting competition; however, if such claims are patently false or shed a misleading light on a competing product, a company making the claim can leave itself open to lawsuits and damages that would destroy the value created by the advertisement. This article briefly reviews the current state of the law on comparative advertising and suggests certain strategies that companies should consider when employing an advertising campaign based on comparative advertising to prevent litigation.

Before initiating a suit under Federal or State laws (including the Lanham Act), a party harmed by a comparative advertising claim should consider availing itself of the following non-legal options that may result in a cost effective resolution to its claims of infringement and damages. A potential plaintiff may challenge a competitor's claims by employing the following tactics:

- Drafting and sending the competitor a demand letter to remove the offending advertisement from circulation;
- Reaching out to the media outlet with a demand letter to remove the offending advertisement from circulation;
- Contact state and federal regulators; or both; or
- Initiating a proceeding with the National Advertising Division of the Better Business Bureau.

If none of the above referenced options results in a successful outcome, a plaintiff may bring an action under the Lanham Act or relevant state statutes covering comparative advertising claims. It is important to note that an aggrieved party may initiate more than one option at a single time, and even if one course of action fails to achieve the desired result, another may prove successful.

The Federal Trade Commission

Comparative advertising has been encouraged by the Federal Trade Commission (FTC) since the late 1960s and early 1970s by its statements and by adopting a hands-off approach to complaints from aggrieved competitors. The reason was that comparative advertising, if not misleading, increased the consumer's knowledge about alternative products, brands and services which encouraged competition among businesses. According to the FTC, "Comparative advertising is defined as advertising that compares alternative brands on objectively measurable attributes or price, and identifies the alternative brand by name, illustration or other distinctive information."[1] One of the first companies generally credited with employing comparative advertising to promote brand awareness and increased sales is Avis with its "We try harder" television ads that did not specifically mention Hertz as the leading rental car service at that time. The "We try harder" campaign created a relative, believable and compelling strength for Avis, eroding Hertz's dominance in the rental car business and becoming the "right choice" in the mind of the consumers. In part as a result of this successful campaign, the floodgates opened to pronouncements by advertisers in all industries of higher quality and more durability than their competitors. Inevitably, the competitors asserted that the ads were misleading and patently false but had no statute on which to make the basis of a claim. Advertisers on the receiving end of false or misleading comparisons needed some legal basis to halt the distribution of the offending advertisements and, in some cases, to obtain compensation for lost sales or loss of goodwill. Such relief would appear in the form of the Lanham Act.

Before initiating a discussion of the Lanham Act, it is important to note that a plaintiff may contact the FTC to address a comparative advertising complaint in tandem with filing a complaint based upon a comparative advertising campaign in which false or misleading claims about the plaintiff's product have been made. The FTC will consider an advertisement to be deceptive if the plaintiff can successfully prove the following: (1) that the advertisement contains a statement, omission, or representation that is likely to mislead a "reasonable" consumer; (2) that the statement, omission, or representation will affect the consumer's choices or conduct with respect to the good or service in question; and (3) that the infringing advertiser possesses no reasonable basis for making the damaging statement, omission or representation. Please note that a plaintiff seeking redress from the FTC has often found the process to be slow and frustrating. Generally, the FTC will not take a case unless it has a high profile or concerns sensitive issues such as health, public safety or fraud. Plaintiffs should also bear in mind that complaining to the FTC could expose its own advertising practices to scrutiny by the FTC, thereby increasing the possibility of further harm and expense to the plaintiff.

The Lanham Act

Rather than complain to the FTC, most competitors seeking redress for false or misleading advertisements file civil lawsuits in federal court under Section 43(a) of the Lanham Act (the "Act"). A defendant would be liable for a defamatory statement, omission, or representation where (1) the claim is literally false, whether factually or by implication if such claim can only be interpreted in a way that harms the plaintiff; and (2) the claim is true or ambiguous, but the interpretation of the claim deceives the consumer because of the inference of the message. Under the latter cause of action, the plaintiff bears a heavier burden of proof in that it must prove that the claim is false *and* that consumers actually were deceived by the claim. If successful, the Act provides for the following relief:

> any person who, on or in connection with any goods or services…uses in commerce any word, term, name, symbol, or device, or any combination thereof, or any false designation of origin, false or misleading description of fact, or false or misleading representation of fact, which…in commercial or advertising or promotion, misrepresents the nature, characteristics, qualities, or geographic origin of his or her or another person's goods, services, or commercial activities, shall be liable in a civil action by any person who believes that he or she is likely to be damaged by such act.

As a result, if the advertisement is false on its face, the court could issue an injunction halting the distribution of the ad, without any evidence of consumer confusion. However, if the ad is merely misleading and not facially false, the injured entity must show a likelihood of deception or confusion on the part of the consumer that was caused by the misleading ad in order to obtain the injunction. Furthermore, to recover damages, the plaintiff has to establish actual confusion or deception resulting from the false or misleading ad. In a civil action, plaintiffs would be eligible to receive the following remedies for breach of the Lanham Act including (1) immediate relief by means of an injunction to remove the misleading advertising from general circulation, whether as a temporary restraining order or as a cease and desist order, (2) obligating the defendant to run corrective advertising by way of an affirmative disclosure order, and / or (3) the award of damages to the plaintiff for lost profits and various expenses incurred as a result of the misleading advertisement. In one or two rare cases, punitive damages have been awarded to a plaintiff where the false or misleading advertising campaign was found to be malicious, egregious and willful.[2]

The Lanham Act initially appears to afford the plaintiff with an adequate forum in which to pursue its claims, but actions filed under the Act generally have not resulted in a satisfactory outcome for most plaintiffs. Disadvantages to pursuing litigation under the Lanham Act include:

- Time to Resolution—Litigation can take over a year from start to finish;
- Expense—Litigation is costly and a plaintiff must consider defending counterclaims and appeals;
- Disruption to plaintiff's business—depositions, interviews, expert testimony and discovery; and
- Unclean Hands—Litigation could expose a plaintiff to potentially damaging information about its own advertising practices.

Furthermore, should a plaintiff initiate a claim under the Act, unless the claim was patently false or misleading, the court would place the initial burden of proof upon the plaintiff to establish the infringing nature of the defendant's advertisement. The plaintiff must show that (1) the defendant made false or misleading statements of fact concerning his own product or another's; (2) the statement actually or tends to deceive a substantial portion of the intended audience; (3) the statement is material in that it would likely influence the deceived consumer's purchasing decisions; (4) the advertisement was used in interstate commerce; and (5) some causal link exists between the misleading statements and harm to the plaintiff. The plaintiff can support its claims by employing consumer surveys that clearly show how consumers interpreted a particular advertisement and subsequently their purchasing choices; however, such surveys are costly and time consuming.

In June 2011, the Northern District of Illinois, Eastern Division denied a plaintiff a temporary restraining order ("TRO") in a Lanham Act case between rival restaurateurs who are different factions of the same family.[3] Vienna Beef (the "Plaintiff"), which controls ¾ of Chicago's hot dog community, initiated a suit under the Act to prevent Red Hot Chicago, Inc. (the "Defendant"), run by the grandson of the Plaintiff's founder, from making statements that alluded to the family's recipes and history of sausage making on signs, billboards and other promotional materials. As background on this case, the grandson, who had worked in the family business for twelve years, left the Plaintiff's employ, sold all of his equity in the business and waited 2½ years for his non-compete to expire. The Plaintiff claimed that the Defendant's statements implied that the Defendant maintained a connection to the Plaintiff's business, effectively misleading consumers as to his connection with the Plaintiff. Judge Coleman denied the TRO, primarily due to the fact that the Defendant had made the alleged infringing claims for years, which undermined the need for expediency to grant the TRO. Furthermore, the Court determined that (1) Defendant's statements about its family tradition were true, literally, (2) Defendant's use of phrases such as "drag it through the garden" were merely descriptive; and (3) Defendant's statements did not cause consumer confusion as required by the Act. The takeaway from this case for potential plaintiffs is that a plaintiff should not bring a TRO against a defendant that continued to employ a long-standing marketing campaign. In addition, a plaintiff must present third party evidence of actual misleading or confusion to succeed in a claim that the advertising creates a false impression.

If a plaintiff successfully meets its aforementioned burden, defendants may avail themselves of certain affirmative defenses such as claiming "puffery." Puffery can be defined as an exaggeration, bluster, or boasting upon which no reasonable buyer would rely upon or general claims of superiority that are so vague that they are understood only as a matter of opinion. Such a defense will seek to categorize the defendant's claim as an opinion and therefore non-actionable. Finally the cost of initiating a lawsuit in federal court can be expensive and time consuming, thereby acting as additional barriers to prospective plaintiffs. It is interesting to note that, despite the probability that a plaintiff will not achieve an award of damages or an injunction under the Act, legal disputes brought under the Act are frequent.

New York State Law

As an alternative to initiating a suit under federal law, a plaintiff may seek redress for misleading and false advertisements in state courts. Article 22-A of the New York State General Business Laws, titled "Consumer Protection from Deceptive Acts and Practices" functions largely in the same way as the Act and is intended to protect those who purchase goods, services or property primarily for "personal, family or household purposes." This statute only protects consumers who fall victim to misrepresentations made by sellers of goods, rather than claims by disgruntled businesses that may have been harmed by competing claims. Note also that New York State courts rarely impose damages on a defendant for cases of this nature.

National Advertising Division of the Better Business Bureau

An alternative to litigation, a plaintiff can challenge a comparative advertising campaign by filing a complaint with the National Advertising Division ("NAD") of the Council of Better Business Bureaus. The NAD was formed by the major trade organizations within the advertising industry and boasts a compliance rate of over 95% for decisions involving false or misleading advertising complaints. The NAD's treatment of comparative advertising claims generally mirrors that of the FTC; however, the NAD takes a more liberal view of permitting allegedly unfair or misleading advertisements to continue to be run unless it finds that the advertisement in question contains a reasonable basis to support its claims, whether express or implied. The NAD permits comparisons that are factually accurate and meaningful to consumers, and allows comparisons of dissimilar products as long as the items are clearly marked and material differences are clearly disclosed. A big advantage of employing the NAD is that it will rule on a particular matter within 90 days of receiving a challenging party's claim.

Prior to initiating an action through the NAD, participating parties will be required to sign a no-publicity statement that bars both parties from using the proceedings for publicity purposes during or after the proceeding. Upon reaching a final decision, the NAD will issue a publicity statement announcing the outcome, and both parties may provide a statement indicating their compliance with the NAD decision. NAD rules do not allow counterclaims; however, a party subject to a NAD claim may bring a retaliatory challenge to the plaintiff's initial challenge. It is important to note that challenges made under the NAD rarely result in a complete termination of an advertising campaign; however, should the NAD find for the plaintiff, defendants usually modify their ads to remedy the outstanding problems. A plaintiff should also consider employing the NAD to hear a dispute because the proceedings are generally less expensive than full blown litigation and such a proceeding will not open the plaintiff's advertising practices to public scrutiny through counterclaim.

Filing fees for competitive challenges submitted by members of the Council of Better Business Bureaus run $2,500. For non-members, filing fees are determined by a plaintiff's gross annual revenue and range from $6,000 to $20,000. Finally the NAD has no authority to impose damages, so plaintiffs must be content with forcing a competitor to alter its ads; however, given the NAD's reputation within the industry, parties generally honor NAD decisions, regardless of the final determination. Should a party fail to comply with the NAD's decision, the NAD will forward the dispute to the FTC or applicable state regulatory agency for action. Though such referral does not automatically result in a formal investigation, the potential for increased scrutiny often acts as a deterrent, resulting in compliance with the NAD's decision.

Strategies and Suggestions

Prior to commencing an advertising campaign based on comparative claims regarding the value, performance or efficacy of the product or service, consider implementing the following guidelines that should minimize exposure to potentially harmful and embarrassing litigation.

- Have an attorney, expert in advertising law, examine the advertisement or campaign to spot and correct potential problem areas before they result in litigation.
- Compare goods and services with comparable features and purposes.
- Disclose any material limitations on the supporting data used to make the claim.
- Do not present false or misleading statements about the competition's products or services.
- Respect the competition's trademarks and service marks.
- Do not infer that a joint venture or other partnership has been created with the competitors displayed in the advertisement.
- Double check the data and methodology used as the basis for comparison.
- Make sure that the superiority claims on the products and services are pertinent to circumstances in which the product or service is used by the consumer.

Please note that in addition to the preceding guidelines, a business initiating an advertising campaign based on comparative ads can also limit its liability exposure contractually with its advertising agency or by procuring business insurance. When hiring an advertising agency, a business can negotiate an indemnification clause in which the advertising agency agrees to indemnify the business for any and all litigation resulting from the comparative ads; however, the agency would likely require the advertiser to sign off on all advertisements that are made available to the public so that tactic may not prove effective. Absent an indemnity clause, the advertiser being sued by a competitor could claim that its agency was negligent in creating the advertising campaign, which could relieve it from liability. Again, this tactic is not likely a good bet as the advertiser would likely be required by the agency to sign off on running the advertisement. Finally the business can procure insurance either as part of its general business policy or on a project-by-project basis under which it will be covered. Insurance, while costly, is an advertisers best bet to guard against liability based on a comparative advertising claim.

Comparative advertising can be an effective advertising tool, provided that the claims being made are truthful, substantiated and not misleading. Such campaigns do come with greater risks but can also lead to greater rewards. Assume that all campaigns will be monitored closely by the competition; therefore, a business should take care to follow the guidelines set forth above as a strategy to avoid potential litigation.

Endnotes

1. Statement of Policy Regarding Comparative Advertising, Federal Trade Commission, Washington, D.C., August 13, 1979.
2. U-Haul International Inc. v. Jartran, Inc., 793 F.2d 1034 (9th Cir. 1986).
3. U.S. District Court. Northern District of Illinois (Chicago). Civil Docket for Case # 11 C 3825.

The Law Office of Laurence Beckler, PLLC primarily represents individuals and companies in business and corporate matters including drafting and negotiating transactional documents to support the operational needs of the firm's clients. Mr. Beckler has advised clients on a wide range of intellectual property issues related to advertising, marketing and ecommerce issues for national and international brands and has consulted on children's television shows currently being shown on PBS and Nickelodeon.

The FTC's Revised Endorsement Guides Impact How Companies Can Advertise Through Social Media[1]

By Laura Sack

A TV commercial that aired in the early 1980s featured a young Heather Locklear exclaiming that Faberge® Organics shampoo was so good that she "told two friends about it, and they told two friends, and so on, and so on, and so on…." This is how viral marketing worked before the advent of the internet, social media and blogs—advertisers used word of mouth, for example, to increase brand awareness and sales.

Times have changed. These days, people are not just telling their two friends about their favorite products and services—they are telling the entire internet community. In some cases, these endorsers have a commercial relationship with the advertiser. According to the FTC's Revised Endorsement Guides, effective December 1, 2009 (the "Guides"), those relationships must be disclosed to consumers.[2]

To be sure, the Guides have always required endorsers to disclose their relationship with an advertiser "that might materially affect the weight or credibility of the endorsement."[3] An "endorsement" is "any advertising message…that consumers are likely to believe reflects the opinions, beliefs, findings, or experiences of a party other than the sponsoring advertiser, even if the views expressed by that party are identical to those of the sponsoring advertiser."[4] What is now clear is that endorsements issued via social media, including blogs, are covered by the Guides.

What Are the Practical Implications for Bloggers?

If a blogger has *no* relationship with the company whose product or service that blogger is reviewing, then there is nothing to disclose to consumers. Thus, the Guides have little or no impact on bloggers who do not accept freebies, payment, or commission for their blog posts.

The trickier question is when a blogger has a "relationship" that could impact a consumer's view of their endorsement and would therefore require disclosure under the Guides. The following examples illustrate how fine the line may be:

- An advertiser sends a blogger its product (and possibly other freebies) in the mail for the blogger to use free of charge. The blogger then posts a review of the product(s) on his blog. Disclosure is required.[5]
- A blogger receives a free coupon from her local store for a more expensive brand of a product she typically buys. The blogger uses the new product and writes a review on her blog. Disclosure is not required.[6]
- A blogger attends an industry conference and receives a bag full of SWAG, or "stuff we all get." The blogger reviews one of the products he received for free at the conference. Disclosure is not required.[7]
- A blogger provides a review for a product, and near or around that review is a link that connects the reader to the product's website. Each time a consumer purchases the product via the blogger's link, the blogger is paid a commission. Disclosure is required.[8]
- A blogger receives monetary payment or a discount (even one that may be considered *de minimis*) for posting a review of the advertiser's product. Disclosure is required.[9]
- A blogger is employed by the company whose product he endorses. Disclosure is required.[10]

The Guides may apply to negative reviews as well as positive ones. Thus, for example, if a blogger has a relationship with a business and posts a negative review of a product manufactured by a competitor of that business, the blogger may be required to disclose her relationship to the business.

The Guides do not state that there is any one way (or only one correct way) to provide a disclosure, and the FTC has stated that "legalese" is not necessary.[11] So long as the disclosure clearly and conspicuously conveys to the reader the relationship between the blogger and the advertiser, the disclosure will be adequate. If, for example, a blogger receives a product for free from an advertiser and subsequently posts a review of that product, a simple statement such as "Company ABC gave me this product to try…" will suffice.[12] On the other hand, placing a blanket disclosure on the "About Us" or "General Info" page of a blog likely will not satisfy the disclosure requirement, as it is not clear and conspicuous.[13] With respect to Twitter, the FTC stated that hashtags such as "#paid ad," "#paid" or "#ad" (which require very few of the 140 characters permitted in a Twitter post) will satisfy the disclosure obligation.[14]

Even if they clearly and conspicuously disclose their relationship with the company whose product they are endorsing, bloggers still may be subject to liability "for misleading or unsubstantiated representations made in the course of [their] endorsement."[15] According to the Guides, "endorsements must reflect the honest opinions, findings, beliefs, or experiences of the endorser." Thus, bloggers must be mindful that:

- You can't talk about your experience with a product if you haven't tried it.
- If you were paid to try a product and you thought it was terrible, you can't say it's terrific.
- You can't make claims about a product that would require proof you don't have. For example, you can't say a product will cure a particular disease if there isn't scientific evidence to prove that's true.[16]

Put simply, the Guides require bloggers to write what they know. A blogger who makes an unsubstantiated claim that a product can cure a particular disease or is proven to lead to certain extraordinary results, could face a complaint by the FTC or by a consumer if that consumer relied on the blogger's inaccurate endorsement and was financially or physically harmed.

Although the FTC has stated that its "focus will be advertisers, not endorsers,"[17] bloggers should still comply with the Guides to avoid FTC or consumer complaints. Additionally, many advertisers will likely contractually require bloggers and the affiliate marketing companies that work with bloggers to comply with the Guides.

What Are the Practical Implications for Advertisers?

Advertisers of all sizes and in a variety of fields are likely to feel the impact of the FTC's Revised Endorsement Guidelines. For many advertisers, viral advertising through blogs or social media is a cheap and relatively easy way to get a buzz going about a product or service. The Guides do not prevent advertisers from continuing to capitalize on the power of social media and the blogosphere. Rather, the Guides make advertisers liable when the blog, post, or review (1) fails to disclose the relationship between the advertiser and endorser, or (2) contains "misleading or unsubstantiated representations."[18] As explained above, relationships with the advertiser that must be disclosed include bloggers who receive some form of compensation in connection with the review, and employees of the advertiser who endorse the advertiser's product.

Monitoring Outsiders: Bloggers and Consumer Reviews

As discussed above, a relationship "that might materially affect the weight or credibility of the endorsement" (and that therefore requires disclosure) includes a relationship between a blogger who receives freebies or other compensation from an advertiser, and that advertiser.[19] Such relationships must be disclosed to the consumer, and the FTC will largely hold the advertiser (and not the blogger) responsible when the disclosure is either missing or insufficient. Below is one example cited by the FTC:

> A college student who has earned a reputation as a video game expert maintains a personal weblog or "blog" where he posts entries about his gaming experiences. Readers of his blog frequently seek his opinions about video game hardware and software. As it has done in the past, the manufacturer of a newly released video game system sends the student a free copy of the system and asks him to write about it on his blog. He tests the new gaming system and writes a favorable review. Because his review is disseminated via a form of consumer-generated media in which his relationship to the advertiser is not inherently obvious, readers are unlikely to know that he has received the video game system free of charge in exchange for his review of the product, and given the value of the video game system, this fact likely would materially affect the credibility they attach to his endorsement. Accordingly, the blogger should clearly and conspicuously disclose that he received the gaming system free of charge. The manufacturer ***should advise him at the time it provides the gaming system that this connection should be disclosed, and it should have procedures in place to try to monitor his postings for compliance***.[20]

It may seem daunting to an advertiser that utilizes a variety of affiliate marketers (who are rewarded by an advertiser for driving consumers to purchase the advertiser's product) to account for everything mentioned about its product on the internet. In determining whether an advertiser has complied with the Guides, the FTC will consider whether that advertiser has developed a "reasonable program" to monitor what bloggers and affiliate marketers are saying about its product or service.[21] What the FTC deems as a reasonable or unreasonable monitoring program is yet to be seen, but it will likely vary based on the industry of the product or service. The FTC has stated that the "scope of the program depends on the risk that deceptive practices by network participants could cause consumer harm—either physical injury or financial loss."[22] Thus, for example, the FTC may expect an advertiser for health care products to employ greater network supervision than an advertiser for handbags.[23]

As discussed more fully below, the FTC has recently entered into a settlement which included a requirement that the advertiser institute a monitoring program and provide monthly reports to the FTC. In that case, the advertiser (a relatively small company) agreed as part of its settlement with the FTC to monitor the top 50 revenue-generating affiliate marketers, and to randomly select an additional 50 affiliate marketers to monitor each month.[24] The settlement recognizes that it may not be possible to scour the internet for every blog post or twitter feed.

Advertisers designing their own monitoring programs may want to monitor a selection of the most popular or highest revenue-generating websites, followed by a random selection of other websites. Advertisers should also consider modifying their contracts with both bloggers and with the network marketing businesses hired to engage bloggers. The contracts should include clear requirements that the blogger must comply with the disclosure requirements set forth in the Guides. Advertisers may even want to provide bloggers with sample (or required) disclosure language to ensure that the FTC's requirements are met. Additionally, advertisers should make sure that any network marketing business they engage has a program in place to (1) notify the members of the network of the disclosure requirements, and (2) enable the advertiser to periodically check whether the network members are actually making the disclosures.[25]

Monitoring Insiders: Employee Blogs or Social Media Posts

According to the FTC, an employment relationship between a product reviewer or endorser and the advertiser is a "material connection" that must also be clearly and conspicuously disclosed. For example, if a blogger posts a statement about his or her employer's product or service, that blogger "should clearly and conspicuously disclose her relationship to the manufacturer to members and readers of the message board," on the theory that a consumer's understanding of the "poster's employment likely would affect the credibility of her endorsement."[26] In the absence of the disclosure of such a "material connection," an advertiser could find itself liable for damages suffered by a consumer who relied upon an inaccurate, inappropriate statement by one of its employees.

The Guides offer the following example to illustrate the need to disclose the employment relationship when an employee endorses her employer's product:

> An online message board designated for discussions of new music download technology is frequented by MP3 player enthusiasts. They exchange information about new products, utilities, and the functionality of numerous playback devices. Unbeknownst to the message board community, an employee of a leading playback device manufacturer has been posting messages on the discussion board promoting the manufacturer's product. Knowledge of this poster's employment likely would affect the weight or credibility of her endorsement. Therefore, the poster should clearly and conspicuously disclose her relationship to the manufacturer to members and readers of the message board.[27]

Even a more attenuated employment relationship between the product and the endorser can require conspicuous disclosure. For example, in August 2010, the FTC settled its complaint against Reverb Communications, an online public relations firm.[28] According to the FTC, Reverb had its employees post positive reviews on iTunes of its clients' gaming applications, without disclosing that the reviews were posted by individuals who had a material relationship with the app developer.[29] As part of its settlement with the FTC, Reverb agreed not to permit its employees to endorse any product without conspicuously disclosing their connection to Reverb and / or the Reverb client that manufactures the product.[30]

Advertisers are well advised to implement and enforce a written social media policy (and to provide training to their employees with respect to the policy) that either prohibits employees from making comments via social media concerning the employer's goods and services, or requires employees to clearly and prominently disclose their employment relationship when publishing any such online commentary. Like any other disclosure required by the Guides, this disclosure must be clear and conspicuous, and must appear in close proximity to the online endorsement. Simply listing one's employer on his / her "info" page is insufficient;[31] the consumer cannot be expected to search for disclosure of a material relationship between the advertiser and the endorser. Additionally, many companies are diversified and a consumer may not know what products the employer manufactures.

Knowing that someone is employed by Procter & Gamble ("P&G"), for example, does not necessarily equate to knowing that P&G owns Iams, a pet food brand. Someone's Facebook profile could reveal that she is employed by P&G, while elsewhere on Facebook, she touts Iams cat food as the very best cat food money can buy. The average consumer is unlikely to know that she works for the company that owns Iams (namely, P&G), unless she conspicuously discloses that fact as part of (or in close proximity to) her endorsement of their cat food.

In the absence of such a disclosure, the advertiser may ultimately be held liable for damages a consumer suffers if the consumer detrimentally relied upon that employee's endorsement in purchasing the advertiser's products or services, mistakenly believing that the endorsement came from a disinterested consumer rather than from someone who has a material connection to the advertiser. Theoretically, at least, the aggrieved consumer could turn the claim into a class action. And of course, the FTC itself is monitoring social media and has begun to issue complaints against advertisers that violate the Guides. Advertisers that have established appropriate policies and procedures regulating their employees' issuance of endorsements are less likely to be prosecuted by the FTC in an enforcement action. The FTC has also stated that it is unlikely to prosecute employers for the actions of "rogue employees."[32]

Is the FTC Enforcing the Revised Endorsement Guidelines?

Yes. In March 2011, the FTC announced a $250,000 settlement with a company called Legacy Learning Systems, Inc. ("Legacy") and its owner which, according to the FTC, used "misleading online 'consumer' and 'independent' reviews."[33] Legacy advertised its guitar-learning DVD program through the use of an online affiliate program.[34] The affiliates promoted the DVD program through endorsements, and received a commission for products sold when the consumer used the link on the affiliate's web page.[35] The FTC alleged that the affiliates did not disclose their relationship with Legacy, and instead, the endorsements appeared to reflect "the view of ordinary consumers or 'independent' reviewers."[36] The FTC claimed that Legacy generated roughly $5 million in sales as a result of affiliate marketing—making the $250,000 fine 5% of those estimated sales.[37] In addition to the fine, Legacy agreed to monitor its top 50 revenue-generating affiliate marketers and another 50 randomly selected affiliate marketers each month to ensure that the appropriate disclosures are being made.[38] The settlement agreement between the FTC and Legacy can be found here: http://www.ftc.gov/os/caselist/1023055/110315llsagree.pdf.

Ann Taylor also took some heat from the FTC regarding a January 2010 event described as an "exclusive blogger preview" of the 2010 LOFT collection.[39] The invitation to this event indicated that "Bloggers who attend will receive a special gift, and those who post coverage from the event will be entered into a mystery gift card drawing where you can win up to $500 at LOFT."[40] Ultimately, the FTC did not recommend enforcement action, in part because a very small number of bloggers attended the event and "LOFT adopted a written policy in February 2010 stating that LOFT will not issue any gift to any blogger without first telling the blogger that the blogger must disclose the gift in his or her blog."[41] The full letter from the FTC to Ann Taylor's counsel can be found here: http://www.ftc.gov/os/closings/100420anntaylorclosingletter.pdf.

Where Can I Get More Information?

Questions regarding the revised Guides can be submitted to the FTC at endorsements@ftc.com. The Guides themselves (as well as more than 35 examples of how they apply in practical settings) are available online at ftc.gov/os/2009/10/091005revisedendorsementguides.pdf. The FTC's June 23, 2010 FAQs, called "The FTC's Revised Endorsement Guides: What People Are Asking," are available at ftc.gov/bcp/edu/pubs/business/adv/bus71.shtm.

Endnotes

1. The author gratefully acknowledges the substantial contributions of her colleague, Michelle D. Velásquez, to this article.
2. The FTC Guides Concerning the Use of Endorsements and Testimonials in Advertising are codified at 16 CFR Part 255. The Guides address the application of Section 5 of the FTC Act (15 U.S.C. 45). The full text can be located on the FTC website at http://ftc.gov/os/2009/10/091005revisedendorsementguides.pdf.
3. 16 C.F.R. § 255.5 (2010).
4. 16 C.F.R. § 255.0(b) (2010).
5. 16 C.F.R. § 255.5 (2010) (see Example 7).
6. 16 C.F.R. § 255.0(e) (2010) (see Example 8).
7. *See* http://getgood.com/roadmaps/2010/06/29/travel-blogs-ethics-and-the-ftc-endorsement-guidelines/. Mary Engle spoke at a conference for travel bloggers on June 29, 2010 and explained that a disclosure is required if the advertiser is reaching out to specific bloggers with free products. If a blogger receives a free product at a conference, the reason the blogger received the SWAG was that he/she was a member of a group, not as an individual. However, bloggers should be conscious of the fine line between a general conference of bloggers or the general public and the Ann Taylor event discussed below.
8. *See* http://www.ftc.gov/os/caselist/1023055/110315llsagree.pdf.

9. *See* http://business.ftc.gov/documents/bus71-ftcs-revised-endorsement-guideswhat-people-are-asking.
10. 16 C.F.R. § 255.5 (2010) (see Example 8).
11. *See* http://business.ftc.gov/documents/bus71-ftcs-revised-endorsement-guideswhat-people-are-asking. (“Is there special language I have to use to make the disclosure? No. The point is to give readers the information. Your disclosure could be as simple as “Company X gave me this product to try….”).
12. *Id.*
13. *See id.* (“Putting disclosures in obscure places—for example, buried on an ABOUT US or GENERAL INFO page, behind a poorly labeled hyperlink or in a terms of service agreement—isn’t good enough.”).
14. *See id.* (“What about a platform like Twitter?…A hashtag like “#paid ad” uses only 8 characters. Shorter hashtags—like “#paid” and “#ad”—also might be effective.”)
15. 16 C.F.R. § 255.1(d) (2010) (see Example 5).
16. *See* http://business.ftc.gov/documents/bus71-ftcs-revised-endorsement-guideswhat-people-are-asking.
17. *See id.* (“If law enforcement becomes necessary, [the FTC’s] focus will be advertisers, not endorsers—just as it’s always been.”).
18. *See* 16 C.F.R. § 255.1(d) (2010).
19. *See* 16 C.F.R. § 255.5 (2010).
20. 16 C.F.R. § 255.5 (2010) (see Example 7).
21. *See* http://business.ftc.gov/documents/bus71-ftcs-revised-endorsement-guideswhat-people-are-asking. (“Advertisers need to have reasonable programs in place to train and monitor members of their network…It would be unrealistic to say you had to be aware of every single statement made by a member of your network. But it’s up to you to make an effort to know where your people are talking about your product. It’s unlikely that the activity of a rogue blogger would be the basis of a law enforcement action if your company has a reasonable training and monitoring program.”).
22. *See id.*; *see also* Guides Concerning the Use of Endorsements and Testimonials in Advertising, 74 Fed. Reg. 53,136 (October 15, 2009) (to be codified at 16 C.F.R. Part 255) (“The Commission does not believe, however, that it needs to spell out the procedures that companies should put in place to monitor compliance with the principles set forth in the Guides; these are appropriate subjects for advertisers to determine for themselves, because they have the best knowledge of their business practices, and thus, of the processes that would best fulfill their responsibilities.”).
23. *See id.*
24. *In the Matter of Legacy Learning Systems, Inc., et al.*, FTC File No. 1023055, Agreement Containing Consent Order.
25. *See* http://business.ftc.gov/documents/bus71-ftcs-revised-endorsement-guideswhat-people-are-asking. (The FTC stated that affiliate marketing businesses may want to “consider putting a program in place to check periodically whether your members are making [the required] disclosures.”).
26. 16 C.F.R. § 255.5 (2010) (see Example 8).
27. *Id.*
28. *In the Matter of Reverb Communications, Inc., et al.*, FTC File No. 093-3199, Agreement Containing Consent Order. Full text of the consent order is available at http://www.ftc.gov/os/caselist/0923199/100826reverbagree.pdf.
29. *In the Matter of Reverb Communications, Inc., et al.*, FTC Docket No. C-4310 (Nov. 22, 2010). Full text of the complaint is available at http://www.ftc.gov/os/caselist/0923199/101126reverbcmpt.pdf.
30. *In the Matter of Reverb Communications, Inc., et al.*, FTC File No. 093-3199, Agreement Containing Consent Order.
31. *See* http://business.ftc.gov/documents/bus71-ftcs-revised-endorsement-guideswhat-people-are-asking.
32. *See* Guides Concerning the Use of Endorsements and Testimonials in Advertising, 74 Fed. Reg. 53,136 (October 15, 2009) (to be codified at 16 C.F.R. Part 255).
33. *In the Matter of Legacy Learning Systems, Inc., et al.*, FTC Docket No. C-4323, Complaint (June 1, 2011). The full text of the Complaint can be found at http://www.ftc.gov/os/caselist/1023055/110610legacylearningcmpt.pdf.
34. *Id.* at ¶ 5.
35. *Id.*
36. *Id.* at ¶ 10.
37. *Id.* at ¶ 8.
38. *In the Matter of Legacy Learning Systems, Inc., et al.*, FTC File No. 1023055, Agreement Containing Consent Order.
39. *See* http://adage.com/article/news/ann-taylor-case-shows-ftc-keeping-close-eye-blogging/143567/.
40. *Id.*
41. *See* Letter from Mary Engle to Kenneth Plevan, Re: Ann Taylor Stores Corp., File No. 102-3147 (April 20, 2010).

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Anti-Wage Theft Laws: A Solution Creating More Problems Than It Solves?

By Joel J. Greenwald

It has always been the law that employees must be paid all wages due them, and there have always been remedies for employees when they were not: the employee could complain to the federal or state Department of Labor, and / or could bring a private lawsuit (either individually, or together with other, similarly situated workers). Without denying that some workers have been taken advantage of, and without denigrating how serious not being correctly paid is, there was no apparent epidemic of nonpayment sweeping the nation, or any particular reason to think that the existing remedies didn't work.

So if that's the case, why are "anti-wage theft" laws starting to sweep the nation?

New York State's Wage Theft Prevention Act enacted in December 2010 is one of the most talked-about "anti-wage theft" laws. The Wage Theft Prevention Act (WTPA)[1] increased the penalties and exposure to civil liability for failure to pay minimum or overtime wages, and reporting or record-keeping failures, while simultaneously increasing the record-keeping burden on employers. Under the Act, within 10 days of an employee's start date, and annually each January thereafter, employers must provide employees with written notice of:

1. The employee's rate of pay (including overtime rates, for nonexempt employees) (i.e. you have to inform employees of their classification)
2. How the employee's pay is calculated (i.e. by piece, hour, shift, day, week, salary, commission, or other)
3. Any allowances claimed by the employer as part of minimum wage (e.g. tip credit; or meal or lodging allowance) and
4. The employee's regular payday.

The notices must be provided to the employee in English as well as the employee's primary language.

In addition, each time wages are paid—so, each payday—employers must provide their employees with (a) written notice of the dates covered by that payment; (b) items 1, 2 and 3 above, and (c) the employee's gross wages, itemized deductions from gross wages, and net wages. Employers will need to be able to show this information was provided as well.

> *"The Wage Theft Prevention Act (WTPA) increased the penalties and exposure to civil liability for failure to pay minimum or overtime wages, and reporting or record-keeping failures, while simultaneously increasing the record-keeping burden on employers."*

If an employer fails to provide the proper annual or start-date notice, the employee may recover $50 a week until the violation is remedied, up to $2,500 for each employee. Also, if an employer fails to provide the wage statement information, the employee may recover $100 a week until the violation is remedied, up to $2,500. In addition, an employee may recover an equal amount in liquidated damages plus collect his / her costs and attorney's fees. Thus, it is crucial for employers to be in compliance.

The records required by the Act (i.e. the above notices) must be kept for six years, and the Act contains a six-year statute of limitations, or time period during which a legal action could be brought for violations of the Act.

Thus, these requirements hit employers two ways: first, by directly increasing compliance costs; and second, by enhancing the likelihood of private lawsuits by allowing private lawsuits to redress recordkeeping violations.

The federal Department of Labor is currently proposing regulations[2] which will require extensive new disclosures by all employers to their employees. Under the proposed rules, employers will have to notify their workers of their rights under the Fair Labor Standards Act, provide information regarding hours worked and wage calculation, and even perform an explicit "classification analysis" of any workers, such as independent contractors or purported exempt employees, they intend to exclude from the coverage of the FLSA and provide that analysis to workers. Again, this type of notice requirement is meant to bring the issue of correct pay and classification to the employees. If such a regulation is passed, it will result in significantly more costs to employers to analyze both the correct classification of workers and to address the significant liability associated with workers finding they were incorrectly classified.

> *"If you can avoid fines and lawsuits (and bad publicity) while also using the opportunity to improve your practices, you've met the challenge posed by these new rules successfully."*

Other states have jumped on the bandwagon, too. For example, Maryland,[3] Illinois[4] New Mexico[5] and Washington State[6] have all passed their own anti-wage theft laws. The movement's even trickled down to the local level: Miami-Dade County[7] and the city of San Francisco[8] have passed their own ordinances, too. And this just the tip of the iceberg: wage theft laws are being considered or have been passed in jurisdictions all across the country.

While the laws vary—and generally appear to not be as tough as New York's law—what they all seem to have in common is increasing compliance burdens by increasing penalties and expanding liability while simultaneously making the government even more involved in "policing" wage issues than it has been in the past.

The problem is that to catch or deter a minority of businesses, all businesses have significant new mandates and costs imposed on them. Overall, it's reasonable to predict that the aggregate cost to business will exceed any gains—but whether these laws are good or bad, they *are*. That means that businesses must adapt to them?

What can and should an individual business do? First, it's vital to recognize that it is likely that the business is, or will soon be, affected by one or more sets of wage theft rules or laws, on the federal, state, and/or local level. Second, it's important to also recognize that these laws reflect a sea change in the nation's mood—expect that any purported wage theft will be viewed harshly by regulatory agencies and the courts.

With all that in mind, it pays be to be prudent. Consult with employment counsel about both what laws now (or shortly will) affect your business, and have counsel analyze your wage-related practices for compliance. You may also wish to review your wage-related practices from an economic as well as legal perspective. Your goal is to ensure full compliance with the law while also streamlining your processes as much as possible. If you can avoid fines and lawsuits (and bad publicity) while also using the opportunity to improve your practices, you've met the challenge posed by these new rules successfully.

DISCLAIMER: The foregoing is a summary of the laws discussed above for the purpose of providing a general overview of these laws. These materials are not meant, nor should they be construed, to provide information that is specific to any law(s). The above is not legal advice and you should consult with counsel concerning the applicability of any law to your particular situation.

Endnotes

1. Fact Sheet: http://www.labor.ny.gov/formsdocs/wp/P715.pdf.
2. http://www.dol.gov/regulations/factsheets/whd-fs-flsa-record-keeping.htm.
3. MD Code Ann. Lab. & Empl. §§ 3-501 *et seq*, (2009).
4. 820 ILCS 115, (2010).
5. § 1 37-1-5, 50-4-32, 50-4-26, 50-4-26.1 NMSA 1978 (2009).
6. Chapter 42 of the Laws of 2010.
7. Miami–Dade Fla., Code of Miami-Dade County cha. 22 (2010).
8. San Francisco, Cal., Ordinance 101594 (2011).

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Not the Wild West: Regulation of Social Media

By Mark Grossman

It is time for companies to take their blinders off. Social networking is not going away. You can choose to embrace it now or wait until your company is the last one in. Either way, your company will use social networking at some point. Why wait?

If your answer is that there is legal risk, I would submit that this is a poor answer. Most activities carry legal risk and our job as lawyers is to help our clients manage those risks. Moreover, the risks that come from social networking are manageable. This article will help you accomplish this.

The "risk" issue reminds me of when Internet email was hitting corporate desktops in the 1990s. Companies engaged in what today seems like nonsensical debates about whether employees needed email. Of course, they did. Similarly, they worried about legal risk in the face of unknown law. Sound familiar?

I remember writing a column in the 1990s where I said that virtually every employee with a telephone on his or her desk would have email access within five years. That is one prediction I got right.

Now I have a new prediction. Within two years, virtually every company will be using social media like LinkedIn, Facebook, Google+, and Twitter to promote itself. Does your company really want to be last in?

Reining in Risk for the Enterprise

Most commentators would acknowledge that social networking for the enterprise is not without risks. In fact, it is like any other public forum and carries most of the same risks. Some of the issues that your company needs to consider include copyright infringement, trademark violations, litigation-related issues, advertising and employment law, and privacy.

The starting point of any legal analysis of any issue involving the Internet is that the Internet is *not* the Wild West. Rather, it is a forum that is at least as regulated as any newspaper.

The problem is that like any new technology, new law trails the development of the technology. After all, nobody regulates technology that is yet to arrive.

And "new" is where we are with social media in that the law is still developing. Thus, as we had to do with the Internet generally in the 1990s when "Internet Law" was still in its infancy, we must look to current law and use common sense to apply it by analogy to social networking. (The problem is the concept of "common sense" since "law" has been described as "common sense as modified by the legislature and courts.")

> *"Some of the issues that your company needs to consider include copyright infringement, trademark violations, litigation-related issues, advertising and employment law, and privacy."*

Some of the analogies are easier than others. For example, it is certainly clear that your company cannot use material created by others in violation of general copyright law. The Digital Millennium Copyright Act ("DMCA") is yet another Federal statute that is relevant to social networking. The DMCA could require that your company promptly take down material from a social networking site it controls whether or not an employee or third party posted the infringing content.[1]

Likewise, your company's social networking posts must be sensitive to trademark law. If your trademark analysis says that your company could not use "Coke's®" logo in a company brochure, you could not use it on your company's blog. This is the common sense part.

Another easy one is in the area of litigation. There can be no doubt that if your company has a litigation hold in place for whatever reason, this hold would also apply to all social media. Thus, your company may not erase a blog post that is relevant to litigation although common sense says that it would be wise to remove public access to a problematic post.

Another area of concern is advertising law. It is certainly "common sense" to assume that the Federal Trade Commission act, which bans unfair and deceptive trade practices[2] and the CAN-SPAM Act,[3] which regulates "spam," are relevant to the world of social media.

Using copyright and trademark concerns, litigation holds, and advertising and employment law as mere examples, you can begin to see the importance of training your employees. It goes without saying that they are the actors for your company and that their lack of training and sensitivity to these issues is your nightmare waiting to happen.

You must dispel the myths about the "Wild West." In an online environment where the entire world might see a social networking post, you certainly do not want employees posting things like, "Our only competitor is a thief" because, lo and behold, defamation law applies to social networking activities. (That is unless you really want to go down the "truth is an absolute defense to libel" path. I will go out on a limb here and guess that you do not.)

> *"If your company has not yet jumped headfirst into using social networking to its advantage, it is time to do it."*

Employees' Personal Social Networking

A whole other area of concern for your company is how your employees use social networking outside the office. After all, they have personal accounts on Facebook, LinkedIn, Twitter, Google+ and others. They may not understand that what they say on their personal Facebook account could haunt their employer and them.

If your company does not already have a social media policy in place, you are late at getting there. However, you can begin rectifying that today and you should. A great example of a personal blog policy is one Yahoo developed.[4]

Among the most important concepts in the Yahoo policy is that any employees who identify themselves as Yahoo employees "should notify their manager of the existence of their blog just to avoid any surprises."[5] Knowledge is power and your company can mitigate the risk employees create online by merely knowing the post is there. You should encourage this notice.

While many companies may want their employees promoting their business in their personal LinkedIn and Facebook accounts, it is important to sensitize employees to the fact that when they speak on behalf of their employers on a personal social networking page, they are putting their employer at legal risk just as if they were posting on the employer's "official" LinkedIn page. This may not be obvious to the average employee who may think that different rules apply on a personal social networking page. It is the same theme yet again. It is all about training.

Monitoring Employees' Online Activities

Many companies have started to monitor their potential and current employees' online activities. The fact is that people will post "remarkable" stuff online for all to see. Many companies will look at that "remarkable" stuff and choose to pass on a potential hire or consider terminating an employee over online posts.

It can be hard to feel sorry for someone who "friends" his boss on Facebook and posts, "My boss is an incompetent fool." ("Oops. I forgot he was among my friends.") Still, it is important for your company to have a written policy in place that clearly states that the company does and will continue to monitor social networking activities for posts the company reasonably deems inappropriate. Further, this policy should make it clear that termination is among the possible consequences for inappropriate activities.

A bit of caution is in order when monitoring personal activities online because some states, including New York, have laws that prohibit an employer from punishing an employee due to legal leisure time conduct.[6] Nonetheless, many think that it is a best practice to monitor employees' online activities while being aware of the parameters for action set by statutes or otherwise.

Embrace but Understand

If your company has not yet jumped headfirst into using social networking to its advantage, it is time to do it. This should be about as obvious as the need for a corporate website should have been in 1996.

While it is true that the law can be murky with social networks, with some education, training and supervision, you could and should minimize those risks. Do not permit yourself to be a nay-saying lawyer fearful of new technologies. If that is you, hire an outsider to assist. Do whatever it takes. Just do it.

Endnotes

1. 17 U.S.C. § 512.
2. 15 U.S.C. § 45.
3. 15 U.S.C. Chapter 103.
4. Yahoo! Personal Blog Guidelines: 1.0, *available at* http://jeremy.zawodny.com/yahoo/yahoo-blog-guidelines.pdf (last visited October 4, 2011).
5. *Id.*
6. N.Y Labor art. 7 § 201(d) (LAB).

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Banking Regulation as a Weapon in the War Against Terror

By Annemarie McAvoy

The 10th anniversary of 9/11 caused reflection on terrorism, and how to combat the continued efforts by terrorists to attack the United States. The government has used regulations aimed at the financial industry to help fight terrorism. However, the question is whether financial institutions should have to work as an extension of law enforcement. In addition, how much cost can financial institutions be expected to bear to police against terror financing?

The attacks of 9/11 were a wakeup call to America. On September 24, 2001, President Bush stated that "We will direct every resource at our command to win the war against terrorists, every means of diplomacy, every tool of intelligence, every instrument of law enforcement, every financial influence. We will starve the terrorists of funding." After 9/11 the Treasury Department instituted programs to track terrorists by following their money. The Patriot Act was passed in October of 2001. It was signed into law on October 26, 2001, in order to help this effort.

The financial industry has for many years had to try to prevent money laundering in their accounts. After 9/11 that was expanded to specifically include terrorist financing. This is difficult for institutions to watch out for, since most terrorist financing involves the process of reverse laundering, where legitimate funds are later funneled to terrorists. A financial institution may not have any access to information as to the final destination of funds which pass through it. In addition, many of the recent attempted terrorist attacks required very small outlays of a few thousand dollars. Such small amounts are difficult for an institution to notice.

Financial institutions are required to have policies and procedures to protect against money laundering and terrorist financing, along with monitoring systems for detection. All of this carries with it significant cost, both in terms of manpower and financial costs. When an institution is found by regulators to have systems or programs determined not to be sufficient it can be fined many, many millions of dollars. This is the case even when no money for terrorists or criminals is found to have been held by or passed through the institution. The financial industry also has to file Suspicious Activity Reports. Institutions have to do so not only when a transaction is suspected to be illegal, or being done to advance criminal activity. Instead, financial institutions are required to report anything that is unusual that cannot be explained after investigating it, whether or not they think there is something criminal involved.

> *"Non-compliance can subject the institution as well as its employees to significant civil and criminal penalties."*

Even before the Patriot Act was enacted, financial institutions had to do all they could to protect against and detect money laundering. The Bank Secrecy Act of 1970 ("BSA") required institutions to keep records and to file reports in order to help law enforcement detect, prevent and deter money laundering. The Patriot Act amended the BSA to expand the number of businesses to which the BSA applied. It required all of these businesses to implement Anti-Money Laundering ("AML") programs. Pursuant to Section 352 of the Patriot Act, businesses must develop written internal policies, procedures and controls. The AML program must be effectively implemented. It also has to fit the institution's location, size and nature, and must take into account the volume of services provided. In addition, each institution must designate an AML compliance officer, must have on-going training, and must have an independent audit function to test their programs.

Most financial institutions are subject to various regulators. Examiners from these different regulatory and law enforcement agencies can and will come into an institution to determine whether it has an effective AML program. They will also check to see if a business is in compliance with BSA regulations, since that is supposed to help ensure that institutions will not be used by money launderers or terrorists to further their criminal endeavors.

The burden placed on financial institutions is enormous. Non-compliance can subject the institution as well as its employees to significant civil and criminal penalties. For example, in August of 2011 Ocean Bank in Miami, Florida, was assessed a civil money penalty of $10.9 million. In March of 2011 the Office of Comptroller of the Currency ("OCC") ordered the Pacific National Bank in Miami, Florida to pay a $7 million penalty. Zions National Bank in Utah was ordered to pay an $8 million penalty in February of 2011. While these penalties were certainly substantial, they are dwarfed by a penalty levied against Wachovia Bank in March of 2010. The OCC, along with the Financial Crimes Enforcement Network ("FinCEN") and the Department of Justice ("DOJ"), agreed to a Deferred Prosecution Agreement wherein Wachovia was subjected to a $110 million forfeiture, a $50 million civil money penalty with the OCC and a civil money penalty of $110 million with FinCEN which was satisfied with the forfeiture.

"In order to properly comply with all of these regulations lawyers need to be consulted, new systems need to be implemented, and compliance personnel need to be hired and/or re-trained."

In addition to the risk of financial penalties, there is also a tremendous reputational risk for any institution that allows itself to be used by a terrorist as a conduit to funnel funds. Anyone involved in any way, whether knowingly or unknowingly, with the movement of money for terrorist activity will pay dearly in the damage done to its reputation, which will equate to a loss of share price and profit. The likelihood is that media outlets throughout the world would run stories about any institutions that were thought to be transferring funds for terrorists. The mere hint of involvement in the movement of terrorist funds, even if the transfers were done completely innocently by the institution, can be devastating to its reputation, and thus to its business.

Financial institutions are required pursuant to AML laws and regulations to know who their customers are. They also need to monitor accounts to be sure that all of the transactions are appropriate. They have to make sure those they have accounts for and do business with are not on government sanctions lists of those not to do business with under any circumstances. Most institutions wind up spending significant amounts on technology to research new clients, to monitor existing accounts, and to do comparisons of their customer lists with sanctions databases. They have to rate the risk levels of their clients, products and delivery channels. Monitoring must be targeted to the type of clientele and transactions handled by each particular institution, and must take into account all risk factors. The programs and systems must constantly be adapted and adjusted. This can be extremely costly for the institution. It can also be incredibly difficult to find an appropriate monitoring system. The quest for a system tailored to an institution's needs can, in and of itself cost millions.

Institutions are put in an untenable position. They need programs and systems tailored to their particular business, taking into account their size, customers, location, etc. There is nowhere they can go to find out if they have done enough. One regulator that supervises the business may think they have done enough, and another might not agree. Regulators can also force institutions to do "look backs" wherein they have to review prior transactions to check whether there were any that should have been reported but were not. This process, in and of itself, can cost an institution millions of dollars. For example, a recent look back required a global institution to review over 20 million transactions, covering a two year period of time. An outside consultant had to be hired to conduct this review, which took many months to complete. The cost of such a look back is in addition to any fines and other penalties that are imposed on an institution.

The United States is in a very difficult economic situation. Doing business is a challenge in this environment for even the largest of financial institutions. The government nonetheless continues to subject them to more and more regulations. In order to properly comply with all of these regulations lawyers need to be consulted, new systems need to be implemented, and compliance personnel need to be hired and/or re-trained. In the midst of all of this financial institutions are expected to act as an extension of law enforcement, spotting and reporting potentially suspicious illegal activity. It is acceptable to expect institutions to be good corporate citizens. However, to require them to spend millions in prevention and detection efforts, then to fine them many millions if they do not have programs regulators find to be good enough, is too much to expect.

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Current Regulatory Regime for Investment Advisers Post Dodd-Frank

By Michael G. Tannenbaum, Ricardo W. Davidovich and Beth Smigel[1]

I. Introduction

On July 21, 2010, President Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act" or the "Act") into law.[2] In enacting the Dodd-Frank Act, Congress sought to promote stability within the U.S. financial system.[3] The Act provides for major changes to the financial services industry, makes significant amendments to the Investment Advisers Act of 1940, as amended (the "Advisers Act")[4], and creates a number of new requirements found in Title IV of the Act ("Title IV") entitled the "Private Fund Investment Advisers Registration Act of 2010." Title IV increases regulatory oversight of investment advisers to larger private funds, thereby enabling the Securities and Exchange Commission (SEC) to assess whether these private funds present a systemic risk to the U.S. economy. Title IV of the Act directed the SEC to create rules implementing certain provisions of the Act. The SEC believes these new rules will "fill a key gap in the regulatory landscape."[5] The SEC issued the final versions of these rules on June 22, 2011.[6]

Among the changes of note is the rescission of an oft-relied upon exemption from registration for advisers who had fewer than fifteen (15) clients during the preceding twelve (12) months. New exemptions have been installed in its place, including exemptions for certain advisers to private funds and for certain foreign advisers with limited contact with the U.S. For purposes of determining SEC and state registration eligibility, the final rules create a new category of investment advisers for those who have between $25 million and $100 million in assets under management. This new category of mid-size advisers in turn raises the threshold for investment advisers that are required to register with the SEC from $30 million or more in assets under management to $100 million or more in assets under management. This article addresses all of the foregoing.

The provisions of the Dodd-Frank Act were effective as of July 21, 2011 but, pursuant to the final rules, the SEC postponed the implementation of several registration and compliance requirements for investment advisers until 2012, as discussed further herein.

II. Registration of Private Fund Advisers

Pursuant to the rules governing investment advisers prior to the Dodd-Frank Act, investment advisers who had $25 million or more assets under management were permitted to register with the SEC, and investment advisers who had $30 million or more assets under management were required to register with the SEC absent an exemption from registration, such as Advisers Act § 203(b)(3).[7] As discussed below, Title IV and the amendments to the Advisers Act contain provisions that significantly change the registration requirements for investment advisers and the exemptions therefrom.

> *"In enacting the Dodd-Frank Act, Congress sought to promote stability within the U.S. financial system."*

A. Eligibility for SEC Registration

1. Creation of New Categories of Investment Advisers

The provisions set forth in Dodd-Frank Act § 410 and codified in Advisers Act § 203A(a)(2) create a new classification of "mid-sized advisers." A "mid-sized adviser" is one that has regulatory assets under management (RAUM) (a new term used by the SEC which is discussed further herein) of between $25 million and $100 million.[8] Subject to certain exemptions discussed in section II (A)(2) of this Article below, Dodd-Frank Act § 410 prohibits a mid-sized adviser from registering with the SEC if (i) the adviser is "required to be registered"[9] as an investment adviser in the state where it has its principal office and place of business and, (ii) if registered, is subject to examination as an adviser by that state. If both elements are not met with respect to a mid-sized adviser, it must register with the SEC. The SEC surveyed all fifty states' securities authorities and has indicated that only advisers in New York and Wyoming are not subject to examination.[10] In addition to the newly created category of mid-size advisers, Dodd-Frank Act § 410 also raised the minimum threshold for required registration with the SEC to $100 million RAUM.

According to Advisers Act § 203A, if an adviser has less than $25 million RAUM, it is labeled a "small adviser." All "small advisers" are prohibited from registering with the SEC and must register or qualify for an exemption from registration at the state level, unless a small adviser qualifies for an exemption from the prohibition on SEC registration (as discussed below).[11] Finally, any investment adviser that is either an adviser to a business development company (BDC) (and also has at least $25 million RAUM) or an adviser to a registered investment company (RIC) (regardless of its level of RAUM) is *required* to register with the SEC.[12]

2. Exemptions from the Prohibition on SEC Registration

Although the Dodd-Frank Act prohibits many small and mid-sized advisers from registering with the SEC, there are several exemptions from this prohibition on SEC registration. Any adviser, regardless of its RAUM level, is allowed to register with the SEC rather than at the state level if it fits into one of the following categories: (i) certain pension consultants; (ii) certain investment advisers affiliated with an adviser registered with the SEC; (iii) investment advisers expecting to be eligible for SEC registration within 120 days of filing Form ADV; (iv) certain multi-state investment advisers;[13] and (v) certain internet advisers.[14]

3. Assets Under Management Calculation

The SEC redefined its method of calculating assets under management for the purposes of classifying investment advisers, determining their eligibility for SEC registration and determining their eligibility for certain exemptions from SEC registration. Form ADV will now refer to an adviser's RAUM in order to have a uniform system of calculating assets under management. For the purposes of Form ADV, RAUM includes all securities portfolios for which investment advisers "provide continuous and regular supervisory or management services, regardless of whether these assets are family or proprietary assets, assets managed without receiving compensation, or assets of foreign clients" whereas an adviser could previously exclude these assets from its calculation of assets under management. RAUM are calculated on a "gross basis" without deducting any outstanding indebtedness or accrued but unpaid liabilities. The SEC is also requiring an annual determination of an adviser's RAUM (rather than a more frequent basis).[15]

4. Process for Transition to State Registration

As many investment advisers previously registered with the SEC will now have to withdraw their federal registration and register at the state level, the SEC has set forth guidelines for this transition.

Existing Registrants. All advisers currently registered with the SEC must file an amended Form ADV by March 30, 2012 to indicate whether or not they remain eligible for SEC registration.[16] Any mid-sized adviser that no longer qualifies for SEC registration must file a Form ADV-W, a form indicating their withdrawal from SEC registration, and register at the state level by June 28, 2012.[17] Any investment adviser that is currently registered with the SEC must remain registered until January 1, 2012 (unless an exemption from registration applies), in order for the SEC to accommodate updates to the Investment Adviser Registration Depository (IARD) system.[18]

New Applicants. Mid-sized advisers must now register with the appropriate state securities authority. Only those advisers who have over $100 million in RAUM, who qualify for an exemption from the prohibition on SEC registration, or who are otherwise eligible for federal registration will be allowed to register at the federal level, and must do so by filing a Form ADV by March 30, 2012.[19]

Assets Under Management Buffer. Under the previous rules, an investment adviser would not be required to register with the SEC until it had assets under management of over $30 million and would be permitted to register with the SEC if it had assets under management between $25 million and $30 million. In a similar fashion, amended Advisers Act Rule 203A-1(a)(1) provides that a mid-sized adviser does not have to register with the SEC until its RAUM exceeds $110 million (as determined at the end of that adviser's current year-end in its annual updating amendment to Form ADV). Similarly, an already registered investment adviser does not have to withdraw its SEC registration until its RAUM is less than $90 million (at the end of that adviser's current year-end).[20] It is important to note that an adviser does not have to utilize these buffers.

B. Changes to Exemptions from Registration under the Advisers Act for Private Fund Advisers[21]

1. Elimination of Private Adviser Exemption

Title IV eliminated the private adviser exemption that was previously found in Advisers Act § 203(b)(3) (known as the "private adviser exemption"). The private adviser exemption provided that an adviser who (i) had fewer than fifteen (15) clients (where each fund was counted as one client) during the preceding twelve (12) months, (ii) did not hold himself out generally to the public as an investment adviser, and (iii) did not act as an adviser to a RIC or a BDC, was exempt from registration as an investment adviser under the Advisers Act. Prior to the Dodd-Frank Act, many investment advisers relied on this private adviser exemption. The elimination of this exemption is one of the most notable amendments to the registration rules of the Advisers Act and will require many previously unregistered investment advisers who meet the jurisdictional thresholds described herein to register as investment advisers with the SEC (unless an exemption from registration applies) or a state.

2. Limitation on Intrastate Exemption

The Act narrowed the "intrastate exemption" found in Advisers Act § 203(b)(1), which provides an exemption from SEC registration for certain intrastate advisers. As revised, this exemption is no longer available to investment advisers of private funds as of July 21, 2011.

3. Change to CFTC-Registered Exemption

The Act preserves Advisers Act § 203(b)(6), which provides an exemption from registration to commodity trading advisors (CTAs) registered with the U.S. Commodities Futures Trading Commission (CFTC) "whose business does not consist primarily of acting" as investment advisers as defined in Advisers Act § 202(a)(11) and who do not serve as investment advisers to a RIC or a BDC. However, Title IV also expands the exemption for registered CTAs who manage a private fund as long as, after July 21, 2011, the business of the adviser does not become "*predominantly* the provision of securities-related advice." Of note, the term "predominantly" is not defined in the Act.

C. New Exemptions from Registration under the Advisers Act

1. Addition of Exemption for Certain Private Fund Advisers

Advisers Act Rule 203(m)-1 provides a new exemption from registration for any investment adviser that (i) acts solely as an adviser to private funds[22] and (ii) has RAUM in the U.S. of less than $150 million. For foreign investment advisers, the exemption is available only if that adviser's U.S. clients are strictly private funds, and all assets managed by that adviser at a place of business in the U.S. do not exceed $150 million in private fund RAUM. The SEC has stated that private fund RAUM must only be calculated on a yearly basis. This exemption will not be available to investment advisers that have any clients other than private funds. Investment advisers exempted under this rule will be required to maintain appropriate records and provide periodic reports to the SEC on Form ADV.

2. Addition of Exemption for Foreign Private Advisers

Title IV amends Advisers Act § 203(b)(3) to add an exemption for "foreign private advisers." A "foreign private adviser" is an adviser who (i) has no place of business in the U.S., (ii) has, in total, fewer than 15 clients *and investors* in the U.S. in private funds advised by the investment adviser, (iii) has aggregate RAUM attributable to clients in the U.S. and investors in the U.S.[23] in private funds advised by the investment adviser of less than $25 million, and (iv) neither (a) holds itself generally to the U.S. public as an investment adviser, nor (b) acts as (I) an investment adviser to any RIC or (II) a company that has elected to be a BDC and has not withdrawn its election.

Advisers Act Rule 202(a)(30)-1 allows an adviser to treat as a single client a natural person as well as (i) that person's minor children; (ii) any relative, spouse, or relative of the spouse with the same principal residence; and (iii) all accounts and all trusts of which that person and/or the person's minor child or relative, spouse or relative of the spouse with the same principal residence are the only primary beneficiaries. Rule 202(a)(30)-1 also allows advisers to treat as a single client a corporation, general or limited partnership, trust or other legal organization to which the adviser provides legal advice, as well as two or more legal organizations that have identical shareholders, partners, limited partners, member or beneficiaries. The SEC is also requiring advisers to count as "clients" those persons for whom the adviser provides advisory services without compensation.[24]

3. Addition of Exemption for Venture Capital Fund Advisers

Title IV also added Advisers Act § 203(l) to provide an exemption from registration for investment advisers that advise solely one or more "venture capital funds." In Rule 203(l)-1, the SEC generally defined the term "venture capital fund" as a private fund that: (i) represents to investors and potential investors that it pursues a venture capital strategy; (ii) holds no more than twenty percent (20%) of the fund's capital commitments in non-qualifying investments[25] (other than short-term holdings); (iii) does not borrow or otherwise incur leverage, other than limited short-term borrowing (excluding certain guarantees of qualifying portfolio company obligations by the fund); (iv) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; (v) is not registered under the Company Act; and (vi) has not elected to be treated as a BDC.

The SEC has also adopted a "grandfather" clause in Advisers Act Rule 203(l)-1 that allows an existing private fund to qualify as a "venture capital fund" if it (i) represented to investors and potential investors at the time the fund offered its securities that it pursues a venture capital strategy; (ii) has sold securities to one or more investors prior to December 31, 2010; and (iii) does not sell any securities to, including accepting any capital commitments from, any person after July 21, 2011. All investment advisers exempt pursuant to Advisers Act § 203(l) will be required to maintain appropriate records and provide periodic reports to the SEC.

"The enactment of the Dodd-Frank Act, specifically Title IV of such Act, prompted several significant amendments to the Advisers Act that will alter the regulatory landscape for investment advisers."

4. Addition of Exemption for SBIC Advisers

Title IV adds Advisers Act § 203(b)(7) to provide an exemption for an investment adviser who is not a BDC and who solely advises (i) small business investment companies that are licensees under the Small Business Act of 1958, (ii) entities that have received a notice to proceed to qualify as a small business investment company and (iii) applicants that are affiliated with any entity described in subparagraph (i) who have a pending application to be licensed under the Small Business Investment Act.

D. New Reporting Requirements for Investment Advisers

1. Form ADV

In an effort to increase oversight of investment advisers, the SEC has adopted several rules that revise the existing Form ADV.

Private Fund Reporting (Item 7.B). Item 7.B requires information about each of the private funds advised by an adviser, including a separate § 7.B.(1) and a separate Schedule D for each private fund that the adviser manages. These require information about the size, strategy, organization and other detailed characteristics of each private fund (Part A) as well as information about several of each fund's service providers, including auditors, prime brokers, custodians, administrators and marketers (Part B). All of the information collected by the SEC in Item 7.B will be disclosed to the public.

Advisory Business Information (Item 5). Item 5 requires advisers to provide information regarding the adviser's business, employees, client base and RAUM as well as details about the types of services they provide. In addition, advisers must report approximate percentages of RAUM by client type in broad ranges (e.g., twenty-five percent (25%) segments).

Other Business Activities and Financial Industry Affiliations (Items 6 and 7). Items 6 and 7 require advisers to provide information pertaining to all types of financial services that they provide to their clients (e.g., whether an adviser is a related person, is a trust company, registered municipal advisor, registered security-based swap dealer or major security-based swap participant, accountant or lawyer). These new rules also require advisers to provide information about other types of business that they are engaged in as well as identifying information for the adviser's related persons.

Additional Form ADV Revisions. The SEC has also made revisions to several other sections of Form ADV including Item 8 (Participation in Client Transactions), Item 9 (Custody) and Item 1.O (Reporting $1 Billion in Assets) and several other technical amendments.

2. Exempt Reporting Advisers

The SEC has set forth new reporting requirements for investment advisers claiming an exemption from federal registration (as discussed below). Certain exempt advisers (those relying on the exemptions found in Advisers Act § 203(l) (venture capital fund advisers) and 203(m) (certain private fund advisers) as discussed further herein must now complete and file certain portions of Form ADV[26] on an annual basis. In addition, any adviser claiming an exemption under the Advisers Act must submit an initial Form ADV within sixty (60) days of relying on such exemption. Further, these exempt reporting advisers must file an updated Form ADV annually within ninety (90) days of the end of the adviser's fiscal year. An exempt reporting adviser must also file more frequent updates if certain Form ADV responses become inaccurate. Finally, an adviser must file an amendment to its Form ADV to indicate that it is filing a final report once it no longer relies on an exemption from registration. The SEC does not plan to conduct compliance examinations of exempt reporting advisers on a regular basis, but may do so if it believes there are any indications of wrongdoing.[27]

III. Conclusion

The enactment of the Dodd-Frank Act, specifically Title IV of such Act, prompted several significant amendments to the Advisers Act that will alter the regulatory landscape for investment advisers. Investment advisers must therefore determine what actions they need to take to comply with the new regime.

Endnotes

1. The authors would like to acknowledge Richard E. Strohmenger, an associate in the law firm's Financial Services Department, for his help in the preparation of this Article.
2. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
3. *See id.*
4. Unless otherwise noted, when we refer to the Advisers Act, or any paragraph of the Advisers Act, we are referring to 15 U.S.C. § 80b of the U.S. Code.
5. SEC Adopts Dodd-Frank Act Amendments to Investment Advisers Act, SEC, June 22, 2011, <http://www.sec.gov/news/press/2011/2011-133.htm>.
6. Rules Implementing Amendments to the Investment Advisers Act of 1940, Advisers Act Release No. 3,221 (Jun. 22, 2011); Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Advisers Act Release No. 3,222 (Jun. 22, 2011).
7. *See* Advisers Act § 203(b)(3) as in effect before July 21, 2011. Other investment advisers, such as investment advisers to registered investment companies, were required to register with the SEC regardless of the level of their assets under management.
8. Advisers Act § 203A(a)(2).
9. An adviser is "required to be registered" in a particular state unless that adviser is exempt from registration under the law of the state in which it has its principal office and place of business, or is excluded from the definition of investment adviser in that state. Advisers Act § 203A(a)(2).
10. *See* <http://www.sec.gov/divisions/investment/midsizedadviserinfo.htm>.
11. Advisers Act Rule 203A-2. Unless otherwise noted, when we refer to an Advisers Act Rule, or any paragraph of any Advisers Act Rule, we are referring to the appropriate section of the Code of Federal Regulation ("CFR") in which these rules are published.
12. Amended Form ADV, Part 1A, Items 2.A.(6) and (12).
13. In accordance with the Dodd-Frank Act, the SEC amended Advisers Act Rule 203A-2 to allow any investment adviser that is required to register as an adviser with fifteen (15) or more states to register with the SEC.
14. Advisers Act Rule 203A-2.
15. *See* amended Form ADV: Instructions for Part 1A, instr. 5.b.; Amendments to Form ADV, Advisers Act Release No. 3060 (Jul. 28, 2010).
16. Advisers Act Rule 203A-5(b).
17. Advisers Act Rule 203A-5(c)(1).
18. Advisers Act Release No. 3,221 § II.A.1.
19. Advisers Act Rule 203A-5(b).
20. This buffer is not available for advisers to either a RIC or a BDC and is also not available to advisers that are eligible for one of the exemptions from the prohibition on SEC registration as listed in Advisers Act Rule 203A-2.
21. Title IV adds a definition of "private fund" in Advisers Act § 202(a)(29). The term "private fund" is defined as an issuer that would be an investment company, as defined in Investment Company Act of 1940 § 3, as amended (the "Company Act"), but for § 3(c)(1) (i.e., privately-offered funds with fewer than 100 investors) or § 3(c)(7) (i.e., privately offered funds where all investors are qualified purchasers) of the Company Act.
22. The SEC expanded the Title IV "private fund" definition in Advisers Act Rule 203(m)-1(d)(5) to also include any fund that qualifies for an exclusion from the definition of "investment company" found in Company Act § 3, as well as any private fund that invests in other private funds.
23. Advisers Act § 202(a)(30). The SEC generally incorporated the definition of "in the U.S." from that found in Regulation S (with some minor definitional additions).
24. Advisers Act § 202(a)(30).
25. The SEC defines "qualifying investments" as equity securities (i) of qualifying portfolio companies that are directly acquired by the fund from the company, (ii) of qualifying portfolio companies that are exchanged for directly acquired equity issued by the same qualifying portfolio company, or (iii) issued by a company of which a qualifying portfolio company is a majority-owned subsidiary or predecessor, and that is acquired by the fund in exchange for directly acquired equity. Advisers Act Rule 203(l)-1(c)(3).

    The SEC defines a "qualifying portfolio company" as a company that "(i) is not a reporting or foreign traded company and does not have a control relationship with such company, (ii) does not incur leverage in connection with the investment by a private fund and distribute the proceeds of any such borrowing to the private fund in exchange for the private fund investment, and (iii) is not itself a fund." Advisers Act Rule 203(l)-1(c)(4).
26. Exempt reporting advisers must complete Items 1, 2.B., 3, 6, 7, 10 and 11 of Form ADV.
27. Advisers Act Rule 204-4.

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Dodd-Frank Act Changes Affecting Private Fund Managers and Other Investment Advisers

By Adam Gale and Garrett Lynam

I. Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"),[1] which was signed into law on July 21, 2010, fundamentally changes a number of areas affecting private funds, including the regulation of swaps, a new restriction on the ability of banking entities to sponsor or invest in private funds (the "Volcker Rule"), and new reporting requirements for fund managers. This article discusses those changes, as well as more minor changes affecting the accredited investor definition, the qualified client definition and Rule 506 disqualifications.

One of the most fundamental Dodd-Frank changes affecting private funds is the elimination of the "private advisers" exemption from registration with the SEC as an investment adviser (also known as the "15-client" exemption). In its place, Dodd-Frank created several new, but less comprehensive, exemptions, with the result that most U.S. fund managers with $150 million or more in assets under management will need to register with the SEC, and most fund managers that also have non-fund clients (such as separately managed accounts) will need to register with the SEC or a state. Those changes are discussed in a separate article in this issue of *Inside*, and accordingly are not addressed here.[2]

II. Regulation of Swaps

Dodd-Frank provides for the comprehensive regulation of swaps and requires "swap dealers" and "major swap participants" to register with regulators.[3] As many private funds engage in various types of swaps and derivatives transactions, private fund managers will need to determine if their funds are captured by these new categories, which would then require registration and compliance with numerous new compliance requirements. Since many of the rules and definitions have only been proposed and not finalized, however, it is not possible to make any final determinations at this time.

Additionally, Dodd-Frank imposes mandatory clearing and trade execution requirements on most standardized swaps.[4] Prior to the implementation of Dodd-Frank, over-the-counter swaps were largely unregulated. The terms of many swaps were negotiated between eligible contract participants and not materially impacted by Commodity Futures Trading Commission ("CFTC") or SEC regulations. However, Dodd-Frank brings all swaps under CFTC or SEC regulation.[5] This article provides a brief overview of the new regulations.

A. Effective Dates

Originally, several provisions under Dodd-Frank concerning swaps would have taken effect on July 16, 2011, but since such provisions required the SEC and CFTC to implement final rules, that date was not achievable.[6] The effective date of most provisions was consequently delayed until December 31, 2011 or until new rules become effective, if earlier.[7] Importantly, any provision that references "swap," "security-based swap," "swap dealer," and "major swap participant" is delayed because these definitions have not yet been finalized.[8] Once finalized, these provisions will set forth most of Dodd-Frank's most stringent operating requirements.

B. Definitions of Key Terms

i. Definitions of "Swap" and "Security-Based Swaps"

Dodd-Frank required the SEC and the CFTC to issue a joint rule clarifying the definition of the term "swap" and "security-based swap."[9] Although not yet finalized, the definitions of "swap" and "security-based swap" under Dodd-Frank[10] are very broad and include commodity swaps, interest rate swaps, and the derivatives set forth in the definition of "security-based swap" in the Securities Exchange Act of 1934 (the "Exchange Act").[11]

ii. Definition of "Swap Dealer"

Dodd-Frank defines a "swap dealer" to include one who "regularly enters into swaps with counterparties as an ordinary course of business for its own account," among others.[12] Under a recently proposed rule,[13] a "swap dealer" is any entity that engages in at least one of the following activities:

1. Holds itself out as a dealer in swaps;
2. Makes a market in swaps;
3. Regularly enters into swaps with counterparties in the ordinary course of business for its own account; or
4. Engages in any activity that causes it to be commonly known as a dealer or market maker in swaps.

These definitions are designed to encompass certain large swap providers, including most major financial institutions. The SEC and the CFTC expect market participants to make their own determinations as to whether their activities make them "swap dealers."[14] Factors indicating that an entity holds itself out as a swap dealer include (i) contacting potential counterparties to solicit interests in transactions; (ii) membership in a swap association in a category reserved for dealers; (iii) providing marketing materials that solicit interest in swap transactions; or (iv) generally expressing a willingness to provide a range of financial products that includes swaps.[15]

Excluded from the definition of "swap dealer" are entities entering into swaps for their own account and "not as part of a regular business."[16] Accordingly, it is likely that many private funds would be excluded from the definition, in the same way that private funds are generally considered to be "traders" and not "dealers" under Section 3(a)(5) of the Exchange Act because they buy and sell securities for their own account and not as part of a regular business. Additionally, a person or entity that engages in a *de minimis* quantity of swap dealing is not a swap dealer, but the definition of what constitutes a *de minimis* quantity has not yet been finalized.[17]

iii. Definition of "Major Swap Participant"

Dodd-Frank defines a "major swap participant" as a person or entity that:[18]

1. Maintains a substantial position in swaps (except positions held for hedging or mitigating commercial risk or positions hedging employee benefit risk);
2. Has outstanding swaps that create substantial counterparty exposure that could have serious adverse effects on the U.S. banking system; or
3. Is a highly leveraged financial entity not subject to federal banking agency requirements.[19]

Even if an entity otherwise holds a "substantial position" in swaps, it would not qualify as a major swap participant if those positions are held for "hedging or mitigating commercial risk," among other exceptions.[20] However, the proposed definition of "hedging or mitigating commercial risk" would exclude swap positions held for speculative purposes.[21] As most private funds would presumably be deemed to be holding their swap positions for speculative purposes, that exclusion is unlikely to apply to them. However, depending on the final definitions of "substantial position" and "substantial counterparty exposure," it is likely that only very large funds would end up meeting the definition of a major swap participant.

C. What Does It Mean to Be a Swap Dealer or a Major Swap Participant?

Swap dealers and major swap participants (collectively, "Regulated Swap Entities") will face the following operating requirements, most of which have been elaborated upon by proposed rules of the SEC and the CFTC:[22]

1. Registration with the CFTC and / or the SEC;
2. Swap position monitoring;
3. Compliance reporting;
4. Implementation of risk management procedures;
5. Appointment of a chief compliance officer;
6. Comprehensive recordkeeping of swap transaction data;
7. Capital reserve requirements;
8. Margin-collateral collection obligations;
9. Business conduct and governance standards;
10. Counterparty eligibility requirements; and
11. Segregation of uncleared funds.

D. Mandatory Clearing and Exchange Trading

Dodd-Frank requires that most swaps be cleared through a regulated clearinghouse if the clearinghouse accepts the swap for clearing. Under the proposed rules, all non-exempt swaps (i.e., swaps that are not subject to the "End User" exception discussed below) are generally expected to be subject to clearing and exchange trading requirements.[23] Additionally, swaps approved for clearing must be traded on a registered exchange approved by the applicable regulator (i.e., the CFTC or the SEC, depending on the type of swap), unless no registered exchange accepts the swap for trading.[24]

Dodd-Frank creates an exception from mandatory clearing and exchange trading for "End-Users."[25] An "End-User" may not be a "financial entity," which is broadly defined to include Regulated Swap Entities and certain other entities engaged in financial activities.[26] The proposed rules include certain exemptions for swaps entered into by End-Users for the purpose of hedging commercial risk, but not for those entered into as speculative investments or for any other purpose.[27]

Dodd-Frank subjects uncleared swaps to a number of operational requirements. For example, data on uncleared swaps must generally be reported to a registered swap data repository ("SDR") regardless of whether the parties are Regulated Swap Entities or qualify as "End-Users."[28] If a swap is neither cleared nor accepted by a SDR, both parties to the swap must maintain detailed records of the swap data.[29] Additionally, certain transaction data for all swaps (regardless of their execution method and whether they are cleared) must be made publicly available "as soon as technologically practicable" after execution (i.e., through "real time" reporting).[30] Regulated Swap Entities must abide by margin requirements and provide counterparties to uncleared swaps with the right to segregate any initial margin that was posted in respect of the swap.[31] Finally, certain entities engaged in swap trading will need to abide by capital reserve requirements and position limits.[32] The overall effect of these rules is that even private funds that are not Regulated Swap Entities may need to keep new records and face new costs and burdens in order to trade swaps.

III. The Volcker Rule

Section 619 of Dodd-Frank (the "Volcker Rule") generally prohibits any banking entity, including affiliates of banks, from the following (all of which are subject to a number of exceptions): (i) engaging in, sponsoring or investing in a "covered fund" (e.g., a hedge fund, private equity fund, and numerous other private funds and pooled investment vehicles), and (ii) having certain relationships with a covered fund.[33] Additionally, the Volcker Rule places further restrictions on banking entities and their affiliates from serving as an investment adviser to a private fund.[34] The Volcker Rule also prohibits banking entities from engaging in "proprietary trading,"[35] but that portion of the Rule does not affect private funds, so is not discussed here. Banking regulators and the SEC recently released proposed regulations pursuant to Dodd-Frank, though most of the proposed regulations relate to the proprietary trading restrictions, rather than the private fund restrictions.[36]

A. Effective Dates

The Volcker Rule prohibitions come into effect on July 21, 2012, regardless of whether the regulations are finalized by that point.[37] Banking entities have a further period of two years from the effective date to comply with the Volcker Rule.[38] Additionally, regulators may, upon application by any banking entity, extend the transition period for the requesting banking entity (i) for up to five years (which is in addition to the two year transition period),[39] and (ii) to the "extent necessary to fulfill a contractual obligation that was in effect on May 1, 2010" to take or retain any ownership interest in, or otherwise provide additional capital to, an "illiquid fund."[40] Accordingly, it is likely that banking entities that were invested in private equity funds (as well as in venture capital and other types of illiquid funds) prior to May 2010 will be able to obtain an extension and therefore will not need to transfer their interests or breach capital commitments.

B. Affected Banking Institutions

Both of the Volcker Rule prohibitions affect a "banking entity," which is generally defined as:[41]

- any insured depository institution (as defined in Section 3 of the Federal Deposit Insurance Act);
- any company that controls an insured depository institution;
- any company that is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978;
- any affiliate of the above; and
- any subsidiary of the above.

Affiliates or subsidiaries of banks that are asset managers or other investment advisers are included in the definition of "banking entity."

C. Prohibition on Sponsoring and Investing in Covered Funds

The Volker Rule generally prohibits a banking entity from acquiring or retaining any ownership interest in,[42] or "sponsoring," a "covered fund,"[43] which includes hedge funds and private equity funds,[44] subject to the exceptions for "permitted activities" described below.[45] "Sponsoring" is defined as (i) serving as a general partner, managing member, or trustee of a covered fund; (ii) selecting or controlling (or having agents who constitute) a majority of the directors, trustees or management of a covered fund; or (iii) sharing the covered fund's name or a variant thereof.

i. Impact on Advisers to Covered Funds

The Volcker Rule permits advisers to advise covered funds if the adviser and the covered fund do not share the same name or a variant thereof. Merely advising a covered fund, however, subjects the adviser (if it is a "banking entity") and its affiliates to the restrictions set forth in Sections 23A and 23B of the Federal Reserve Act.

ii. The 3% and One-Year Seed Financing Permitted Activity

A banking entity may generally organize or offer a covered fund if, among other things, it (i) owns not more than 3% of the total ownership interests in any single fund within one year after establishment;[46] and (ii) invests an aggregate amount not exceeding 3% of the banking entity's Tier 1 capital (i.e., the bank's regulatory capital) in covered funds as a whole.[47] There is an exception to the 3% rule to allow the banking entity to make a seed investment in a fund (in which case it can own 100% of the fund),[48] provided that within one year of the covered fund's establishment, the banking entity must reduce its ownership to no more than 3% of the total ownership interests in the covered fund.[49]

In addition to the requirements discussed above, the Volcker Rule sets forth other requirements for "permitted activities" involving the 3% limit and seed investments. For example, the banking entity must not (i) directly or indirectly guarantee, assume or otherwise insure the obligations or performance of the covered fund, or of any fund in which such covered fund invests;[50] (ii) share the same name or a variant thereof with a covered fund and use the word "bank" in its name;[51] and (iii) violate Sections 23A and 23B of the Federal Reserve Act.[52]

iii. Permitted Activities for Foreign Activities by Foreign Banking Entities

A banking entity may invest in or sponsor a covered fund if (i) the banking entity is not directly or indirectly controlled by a U.S. banking entity;[53] (ii) the banking entity is a "foreign banking organization," or, if not a foreign banking organization, meets at least two of the following tests: (a) total non-U.S. assets exceed total U.S. assets;[54] (b) total non-U.S. revenues exceed total U.S. revenues;[55] and (c) total non-U.S. income exceeds total U.S. income; (iii) no ownership interests in the covered fund are offered or sold to a U.S. resident,[56] and (iv) the investment or sponsoring occurs solely outside the U.S.[57]

iv. Permitted Activities for Risk-Mitigating Hedging

A banking entity may acquire or retain an ownership interest in a covered fund for hedging purposes if the acquisition or retention of the ownership interest meets specified criteria. Among other things, the hedging activity must (i) be made in accordance with the banking entity's internal controls (which must comply with certain requirements);[58] (ii) be performed by persons whose compensation arrangements are not designed to reward proprietary risk-taking;[59] and (iii) be made in connection with liabilities of the banking entity that are (a) conducted on behalf of a non-banking entity customer to facilitate exposure by the customer to the covered fund; or (b) directly connected to a compensation arrangement for an employee who directly provides investment advisory services or other services to the covered fund.[60] Additionally, the banking entity must document all hedging activities in accordance with guidelines established by the regulators.[61]

v. Additional "Permitted Activities"

Under the proposed rules, additional "permitted activities" include (i) loan securitizations;[62] (ii) acquiring or obtaining an ownership interest in, or sponsoring, a covered fund that is (a) a small business investment company,[63] (b) an investment designed to promote "public welfare,"[64] or (c) an investment that is a "qualified rehabilitation expenditure;"[65] and (iii) investing in, or sponsoring, certain types of vehicles (e.g., joint ventures, wholly owned subsidiaries and acquisition vehicles).[66]

D. Additional Limitations in the Volcker Rule

In addition to the limitations set forth above, in order to invest in a covered fund or engage in any other "permitted activity" under the Volcker Rule, certain covered fund advisers and sponsors must comply with Sections 23A and 23B of the Federal Reserve.[67] Also, in order to invest in a covered fund or engage in any other "permitted activity" under the Volcker Rule, no transaction may, among other things (i) involve or result in a "material" conflict of interest between the banking entity and its clients, customers, or counterparties;[68] (ii) pose a threat to the safety and soundness of such banking entity;[69] or (iii) pose a threat to U.S. financial stability.[70]

IV. Other Changes Impacting Private Funds

A. Changes to the Definition of "Accredited Investor"

Effective July 21, 2010, the definition of "accredited investor," which defines eligible participants to certain private and limited offerings that are exempt from the registration requirements of the Securities Act of 1933, was amended to exclude the value of a person's primary residence for purposes of the net worth calculation.[71] This change impacts all private offerings under Regulation D. Accordingly, if they have not done so already, private fund managers should amend the investor representations and questionnaires in their fund subscription documents concerning accredited investor status.

B. Changes to the Definition of "Qualified Client"

Subject to a number of exceptions, fund managers that are SEC-registered investment advisers may not charge any type of performance fee or carried interest to their fund investors.[72] Rule 205-3 of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), allows registered fund managers to charge such fees to "qualified clients."[73] Rule 205-3 historically defined "qualified clients" as clients with at least $750,000 in assets under management or a net worth of at least $150 million. Pursuant to Dodd-Frank, the SEC has recently adjusted these thresholds to $1 million and $2 million, respectively.[74] Additionally, a client's primary residence is proposed to be excluded from calculating the client's net worth.[75] Accordingly, private fund managers that currently are registered as advisers, or who will become registered, should change their subscription documents to reflect these changes.

The SEC has proposed two grandfathering provisions to the performance fee restrictions and the qualified client definition. First, as to funds managed by a registered investment adviser, if an investor met the qualified client standard in effect at the time of its investment into the fund, then the investor can remain in the fund, even if the investor does not meet the new standard. Second, as to funds managed by an adviser exempt from registration pursuant to the private adviser exemption (and certain other exemptions), investors in the fund at that time may remain in the fund once the manager becomes registered, regardless of whether the investors were qualified clients at any point. Although these rules are not yet final, it is very likely that the SEC will adopt them.

C. Disqualification of "Bad Actors" from Rule 506 Offerings

Rule 506 is a "safe harbor" for the private offering exemption of Section 4(2) of the Securities Act.[76] Pursuant to a specific Dodd-Frank mandate, the SEC has proposed a rule to disqualify issuers (which would include private funds) from using Rule 506 for any securities offerings involving "felons and other bad actors."[77] The "bad boy" disqualification would prohibit private funds from relying on Rule 506 if the fund, any general partner or managing member of the fund, the fund's placement agent, any 10% owner of the fund, or certain other parties, have engaged in any "bad acts," including having been convicted or sanctioned for violating specified laws, including securities fraud.[78] Once the rules are adopted and become effective, private fund managers will need to implement procedures to ensure that the fund is in compliance with the rule.

D. New Reporting Requirements for Private Fund Managers

Dodd-Frank includes a number of provisions requiring increased reporting by private fund managers. Pursuant to Dodd-Frank, the SEC, in its recent amendments to Form ADV, added a number of items concerning detailed disclosure of various information concerning private funds managed by the registered adviser. In addition, pursuant to a Dodd-Frank mandate that the SEC require private fund advisers to file reports for the assessment of systemic risk by the Financial Stability Oversight Council, the SEC has proposed, but not finalized, a new Form PF,[79] which will apply to most registered private fund advisers, with additional reporting required by certain fund managers with $1 billion in assets under management. Dodd-Frank also amends Section 13(f) of the Exchange Act to require the SEC to adopt rules providing for the public disclosure of certain information regarding short sales by institutional investment managers (i.e., persons who own or manage U.S. $100 million or more in publicly traded securities) who are currently required to file Form 13F beneficial ownership reports quarterly with the SEC.[80] The SEC has not yet proposed rules in this regard.

Endnotes

1. H.R. 4173, 111th Cong. (as passed by House of Representatives, Dec. 11, 2009) [hereinafter Dodd-Frank], *available at* http://financialservices.house.gov/Key_Issues/Financial_Regulatory_Reform/FinancialRegulatoryReform/111_hr_finsrv_4173_full.pdf.
2. In addition, due to space limitations, this article does not address every Dodd-Frank change affecting private funds.
3. *See* Further Definition of ''Swap Dealer,'' ''Security-Based Swap Dealer,'' ''Major Swap Participant,'' ''Major Security-Based Swap Participant'' and ''Eligible Contract Participant,'' 75 Fed. Reg. 80,174 (Dec. 21, 2010) [hereinafter Proposed Rules on Definitions].
4. *See id.*
5. Proposed Rules on Definitions, *supra* note 3. In addition, "mixed swaps" are subject to joint jurisdiction by the CFTC and the SEC.
6. *See, e.g.*, Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, § 754.
7. *See, e.g.*, Temporary Exemptions and Other Temporary Relief, Together with Information on Compliance Dates for New Provisions of the Securities Exchange Act of 1934 Applicable to Security-Based Swaps, Exchange Act Release No. 34-64678, 17 C.F.R. § 240, *available at* http://sec.gov/rules/exorders/2011/34-64678.pdf.
8. *See, e.g.*, *id.*
9. Wall Street Reform and Consumer Protection Act, *supra* note 6, § 712(d)(1).
10. *Id.* § 721.
11. *See* Section 3(a) of the Securities Exchange Act of 1934. For purposes of this article, "swap," "security-based swap" and "mixed swap" are collectively referred to as "swaps."
12. *Id.* § 721.
13. Proposed Rules on Definitions, *supra* note 3.
14. *Id.* at 80,175.
15. *Id.* at 80,178.
16. *Id.* at 80,175.
17. *Id.*
18. Wall Street Reform and Consumer Protection Act, *supra* note 6, § 721(a)(33).
19. The proposed rules provide definitions for "substantial position," "substantial counterparty exposure" and "financial entity." Proposed Rules on Definitions, *supra* note 3, at 80,190, 198. Note that an alternative test for "substantial position" also exists. *See id.*
20. *Id.* at 80,201.
21. *See, e.g.*, *id.* at 80,187.
22. This is not an exhaustive list.
23. *See* Requirements for Processing, Clearing, and Transfer of Customer Positions, 76 Fed. Reg. 13,101 (Mar. 10, 2011).
24. *See id.* at 13,102.
25. Wall Street Reform and Consumer Protection Act, *supra* note 6, § 723; End-User Exception to Mandatory Clearing of Swaps, 75 Fed. Reg. 80,747 (Dec. 23, 2010).
26. End-User Exception to Mandatory Clearing of Swaps, *supra* note 25, at 80,748.
27. *Id.* at 80,752.
28. *See, e.g.*, Reporting, Recordkeeping, and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants, 75 Fed. Reg. 76,666 (Dec. 9, 2010).
29. *See, e.g.*, Wall Street Reform and Consumer Protection Act, *supra* note 6, § 729.
30. *See* Real-Time Reporting of Swap Transaction Data, 75 Fed. Reg. 76,140 (Dec. 7, 2010).
31. *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23,732 (Apr. 28, 2011).
32. *See* Capital Requirements of Swap Dealers and Major Swap Participants, 76 Fed. Reg. 27,802 (May 12, 2011).
33. Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equi-

ty Funds (Oct. 6, 2011), at 112 [hereinafter Proposed Rule], *available at* http://fdic.gov/news/board/2011Octno6.pdf. Comments on the proposed regulations are due January 13, 2012. *Id.*

34. *Id.* at 115.
35. *Id.* at 11.
36. *See id.*
37. *Id.* at 22.
38. *See* 12 U.S.C. § 1851(c)(2) (2006).
39. *Id.* § 1851(c)(3)(B).
40. *Id.* § 1851(c)(3)(A). A banking entity is eligible for the extended transition period to make investments in an illiquid fund if (i) the illiquid fund was a covered fund that as of May 1, 2010 principally invested in illiquid assets or was committed to invest in illiquid assets; and (ii) the illiquid fund's investment was necessary to fulfill an investment obligation of the banking entity that was in effect on May 1, 2010. *Id.* § 1851(h)(7)(A).
41. *Id.* § 1851(h)(1).
42. "Ownership interest" generally does not include carried interest, which can be held by a banking entity subject to certain conditions. (see proposed rule)
43. Proposed Rule, *supra* note 33, at 112.
44. *Id.* at 115. The proposed rules permit a banking entity to acquire and retain an ownership interest in a covered fund that is an issuer of mortgage-backed securities, so long as the assets consist entirely of (i) loans; (ii) "contractual rights or assets directly arising from those loans supporting the asset-backed securities;" and (iii) "interest rate or foreign exchange derivatives that (a) materially relate to the terms of such loans or contractual rights or assets, and (b) are used for hedging purposes with respect to the securitization structure." *Id.* at 147.
45. "Hedge fund" and "private equity fund" are both defined as an issuer that would be an investment company as defined in the Investment Company Act of 1940, as amended (the "Investment Company Act"), but for section 3(c)(1) or 3(c)(7) of the Investment Company Act, or "such similar funds" as the appropriate regulator may, by rule, determine. 12 U.S.C. § 1851(h)(2). Note that unlike the amendments concerning the registration of advisers to venture capital funds pursuant to the Advisers Act, there is no exemption in the Volcker Rule for venture capital funds.
46. *Id.* § 1851(d)(4)(B)(ii)(I).
47. *Id.* § 1851(d)(4)(B)(ii)(II).
48. *Id.* § 1851(d)(4)(A)(i).
49. *Id.* § 1851(d)(4)(B)(ii)(I). This one-year limit may be extended for two additional years. *Id.* § 1851(d)(4)(C).
50. *Id.* § 1851(d)(1)(G)(v).
51. Proposed Rule, *supra* note 33, at 121.
52. *Id.* at 124.
53. *Id.* at 144.
54. *Id.*
55. *Id.*
56. *Id.* at 145.
57. *Id.*
58. *Id.* at 141.
59. *Id.*
60. *Id.*
61. *Id.* at 142.
62. *Id.* at 147.
63. *Id.* at 138.
64. *Id.*
65. *Id.*
66. *Id.* at 150.
67. *Id.* at 124.
68. 12 U.S.C. § 1851(d)(2)(A)(i) (2006).
69. *Id.* at § 1851(d)(2)(A)(iii).
70. *Id.* at § 1851(d)(2)(A)(iv).
71. SEC Proposes Net Worth Standard for Accredited Investors Under Dodd-Frank Act (last visited Oct. 21, 2011), http://www.sec.gov/news/press/2011/2011-24.htm. The SEC will further adjust the definition of "accredited investor" periodically. *Id.*
72. Investment Advisers Act of 1940, § 205, *available at* http://www.sec.gov/about/laws/iaa40.pdf. The fee restrictions do not apply to a fund relying on Section 3(c)(7) of the Investment Company Act, or to the non-U.S. investors of a non-U.S. fund. *See id.*
73. Rule 205-3: Exemption From the Compensation Prohibition Section of 205(A)(1) for Investment Advisers, *available at* http://www.sec.gov/rules/extra/iarules.htm
74. *See* Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 under the Investment Advisers Act of 1940 (July 12, 2011), *available at* http://www.sec.gov/rules/other/2011/ia-3236.pdf.
75. Investment Adviser Performance Compensation, Investment Advisers Act Release No. 3198, 76 Fed. Reg. 27,959 (May 13, 2011). Pursuant to Dodd-Frank, the SEC must further adjust the "qualified client" dollar thresholds for inflation at least once every five years. *Id.*
76. *See* Rule 506 of Regulation D (last visited Oct. 21, 2011), http://www.sec.gov/answers/rule506.htm.
77. Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, SEC Release No. 33-9211, *available at* http://www.sec.gov/rules/proposed/2011/33-9211.pdf. The current version of Rule 506 does not disqualify "bad actors" from a Rule 506 offering. *See id.* at 5.
78. *Id.* at 5
79. *See* SEC Proposes Private Fund Systemic Risk Reporting Rule, http://www.sec.gov/news/press/2011/2011-23.htm (last visited Oct. 11, 2011).
80. *See* Dodd-Frank, *supra* note 1, § 951.

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EU's Environmental Liability Directive: Can Your Company Afford the Consequences of Uninsured Environmental Liability?

By Howard Tollin and Boris Strogach

The need for an integrated approach for the protection of the environment as a whole has been accepted as a political principle by the European Union ("EU") member states. The European Parliament and Council recognized the need to "establish a common framework for the prevention and remedying of environmental damage at a reasonable cost to society." The EU-wide environmental legislation, called the Environmental Liability Directive 2004/35/CE ("ELD"), was adopted on April 21, 2004. Each member state was initially required to have a "transposition deadline" to implement its country's specific regulations by April 30, 2007. Unfortunately, difficult economic times in the EU slowed down the urgency to adopt and enforce any new regulatory impediments to industry. While sensitive to the needs of helping industry out of the recession, all countries had finally transposed the ELD into their national law by 2010. This article will highlight the scary areas of liability under the ELD which are common to all EU countries. In addition, this article will discuss the increasing importance for a company to understand and address its environmental exposures, and make a conscious decision on how much of the potential financial consequences it seeks to transfer to an environmental insurance carrier.

I. Fundamental Principles of the Environmental Liability Directive

The Environmental Liability Directive ("ELD") was introduced in the EU to ensure that the environment itself has the right to recourse with the objectives of holding companies financially responsible for preventing and remedying environmental damage caused by their businesses. By holding the polluters responsible for damages caused, there is assurance that ecologically damaged areas are restored while innocent taxpayers are not burdened with unnecessary reparations. The ELD created new liabilities for costs, damages and losses for persons, "operators" and companies.

The two fundamental components of the ELD are:

1. The precautionary principle, which requires companies to take preventative measures when their activities pose an "imminent threat of environmental damage;" and
2. The concept of "polluter pays," which makes businesses legally and financially accountable for environmental damage to water, air, land, and protected animal species that they cause. Environmental damage liability is a much larger exposure than just pollution.

ELD principles include holding a broad class of operations strictly liable for environmental loss or damage regardless of fault or negligence, and without any limit on financial liability. The ELD imposes an obligation on all operators to immediately report an environmental incident and it is a criminal offense not to do so. Citizens, communities or environmental groups can easily launch their own ELD claims against polluters. Accordingly, community based organizations will be encouraged to pursue companies that cause environmental damage, and will have legal standing. The ELD further encourages all member states to develop a system for compulsory financial security. Accordingly, many member states are developing mandatory financial security requirements to ensure that polluters have the capacity to carry out environmental remediation and restoration.

Perhaps most significantly, "biodiversity damages" present a large financial exposure to businesses. This concept is similar to natural resource damages in the United States. However, the ELD is actually quite broader in its scope than the United States approach due to the protection of species and natural habitats as "damage to biodiversity." Indeed, the process of fully restoring all environmental damage as part of biodiversity damages can include all of the following four categories:

1. **Primary**: Remediation, which is any remedial measure needed to return the damaged natural resources and/or impaired services back to its original condition.
2. **Complementary**: Additional restoration and measures needed to compensate for the fact that primary remediation does not fully restore the damaged natural resources and/or services back to its original condition.
3. **Compensatory**: Actions needed to compensate for the interim loss of natural resources and/or ser-

vices that occur from the date of damage until the primary remediation has achieved its full effect.

4. **Interim Losses**: Losses which result from the fact that the damaged natural resource and / or services were not able to perform their ecological functions, or provide services to other natural resources.

Companies are often unaware of the catastrophic amount of loss they face resulting from environmental exposures. Many risk managers and legal counsel mistakenly believe that their general liability policies will cover these risks. However, there is a large gap of coverage in general liability policies due to pollution exclusions, and only narrow give-backs are available for payments resulting from sudden and abrupt releases, with short reporting time periods to the insurer.

The ELD applies to companies and certain persons with any operations in EU member states. Thus, liability under the ELD will be imposed on a United States company with operations in Europe, and may further affect corporate officers personally. For many operations, as defined in Annex III of the ELD, strict liability for damage will be imposed with no requirement for fault or negligence. Where strict liability is not imposed, there may be a weak causation link between an operator's acts and the environmental damage caused in order to force payment. Directors and Officers, including non-executive directors, may be personally liable for non-compliance with the ELD and for failing to take appropriate action. Not surprisingly, the adoption of the ELD was a lengthy and controversial process as it invited differences of opinion amongst member states. The controversy over the severe ramifications and breadth of the ELD was heightened because environmental laws had historically been enforced by member states rather than centralized under the Union.

A. Polluter Pays Principle

The ELD was the first legislation to enshrine the "polluter pays" principle into EU law. Significant scary liabilities that companies ("operators" in ELD terms) face under the Directive include: (1) an obligation to restore protected species and natural habitats; (2) strict liability to pay or reimburse for biodiversity damages; and (3) new costly clean-up obligations in the form of complementary and compensatory remediation.

Annex III of the ELD defines all of the operations for which strict liability will be imposed. The general classes of businesses include all operations licensed under the EU Integrated Pollution and Control Directive (2008 / 1 / EC), waste management activities as per prior Directives (75 / 442 / EEC; 1999 / 31 / EC; and 2000 / 76 / EC), mining, quarries, extractive industries, operations needing consent to discharge to water under prior Directives (76 / 464 / EEC; 80 / 68 / EEC; 2000 / 60 / EC and 2000 / 60 / EC), transportation of hazardous materials, and the manufacture, processing and storage of various substances and products under prior Directives (67 / 548 / EEC; 1999 / 45 / EC; 91 / 414 / EEC; and 98 / 8 / EC).

Moreover, the ELD requires that operators take appropriate preventative measures, and immediately notify the authorities of any environmental damage that occurs. Authorities themselves are similarly obligated to take action if they become aware of any environmental damage. This signals a large legal obligation and financial exposure to all companies, and particularly to those which carry out high-risk activities. And of course these environmental awareness and reporting standards translate into the potential for increased claims and lawsuits and additional causes of action for failure to act. Accordingly, The ELD presents an opportunity and obligation for corporate counsel to become knowledgeable about EU environmental laws.

Even a company which has never polluted the environment may still be held liable for environmental damage if an event negatively affects a natural resource. A fire during which chemicals are released into a stream could be one example. The ELD requires that operators remedy damage, or any imminent threat of damage, to protected species and natural habitats, water and land. Damage to water is broadly defined as those waters that are covered by the 2000 Water Framework Directive. Any fish kill or impact to a drinking water well will certainly need to be remedied. Land contamination includes anything which poses a significant risk of harming human health. Again, an innocent polluter is still a polluter under the ELD. These ELD standards should be viewed as potentially having a devastating financial impact on most corporations doing business in the EU because virtually all companies have an environmental footprint.

B. Strict Liability v. Fault-Based Liability

Companies fall into two categories, those who are subject to strict liability and those who are subject to fault-based liability. Strict liability applies to environmental damage or the imminent threat of such damage caused by the operations or activities detailed in Annex III of the directive. Annex III companies generally include those that:

- Transport dangerous goods;
- Require authorization to discharge to or abstract surface water or groundwater;
- Provide waste management services that include the collection, transport, recovery, and disposal

of waste and the operation of hazardous waste landfills and incinerators;

- Manufacture, use, store, and / or handle pesticides, biocides, and other dangerous substances;
- Are regulated by various environmental permits, such as integrated pollution prevention and control (IPPC) legislation, and also subject to air emission controls; and
- Use, transportation of, or deliberate release of genetically modified organisms (GMOs).

The ELD imposes strict liability for biodiversity damage. Corporate counsel will need to become familiar with Annex III and provide professional advice on whether operations could be interpreted to fall within Annex III. In addition, corporate counsel should help companies and clients explore the best risk management options to address these liabilities. Counsel should become aware of the limitations in general liability policies, and understand the availability of environmental insurance to cover significant coverage gaps in most corporate insurance programs. This becomes particularly essential when a company can be held strictly liable.

Fault-based liability means that the company, through a deliberate action, omission or negligence, has caused damage to the environment. If fault can be established, a company can be held accountable in exactly the same manner as those operators that carry out Annex III higher risk activities. Case law in member states will likely be developed both as to the classes of businesses requiring fault, and the standards for determining the degree of negligence needed for liability to pay for the damage or loss.

C. More Onerous Remediation

Another key change to environmental protection under the ELD is the introduction of complementary and compensatory remediation. These are enforceable for damage affecting protected species and natural habitats and water, but not land. For these exposures, the ELD aims to restore the environment to its baseline condition before the damage occurred. Complementary Remediation is any remedial measure needed to compensate for the fact that primary remediation does not result in fully restoring the damaged natural resources and / or services. Where primary remediation back to the baseline condition is not possible, operators must compensate for the damage caused to the environment through complementary remediation at an appropriate alternative site as close as possible to the damaged site. This may require relocating large schools of fish to a different habitat or installing a new drinking water well field.

During the period of time needed to fully restore or replace the natural resource, compensatory remediation may also be sought. Compensatory remediation is the action taken to compensate for interim losses of natural resources or services that occur from the date of damage until primary remediation has been fully achieved. Examples are supplying bottled water to those affected by contamination to the drinking water wells, a replacement of the habitat for fish in a nearby river, or enhancement of the habitat for wildlife in nearby woodland or meadow.

D. Competent Authority

The Directive does not set a level playing field for environmental damage regulation and enforcement across Europe, nor was it ever intended to do so. The ELD recognized the availability of certain defenses, aside from strict liability, but left the “transposition” up to each member state as the competent authority. Defenses in a particular member state may include: (i) a third party causes the environmental damages through no fault of the company; (ii) the damage results from the compliance with an order or instruction from a public authority; or (iii) the environmental damage occurs through a previously permitted process and was not considered likely to cause environmental damage according to scientific and / or technical knowledge at the time. This is known as the “state of the art” defense.

Any competent authority involved in regulation can either expand or differently interpret the risky activities in Annex III. Member states are also expected to take different approaches to the application of joint and several or proportional liability. A further area which will differ across the EU is corporate funding requirements for pollution. Article 14 of the Directive requires that member states take measures to encourage the development of appropriate financial security instruments.

Financial security can take a number of forms including a suitable environmental insurance policy or bonds, escrow accounts, and letters of credit. To date, eight countries (Portugal, Spain, Greece, Hungary, Romania, Bulgaria, Slovakia and Czech Republic) have committed to developing compulsory financial security to pay for environmental loss. Similar financial security provisions have been part of U.S. regulations for more than 20 years. The majority of environmental insurance policies that provide financial security in the United States are associated with storage tank liability, and closure / post-closure requirements for various treatment, storage and disposal (TSD) facilities.

E. ELD Claims Examples

More than 50 reported cases are already being addressed under the ELD. In addition, a number of environmental disasters have occurred in Europe since the ELD was adopted. A few of the claims examples include:

- On July 31, 2007, the chemical plant of Chimac-Agriphar released insecticides into the Meuse River. This accident was a result of failed detection of toxic material systems. The case was tried in Court. It was difficult to estimate the environmental damage. Experts estimated that a quarter of the fish stock were killed (more than 15 tons of fish). The economic damages alone were 300,000 Euro.
- On March 16, 2008, a pipe leak caused a spill of an estimated 500 tons of bunker fuel during the loading of a vessel at the Donges Refinery located in the Loire-Atlantique region in France. Cleanup costs and environmental damage was estimated at 50 million Euro, including at least 2 million Euro to compensate the fishermen.
- In July 2009, United Utilities caused water pollution that caused the death of 6,000 fish at Three Waterway in Southport, United Kingdom. In addition to heavy fines, the UK Environmental Agency required compensatory remediation and required that the habitat be returned to the same level of natural resource as would have existed if the damage had not occurred.
- In August 2009, oil spilled from an underground pipeline in the southern region of Bouches-du-Rhone, France. The government declared an environmental disaster in what was considered one of Europe's most beautiful nature reserves. The cleanup costs and environmental damages are estimated to cost 20 million pounds.
- On October 4, 2010, a flood of toxic red sludge was released from an aluminum processing plant in Hungary. The sludge escaped from a reservoir in the Hungarian city of Ajka covering 16 square miles of land. The cleanup costs alone are estimated to cost 20 million pounds. That figure does not include private action claims. The operator Mal Zrt had a minimal amount of financial security in place, but will not be able to cover the clean-up costs. Accordingly, the company was forced to become nationalized after the incident, and thus the taxpayers of Hungary will have to foot this bill.

II. Transferring Risk for Uninsured Environmental Loss and Damage

The liabilities under the ELD include historical land damage which presents a threat to human health, water damage as broadly defined in Directive 2000/60/EC, and threats to protected species and natural habitats which are biodiversity damages. General liability policies will generally not cover these environmental exposures. Specifically, coverage gaps will include the restoration process for environmental damage, and environmental damage from gradual events. Sudden releases which can specifically be linked to third party liability may be covered under a general liability policy, and that extension of coverage will need to be negotiated.

Environmental insurance policies, also known as pollution liability policies, are intended to respond to environmental and pollution loss and damages, and have a dedicated trigger for environmental damage pursuant to the ELD. In addition, environmental insurance can generally cover legacy pollution conditions from past operations, and waste management practices that caused the gradual release of pollutants. Insuring agreements in a pollution liability policy provide coverage for: third party claims for bodily injury, property damage, clean-up and business interruption; first party on-site clean-up and business interruption; regulatory driven actions by competent authorities; a change in law where standards become more restrictive; loss of use claims; biodiversity damages; transportation and disposal of raw materials, products or wastes; legal defense costs; and any new release that causes any of the above.

Conclusion

While companies are generally more aware of environmental exposures, many are still naïve about the severity of loss from an environmental incident. Corporate counsel and risk managers may mistakenly believe that they are covered under a comprehensive general liability policy; however that coverage is limited for pollution. An erroneous understanding as to environmental liability or scope of coverage will continue to mean that companies are uninsured or underinsured for environmental pollution and damage, particularly under the ELD. It is essential that corporate officers consciously decide to either self-insure its corporate environmental risk or transfer all or some of the risk to an environmental insurer.

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The Evolution Will Not Be Televised: Detecting Patterns in the Ongoing Insurance Regulatory Policy Response to the 2008 Financial Crisis

By Daniel A. Rabinowitz

To purchasers of insurance products and services, insurance regulation may call to mind Churchill's remark about Russia—a riddle, wrapped in a mystery, inside an enigma. At first glance, the financial crisis of 2008 seems only to have made insurance regulation more opaque. For example, the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act,[1] the most visible public policy response to the crisis, has been a seismic event for the nation's banks and derivatives markets and lingers as a political issue even today.[2] Yet despite Dodd-Frank's numerous provisions affecting insurance, the insurance industry and insurance consumers are not nearly as directly affected by the legislation as are other financial sectors. The Bureau of Consumer Financial Protection (the "BCFP"), created by Dodd-Frank as the new federal watchdog agency overseeing consumer finance, does not even have jurisdiction over insurance.[3] Insurance regulation continues, in other words, to evolve largely below the radar, and still predominantly at the state level, having never emerged as a meaningful issue in national electoral politics, even in the post-2008 era.

However, in recent legislative developments occurring both at the state and national levels, we can trace the main outlines of modern insurance regulation and can discern a response to the 2008 crisis just as significant as that occurring in other financial services. The response, consisting largely of an expansion of regulatory authority, tracks the three areas that comprise the main public policy objectives of insurance law. One is consumer protection (or "market conduct"), another is the solvency of particular insurance firms (or so-called "prudential" regulation), and the third is the viability of the insurance marketplace. Insurance law and the regulators who administer it can claim to be informed largely by these three objectives. By the same token, these can be in tension with one another in any given case, and, furthermore, these certainly do not provide automatic justification for any particular use of insurance regulatory discretion.

Consumer protection is the aspect of insurance law most tangibly affecting consumers of insurance. Historically, one of the principal aspects of insurance regulators' oversight of market conduct has involved the offer and sale of insurance policies. As an example of a market-conduct policy response to the 2008 crisis, New York's 2010 legislation[4] merging the state's Insurance Department and Banking Department and creating a new Department of Financial Services meaningfully enhances the regulator's ability to police the marketing and selling of insurance products. The legislation introduces a new term, "financial product or service,"[5] defined as

> any financial product or financial service offered or provided by any person regulated or required to be regulated by the superintendent pursuant to the banking law or the insurance law or any financial product or service offered or sold to consumers except financial products or services: (i) regulated under the exclusive jurisdiction of a federal agency or authority, (ii) regulated for the purpose of consumer or investor protection by any other state agency, state department or state public authority, or (iii) where rules or regulations promulgated by the superintendent on such financial product or service would be preempted by federal law.[6]

The New York law confers authority on the new state Superintendent of Financial Services to penalize "any intentional fraud or intentional misrepresentation of a material fact with respect to a financial product or service or involving any person offering to provide or providing financial products or services."[7]

One noteworthy aspect of the New York legislation's potential reach involves Dodd-Frank's establishment of the new BCFP and related consumer-protection provisions. The New York Superintendent's authority over insurance products is unassailable insofar as insurance products are "required to be regulated by the superintendent pursuant to…the insurance law." However, the exceptions for federally regulated products—*i.e.*, cases where the federal government has "exclusive jurisdiction" or where the superintendent's rules would be "preempted"—may be difficult in some cases to harmonize with the provisions of Dodd-Frank establishing the BCFP. For instance, while the BCFP represents the federal government's most ambitious effort yet to regulate the financial sector, the provisions of Title X of Dodd-Frank (establishing the BCFP) are replete with references to cooperation and consultation with states.[8] As a general matter, one may conclude that Title X of Dodd-Frank does not vest the federal government with much *exclusive* jurisdiction at all. Furthermore, Dodd-Frank's provisions on when "state financial consumer protection law[s]" may be preempted are narrow indeed.[9] The net result of all this may be an increasingly muscular state financial regulatory function, at least in New York.[10]

Solvency regulation has become a flashpoint in the post-crisis era. One aspect of Dodd-Frank that does bear directly on insurers is so-called "systemic risk" regulation, *i.e.*, the ability of the federal government to designate certain non-banks as entities that should be subjected to heightened prudential standards enforced by the Board of Governors of the Federal Reserve System.[11] Observers have speculated on the extent to which insurers will be so designated and the impact that this could have on such firms and on insurance markets generally.[12]

State insurance laws are also oriented toward solvency concerns. Statutes such as those governing insurers' investment concentrations[13] and "risk-based" capital adequacy[14] largely involve quantitative elements of an insurer's financial consition, requiring compliance with certain financial metrics. Of course, solvency itself is the province of state insurance law—insurers are not eligible to be debtors under the federal Bankruptcy Code,[15] and their insolvencies are presided over by state courts, administered by state regulators and governed by state insurance laws.[16]

Another critical way in which states oversee the financial health of insurers is through the regulation of insurance holding companies, and here can be seen most vividly policymakers' response to the 2008 crisis from the standpoint of prudential regulation. Most states have adopted a version of a model law published by the National Association of Insurance Commissioners (the "NAIC") entitled the "Insurance Holding Company System Regulatory Act,"[17] which historically imposed guidelines on relationships between insurers and their affiliate companies. As originally adopted, the Holding Company Act vested broad discretion in the state insurance regulator regarding proposed acquisitions of insurers domiciled in his or her state and also regarding proposed material transactions between such insurers and those controlling the insurer. Every insurer, in fact, that is controlled by any other person or entity (including a holding company) must register and provide annual information to the domiciliary regulator under most states' version of the model Holding Company Act. The policy underlying these requirements included the prevention of "looting" or other misappropriation of insurance company surplus, as well as ensuring that those in control of insurance company corporate affairs were persons of integrity. These concerns are ultimately directed at safeguarding the financial soundness of the insurer.

In December 2010 the NAIC adopted major changes to the Holding Company Act.[18] The changes effectively transform the model law from one regulating relationships *between* insurers and affiliates to one regulating the health of the insurer's consolidated group *taken as a whole*. The amendments introduce the concept of "enterprise risk" (defined, generally, as any "activity, circumstance, event or series of events involving one or more affiliates of an insurer that, if not remedied promptly, is likely to have a material adverse effect upon the financial condition or liquidity of the insurer or its insurance holding company system as a whole…").[19] This concept marks a key policy response to the financial crisis of 2008, which, in the eyes of some public officials, revealed that insurers were at risk not necessarily from any internal mismanagement but rather from the prospect of financial "contagion" resulting from the mismanagement of affiliated companies.

Other changes effected by the amended Holding Company Act include increased restrictions on transactions with affiliates (such as new requirements for regulatory filings and / or approvals in order to divest control over an insurer[20] and expanding the types of inter-affiliate transactions requiring prior notification to and approval by regulators[21]). The amendments also contemplate regulators from multiple states[22] and even from non-U.S. jurisdictions[23] collaborating on oversight of insurance groups that straddle state and national boundaries. Again, these changes are all motivated by the perceived need to increase the supervision of insurance companies' financial condition and overall viability.

As states begin to adopt the amended Holding Company Act,[24] the policy debate will surely continue as to whether this kind of oversight of group-wide risks is effective, desirable or even feasible. Nevertheless, by codifying the expansive notion of "enterprise risk" and by implementing other enhancements to regulatory discretion, the NAIC has certainly illustrated in stark fashion its renewed focus on solvency concerns, and in this respect has echoed somewhat the federal government's response on systemically important banks.

The final pillar of insurance regulatory philosophy, the promotion of an **effective marketplace**, can best be seen in recent events in the provisions of Dodd-Frank governing surplus lines and reinsurance, known as the Nonadmitted and Reinsurance Reform Act of 2010, or "NRRA."[25] These provisions, which had been considered as separate legislation by Congress in 2007 and 2009 prior to being incorporated into Dodd-Frank, have the effect of harmonizing state laws by eliminating extraterritorial application of requirements governing surplus lines (generally, insurance coverage for unique risks for which coverage is unavailable in the regular, or "admitted," insurance market) and reinsurance (the placing of insurance risks in an insurer's portfolio by that insurer with a second insurer, the "reinsurer"). Generally, these provisions prevent multiple states from regulating the same transaction of surplus lines business or reinsurance, vesting this power in the state of domicile of the insured (in the case of the surplus lines provisions) or ceding insurer (in the case of the reinsurance provisions), as the case may be.

A number of distinct dynamics are at work here. These provisions have been hailed by industry as bringing needed reforms to the state-by-state patchwork of state laws in these matters.[26] The NAIC, naturally the most adamant defender of the state regulatory system and the fiercest opponent of federalizing insurance regulation, accepts the harmonization represented by the NRRA ostensibly to demonstrate the resilience of state insurance law and state regulators' responsiveness to changing conditions.[27] Meanwhile, proponents of federal insurance regulation can point to Dodd-Frank's other insurance-related provisions—including the establishment of a new Federal Insurance Office;[28] the possible designation of insurers as entities warranting heightened, federal scrutiny;[29] and even the ability (under certain limited circumstances) for the Federal Deposit Insurance Corporation to administer state insurance insolvency proceedings.[30]

However, yet another prism thorugh which to view the NRRA is that of marketplace efficiency. The NRRA improves market functioning without, strictly speaking, "deregulating"; it merely restricts the number of regulators that have a bite at the apple over any single transaction within the spheres of surplus lines and reinsurance. Although NRRA does represent an elegant and needed series of reforms, it is unclear to what extent NRRA is a useful template for reforms in other areas of insurance or financial services generally. The main reason for this is that the NRRA's subject matter resides outside the scope of retail insurance regulation. Confined to commercial purchasers of specialty coverages and to insurers purchasing protection on their own risks, these provisions are largely irrelevant to the individual consumer. A failure of these provisions to work effectively would likely have little if any direct effect on retail purchasers of insurance or policyholders. Accordingly, there is little at stake politically for policymakers, a luxury that they would be less likely to enjoy in other areas of insurance law reform.

* * *

What does this all mean for the consumer of insurance? Very little of this evolutionary change in insurance law is likely to have any direct, tangible consequence on actual insurance activity in the economy, at least immediately. After all, even in the one area of regulation having the most direct impact on consumer affairs, market conduct, the changes explored herein should not result in significant alterations to policy forms or coverages made available by insurers or services provided to policyholders. However, insurers themselves face a more complex, and in many ways more challenging, compliance environment than they have had to navigate in the past. As Dodd-Frank, NAIC model acts and other regulatory changes are implemented in insurance—and as states and the federal government continue to jockey for primacy in the area of insurance regulation—time will tell whether this evolution of insurance law is ready for prime time.

Endnotes

1. Public Law 111-203 (hereinafter cited as "Dodd-Frank Act").
2. The author's colleague at Chadbourne & Parke LLP, Adam Gale, writes about aspects of Dodd-Frank elsewhere in this issue of *Inside*.
3. Dodd-Frank Act §1002(15)(C)(i).
4. Chap. 62 of New York Laws of 2011.
5. NY Fin. Serv. Law §104(2).
6. *Id.*
7. *Id.*, §408(a)(1)(A).
8. *See, e.g.*, Dodd-Frank Act §1013(b)(3)(B), §1013(b)(3)(D), §1015.
9. Dodd-Frank Act §1044(a) prescribes that a state consumer financial law is preempted only if its application would have a discriminatory effect on a federally chartered bank or branch, the state law "prevents or significantly interferes with the exercise" by such a bank of its powers, or the state law is preempted by some other provision of federal law.
10. For a journalistic account of the new department's function, *see* Liz Rappaport, "A New Watcher On Wall Street," in *The Wall Street Journal*, October 3, 2011.
11. Dodd-Frank Act §115.
12. For examples of commentary and coverage on this topic, *see* Sean P. Carr, "Industry Calls for Specifics as FSOC Looks to Delay Systemic Risk Rules," *BestWire*, September 19, 2011, A.M. Best Company, Inc.; Fran Lysiak, "Csiszar: Federal Regulators Have Looked Like Keystone Kops," *BestWire*, February 28, 2011, A.M. Best Company, Inc.; "US Reform could be a positive: S&P," *Reactions*, August 11, 2010.
13. *See, e.g.*, New York Ins. Law Art. 14.
14. *See, e.g.*, New York Ins. Law §§1322, 1324.
15. 11 U.S.C. §109(b)(2) and §109(b)(3)(A).
16. *See, e.g.*, New York Ins. Law Art. 74.
17. NAIC Model Laws, Regulations and Guidelines 440-1 (hereinafter cited as "Model Act"); *see also* Insurance Holding Company Sys-

tem Model Regulation With Reporting Forms and Instructions, at NAIC Model Laws, Regulations and Guidelines 450-1).

18. Joint Executive Committee / Plenary Conference Call, Natl. Assoc. of Ins. Commissioners, December 16, 2011.
19. Model Act §1(F).
20. *Id.*, §3(A)(2).
21. *Id.*, §5(A).
22. *Id.*, §3(D)(3).
23. *Id.*, §7.
24. As of this writing, Texas, Rhode Island and West Virginia have adopted the amendments. *See* 2011 Texas S.B. 1431; 2011 West Va. S.B. 253; 2011 R.I. H.B. 5730. Indiana has adopted one relatively minor aspect of the amendments (*see* 2011 Indiana H.B. 1486, signed into law on April 6, 2011 as Ind. Public Law No 11-2011), while Florida considered but ultimately did not adopt the amendments in its most recent legislative session. 2011 Fla. H.B. 1167.
25. Dodd-Frank Act, Title V, Subtitle B.
26. *See, e.g.*, "Testimony for the Record of the National Association of Professional Surplus Lines Offices Before the House Financial Services Subcommittee on Insurance, Housing and Community Opportunity Hearing Entitled, 'Insurance Oversight: Policy Implications for Consumers, Businesses and Jobs,'" Natl. Assoc. of Professional Surplus Lines Offices, Ltd., July 28, 2011; "PCI Calls for State Coordinated Response to Surplus Lines Reform" (press release), Property Casualty Insurers Assoc. of America, November 9, 2010.
27. *See, e.g.*, "Surplus Lines: NIMA, SLIMPACT & Next Steps" (slide presentation), James J. Donelan, Insurance Commissioner of Louisiana and VP of the Natl. Assoc. of Ins. Commissioners, June 28, 2011.
28. Dodd-Frank Act §502.
29. Dodd-Frank Act §115.
30. Dodd-Frank Act §203(e)(3). For a discussion of this intriguing, and (one hopes) remote, possibility, *see* Don Mros and Richard Liskov, "Does 'Dodd-Frank' allow for federal liquidator of an insurance company?," *Financial Regulation International*, March 2011.

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Events and Other News

Another Successful Year: The Ken Standard Diversity Internship Program 2011 Reception, Tuesday, July 26, 2011, hosted by Pryor Cashman LLP, New York City

Photo from the Annual Reception to honor our Kenneth G. Standard Diversity Internship Program Awardees. The program's goal is to create a network and forge relationships which will foster greater diversity in corporate legal departments through New York State. L to R: David S. Rothenberg, Chairperson-Elect Corporate Counsel Section and Co-Chair of the Section's Diversity Internship Committee, Trinh Tran, Kara Baquizal, Rossalyn Quaye Fischer, Nicole Scarangella, Martina Davis, Kenneth G. Standard, Epstein Becker & Green, P.C., Past-President NYSBA and namesake of the Program, David J. Lee, Ilan Wong, Seymour W. James, Jr., President-Elect NYSBA and Attorney-in-Charge of the Criminal Practice of The Legal Aid Society in New York City, and Stephen P. Younger, Immediate Past-President NYSBA and partner at Patterson Belknap. Not shown is another Awardee: Chris Copeland. The 2011 organizations hosting an Intern this year were: inMotion, Pepsi, Con Edison of New York, United States Tennis Association, Pfizer, Financial Industry Regulatory Authority (FINRA), and Alliance Bernstein. The 2011 interns are law students from Hofstra, Fordham, New York Law, Cardoza, CUNY School of Law, and Brooklyn Law School.

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