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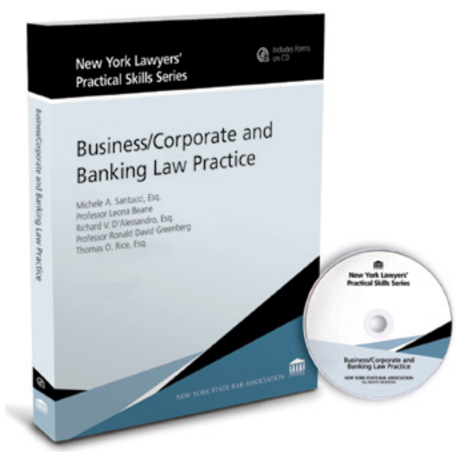

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Headnotes

President Donald Trump has repeatedly promised to dramatically reduce regulatory burdens on business as well as cutting business taxes, and the stock market's relentless climb since the election apparently reflects a belief that he and the Republican-controlled Congress can make this happen. As this issue went to press, however, the outlook was at best uncertain for any meaningful regulatory changes in the short run. Mr. Trump has issued a series of Executive Orders calling for reduction of regulatory burdens by the federal agencies, including the elimination of two regulations for every new regulation promulgated; but the ability of the agencies to achieve this is questionable, as many regulations are mandated by law—for example, the Dodd-Frank Act, passed in 2010, calls for some 400 rule-makings, some of which are still not complete. The Financial CHOICE Act, which would roll back parts of the Dodd-Frank Act, has passed the House, but seems to have little chance in the Senate due its perceived weakening of consumer protections.

One of the Executive Orders sets forth a list of Core Principles, aimed at balancing regulatory burdens with economic opportunity, which the President wants to guide regulatory reform of the financial system. Pursuant to the Executive Order, in June the Treasury Department released its first of four reports, covering depository institutions (banks and credit unions); future reports will address capital markets, asset management and insurance, and nonbank financial institutions, including fintech firms. The first Report endorses many aspects of the CHOICE Act—for example, the "off-ramp" from Dodd-Frank requirements for well-capitalized depository institutions. While many of the objectives of the Core Principles can be accomplished by agency actions, it seems clear that other significant aspects will require legislation by a Congress that remains bitterly divided along partisan lines.

Another highly controversial rule-making is the Department of Labor's (DOL) Fiduciary Rule, which essentially raises the standard from "suitability" to fiduciary duty for brokers and other persons involved in advising on retirement funds. The most significant impact is likely to be on IRA accounts, which are typically held by brokerage firms. Depending on whether one is "blue" or "red" in one's political leanings, the Rule is either a vital and long-overdue protection for retirees against self-dealing, or a compliance nightmare that will drive smaller firms out of the business (there is some evidence this is happening already) and a bonanza for the plaintiff's bar. The Rule was a product of the waning days of the Obama Administration; President Trump delayed its implementation from April to June but at this writing it was still scheduled to move forward. An excellent article on the Rule, describing its background and reviewing the arguments for and against, appears in this issue (see p. 40).

Apart from legislative and executive action, several recent cases have significantly impacted the financial world. Under the National Bank Act, a national bank is permitted to charge the highest interest rate allowed by the usury law of the state in which it is located. In *Madden v. Midland Funding*, a national bank sold defaulted loans to Midland Funding, a non-bank company that specializes in acquiring and collecting on distressed consumer debt. The plaintiff argued that her loan, which was valid when made, became usurious when it was purchased by Midland. Notwithstanding the long-standing principle that a loan that is valid when made does not lose its validity when transferred to a third party, the Second Circuit Court of Appeals held that the loan was indeed usurious in the hands of Midland Funding. The Second Circuit has since declined to rehear the case, and the Supreme Court denied *certiorari*. So at least in the Second Circuit—including, of course, New York—a bank will not be able to sell loans to a non-bank without a loan-by-loan review to determine which might become usurious when sold.

In another closely watched case, the D.C. Circuit in May reheard *en banc* the case of *PHH Corporation v. Consumer Financial Protection Bureau* (CFPB). As we discussed in the last issue, the CFPB had fined PHH for retroactive violation of a CFPB interpretation under the Real Estate Settlement Procedures Act (RESPA) prohibiting certain reinsurance arrangements, even though the arrangement was concededly valid under the interpretation of the Federal Housing Administration (FHA) at the time it was made. The plaintiff challenged the fine, arguing both that the retroactive application of the new interpretation was invalid and that the structure of the CFPB itself was unconstitutional, in that it vests all power in a single director who cannot be fired by the President except for cause. In finding for the plaintiff, the court held that the structure was indeed unconstitutional and the director could be dismissed at will. But the court stayed its decision pending reargument *en banc*. The CHOICE Act would make the CFPB subject to a governing board, similar to the Securities & Exchange Commission (SEC), the Federal Deposit Insurance Corporation (FDIC) and other agencies, and would also subject its budget to the Congressional appropriations process—under the Dodd-Frank Act, the CFPB is funded by the Federal Reserve, although it is not controlled by the Federal Reserve. But the Democrats have opposed these changes, believing they will diminish the CFPB's power. Oral arguments were heard on May 24, and a decision is pending at this writing.

Another area of law that has been subject to the "red-blue" divide is the use of arbitration, especially in consumer disputes. On the one hand, arbitration reduces the burden on the court system and often leads to effective and pragmatic outcomes, since arbitrators typically are people with experience in the industry involved. But on the other hand, for the same reason consumer advocates may argue that arbitration deprives the consumer of her "day in court" and is unfairly stacked against her. Leading off this issue, Jason Kornmehl explores these issues as they relate to disputes in the securities industry. In "Arbitration Vacatur Motions and Equitable Tolling in New York," he discusses the tension between the policy that arbitration should be "the end, not the beginning" of a dispute and the desire of an aggrieved party to obtain judicial review of an arbitration award. In a thoughtful and thorough analysis, he discusses the standards applied by the courts under federal law (the Federal Arbitration Act, or FAA) and New York law under the Civil Practice Law & Rules (CPLR) with respect to motions to vacate arbitration findings. He also discusses in depth the recent Ninth Circuit decision in *Move v. Citibank*, which held that the doctrine of "equitable tolling" could be applied to the FAA, thereby enabling an aggrieved party to pursue her day in court. At the same time, the Second Circuit has consistently rejected the notion that equitable tolling applies to the FAA, since it is a cause of action unknown at common law. Mr. Kornmehl, formerly a practitioner specializing in antitrust law in New York, now serves as a clerk to a Justice of the New Jersey Supreme Court.

The spectacular and well-publicized failure of the law firm Dewey & LeBoeuf in 2012 has resulted in multiple litigations among the firm's partners and others. But one constituency the firm apparently overlooked—its own employees—led to unanticipated and draconian financial consequences. In "How Dewey & LeBoeuf Failed to Fore-WARN," Stuart Newman and Tyler Silvey discuss how the firm failed to comply with the federal Worker Adjustment Retraining Notification Act, known as the WARN Act, which mandates that employers with more than 100 employees provide advance notice to their employees ahead of an event such as a mass layoff or plant closing. New York has a similar WARN Act, but it applies to employers with as few as 50 employees. There are exceptions—for example, a firm attempting in good faith to arrange financing in order to stay in business does not want to give its employees advance notice of a shutdown, which would destroy its ability to arrange such financing. In their usual clear and lucid style, Messrs. Newman and Silvey provide a dramatic cautionary tale regarding how lawyers can overlook their own legal obligations, as well as a primer on the federal and State WARN Acts that is invaluable for any New York practitioner who finds herself counseling a troubled company. Mr. Newman is the founder of the *Journal* and Chair Emeritus of its advisory board; he and Mr. Silvey are attorneys with the New York firm Salon Marrow Dyckman Newman & Broudy LLP.

The Nonprofit Revitalization Act of 2013 (NPRA) massively overhauled New York's Not-For-Profit Corporations Law (NPCL). But in the process it created a number of unanticipated problems—another demonstration, if one were needed, that the Law of Unanticipated Consequences is the only law that can never be repealed. Thanks in no small part to the tenacious efforts of the Business Law Section, in cooperation with the City Bar, the Law Revision Commission and others, a much-needed amendments bill was passed last year and signed into law by Governor Cuomo in November 2016. In "November 2016 Amendments to the Not-For-Profit Corporation Law," Fred Attea discusses and explains the reasons for the amendments. As one example of an unanticipated consequence, he notes that prior to the amendments the definition of "related party" could be read literally to mean that a relative of a director of a hospital could not be admitted to the hospital for treatment without prior approval. Mr. Attea, a partner of Phillips Lytle in Buffalo, is a past Chair of the Business Law Section and the founding Chair of the Section's Not-For-Profit Corporations Law Committee.

The attorney-client privilege continues to be a source of confusion and vexation, for business practitioners as well as their clients. In the *Upjohn* case in 1980, the Supreme Court held that the privilege does apply in the corporate context, but left open the question of whether it applies when counsel speaks with a person who was, but no longer is, employed by the company. In "'Exes and the Attorney-Client Privilege," the *Journal*'s ethics guru, Evan Stewart, brings us up to speed on the state of the law in this area. In particular, Mr. Stewart discusses and analyzes a narrowly divided decision of the Supreme Court of Washington. Along the way, as always he entertains us with a fascinating and humorous look at how the question of dealing with one's 'ex' has been addressed in pop music, from Pat Boone to Taylor Swift. Mr. Stewart, a partner in the New York law firm Cohen & Gresser LLP, was the 2016 recipient of the Sanford D. Levy award, given annually by the New York State Bar Association's Committee on Professional Ethics to a person who has contributed most to the advancement of legal ethics.

A recent TV commercial for a New York bank depicted a woman demonstrating to her little girl how she can deposit a check to her bank by taking a picture of the check on her smartphone. When she then uses the phone to snap a picture of a lion at the zoo, the child visualizes the lion being transmitted to the bank and cries out, "No mommy, no!" Sending a lion to your bank by smartphone is not (yet) possible, but depositing a check certainly is, and potentially creates a whole set of new risks and problems for both the bank and the check writer—in particular, what prevents a payee from depositing the check twice, and what are the legal consequences if he does? The law in this area is only beginning to develop, but in "Electronic Deposit of Checks—Tips to Avoid Problems," Jay Hack, a partner in the New York firm Gallet, Dreyer & Berkey LLP and a past Chair of the Business Law Section, provides some practical advice both for banks and for the writer of the check. He also highlights a particular scam that has been used to victimize attorneys who write checks on their escrow accounts.

Employment is an area of law that is in continuous dynamic change and that affects every business in New York. For this reason, "Recent Employment Laws Impacting Private Employers in New York" by Sharon Parella, a regular feature of the *Journal*, is required reading for business practitioners. Ms. Parella's latest instalment unravels the complexities of New York's new minimum wage law, which differs by business size and location and phases in over the next year. Many aspects of the law are confusing—for example, the applicable minimum for a particular employee depends upon where he or she works, not where the company's head office is located. She also reviews the new New York City ordinance that prohibits employers from inquiring about an applicant's salary history—based on the premise that women, in particular, could be "locked in" to a pattern of wage inequality based on gender. Ms. Parella is the founder of the Parella Firm P.C., which focuses on counseling both employers and individuals in employment law matters, as well as Workplace Bullying Resources Inc., which provides training and counseling to combat workplace bullying.

Another regular feature of the *Journal* is "Inside the Courts," in which the attorneys of Skadden Arps provide a concise but exhaustive overview of significant corporate and securities litigation in the federal courts—in the current installment, from Class Actions to Whistleblowing. "Inside the Courts" is an invaluable tool for our readers, pulling together in one place a complete picture of what is happening in the courts at any time that is relevant for business practitioners. The editors remain indebted to our colleagues at Skadden for their continuing generosity in sharing their knowledge and expertise.

One of the truly gratifying aspects of editing the *Journal* is the opportunity to identify, and reward, exceptional work by law students. This May I was honored to present the 2016 winners of the annual Law Student Writing Competition at the Section's spring meeting: first prize to Caitlin Dance, a student at New York Law School, for her contribution "*In re Coinflip, Inc.*," which appeared in the Summer 2016 issue; and second prize to Lawrence Crane-Moscowitz, a student at Vanderbilt Law School, for "Except for All the Others: A Compromise Proposal for Correcting the Incentives of Credit Rating Agencies in the Wake of the Dodd-Frank Act." Our current issue is graced with two more outstanding student contributions, both of which are, of course, eligible for the 2017 Competition.

First up is Ms. Elena Dain, also a student at New York Law School, with a topic as timely as the headlines (see p. 40). In "The Department of Labor Fiduciary Rule," she analyzes in depth the background of the rule, the reason for its promulgation by the Obama Administration, and the controversy surrounding it in the Trump Administration. Historically, brokers in particular were able to avoid being held to a fiduciary standard for providing advice, since they did so only intermittently. But with the changeover in retirement accounts, from the traditional defined-benefit pension format to the defined-contribution approach of the 401(k) and the IRA account, the Obama Administration determined that it was now appropriate to hold brokers and others who advise on retirement accounts to be held to the higher fiduciary standard. The contrary argument is that the fiduciary standard will increase compliance costs, driving firms out of the business and consolidating the industry in a few large providers; there is some evidence of a trend in this direction. Ms. Dain's research is thorough, and her writing is clear, as she lays out the rationale for the Rule and its content, including the exemptions allowed under the Rule. She also carefully reviews and fairly presents the arguments of both proponents and opponents. She concludes that the Rule, while well-intentioned, in its current form "creates regulatory confusion and threatens financial professionals' ability to adequately serve" their customers.

If any topic in business law has received more attention than the Fiduciary Rule, it is cybersecurity. With the New York State Department of Financial Services (DFS) having promulgated a first-in-the-nation rule requiring all financial institutions and other businesses under its jurisdiction to meet stringent security standards, and with almost daily headlines about computer security breaches in retailing and other industries, it is incumbent on the business lawyer to stay abreast of developments in this critical area. In "Cybersecurity and Its Impact on the Financial Services Industry," Niyati Sangani, also a student at New York Law School, begins by reviewing the major cyber attacks on financial institutions in the past few years, including the NASDAQ Exchange, as well as numerous banks and other institutions. He then reaches back all the way to the U.S. Constitution to propose a remedy: the "letter of marque and reprisal," which effectively authorizes retaliation in the event of an attack—in the computer context, the so-called "hack back." Along the way, in addition to the DFS rule he reviews all federal laws and regulations to date aimed at combating cyber attacks. His article is a provocative and well-researched guide to the state of the art in cybersecurity at present.

Concluding this issue is yet another hot topic, combining fiduciary and computer issues. In "Robo-Advisors: Regulation and Design Features for Risk Mitigation," Melvin Tjon Akon explores the issues that arise when long-standing law applying fiduciary standards to investment advisors is applied to "robo-advisors"—essentially, computer programs that allocate a client's investments based upon algorithms that automatically consider factors relevant to that investor's profile and investment objectives. After explaining how robo-advisors operate and the different business models that are used, Mr. Akon reviews the applicable law—the Investment Advisers Act of 1940 and the SEC rules thereunder. Since they also may direct the purchase and sale of securities, robo-advisers may also be considered brokers under the securities law. To date, the American regulators and their European counterparts have generally attempted to apply existing law to this new technology. Mr. Akon concludes by arguing for a risk-based approach for providers of robo-advisory services to address the regulatory requirements. With a JD equivalent degree from the University of Amsterdam, the Netherlands, and a Master's degree in law from the University of Chicago, Mr. Akon has recently moved to New York to establish his law practice, after having practiced law in the Netherlands and Luxembourg.

David L. Glass

Arbitration Vacatur Motions and Equitable Tolling in New York

By Jason Kornmehl

Arbitration is an important and widely used dispute resolution mechanism, especially in the securities industry.[1] When facing an adverse arbitration award, losing parties may seek to challenge the award by filing a motion to vacate or modify.[2] Challenging an arbitral award, whether in federal or state court, is notoriously difficult.[3] As one federal court put it, "[j]udicial review of arbitration awards is tightly limited."[4] Indeed, even California, a state that has traditionally been hostile to the enforcement of certain arbitration agreements,[5] has acknowledged that an "arbitrator's decision should be the end, not the beginning, of [a] dispute."[6] The Federal Arbitration Act (FAA) and New York Civil Practice Law and Rules (CPLR) delineate the statutory grounds for vacating or modifying an arbitration award in New York. Under the FAA, 9 U.S.C. § 10(a)(1)-(4), the grounds for vacating an arbitration award are "corruption, fraud, or undue means in procurement of the award, evident partiality or corruption in the arbitrators, specified misconduct on the arbitrators' part, or 'where the arbitrators exceeded their powers.'"[7] Similarly, the grounds for vacating an arbitration award under the CPLR are "corruption, fraud or misconduct in procuring the award," "partiality of an arbitrator," where "an arbitrator, or agency or person making the award exceeded his power," or an arbitrator's "failure to follow the procedure[s] of [CPLR Article 75]."[8]

The issue of whether a plaintiff has complied with the procedural dictates of the FAA and CPLR is a concomitant feature of arbitration vacatur motions. Section 12 of the FAA requires that a party moving to vacate an arbitration award serve the opposing party with notice of the motion within three months after the award is filed or delivered.[9] A recent Ninth Circuit decision, in which the panel reviewed "a[n] [arbitration] hearing chaired by an imposter," illustrates that some courts interpret the FAA's limitations period less rigidly than other courts.[10] In *Move, Inc. v. Citigroup Global Markets, Inc.*,[11] the Ninth Circuit, confronting "a matter of first impression," held that the FAA's three-month time limit for vacating arbitration awards is subject to equitable tolling. In contrast, the Second Circuit has made clear that there are no exceptions to this statutory deadline. This article examines the *Move* decision and juxtaposes the Ninth Circuit's approach to construing the FAA's limitations period with that of the Second Circuit.

Move v. Citigroup

In 2008, Move initiated arbitration proceedings before a three-member Financial Industry Regulatory Authority ("FINRA") panel.[12] Move claimed that Citigroup mismanaged $131 million of its funds by investing in speculative auction rate securities.[13] Pursuant to the Code of Arbitration Procedure for Customer Disputes in FINRA's rules, the organization provided Move and Citigroup with a list of proposed arbitrators and their employment histories.[14] Because the dispute involved a complex securities issue, Move preferred that an experienced attorney serve as chair of the panel.[15] Move ranked a man named "James H. Frank" as its top choice to lead the panel. According to FINRA's Arbitrator Disclosure Report, Frank received a law degree from Southwestern University in 1975 and was licensed to practice law in California, Florida, and New York.[16] Ultimately, Frank was installed as the chairperson of the panel.[17]

After conducting six pre-hearing conferences and 20 hearing sessions, the panel issued a unanimous decision in 2009 denying Move's claims.[18] In March 2014, Move learned from an article on a legal news website that Frank had lied about being a licensed attorney and was impersonating a retired California lawyer with a similar name.[19] FINRA later confirmed that Frank lied about his qualifications in the Arbitrator Disclosure Report and subsequently removed him from all cases and from its roster of arbitrators.[20] Move then filed a complaint and a motion to vacate arbitration in the U.S. District Court for the Central District of California in June 2014.[21] Move contended that vacatur was warranted under the FAA because of Frank's misrepresentations. Specifically, Move argued that vacatur was warranted under § 10(a)(3)[22] and (4)[23] of the FAA.[24]

Recognizing that the FAA stipulates that notice of a motion to vacate an arbitration award must be served within three months after the award is delivered and that it served notice of such a motion over four years after delivery of the award, Move asserted that the deadline should have been equitably tolled.[25] In response, Citigroup filed a motion to dismiss, averring that equitable tolling was unavailable under the FAA.[26] Citigroup also argued that even if the FAA's limitations period could be tolled, Move failed to demonstrate that tolling was justified.[27] Finally, Citigroup claimed that even if the deadline was tolled, vacatur was not justified on the merits.[28]

After considering the arguments, the district court denied Move's motion to vacate and granted Citigroup's motion to dismiss.[29] Noting that equitable tolling under

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the FAA presented an "unsettled question of law," the court concluded that it could be applied to the statute's limitations period.[30] The court, however, found that Move failed to demonstrate an adequate ground for vacatur.[31] The court explained that Frank's behavior did not prejudice Move's rights to a fundamentally fair hearing as required by § 10(a)(3) and that the arbitration panel did not exceed its powers in violation of §10(a)(4).[32] Move then appealed the district court's decision to the U.S. Court of Appeals for the Ninth Circuit.[33]

In its decision, the Ninth Circuit first confronted the equitable tolling issue.[34] Acknowledging that it had "not yet decided whether equitable tolling applies to the FAA," the court surveyed the legal landscape and observed that "the case law from other circuits is conflicting."[35] Nonetheless, the tribunal found that most circuits, including the Ninth, had declined to definitively rule on the issue.[36] The court then quoted the Supreme Court's admonition "that limitations periods are customarily subject to equitable tolling . . . unless tolling would be inconsistent with the text of the relevant statute."[37] Agreeing with the district court, the panel concluded that neither the text, structure, or purpose of the FAA is inconsistent with equitable tolling and that Move satisfied the substantive requirements of equitable tolling.[38]

Turning to the merits of Move's vacatur claim, the court held that the Move was entitled to vacatur under §10(a)(3) of the FAA because the company was deprived of a fundamentally fair hearing and prejudiced by Frank's fraudulent conduct.[39] The court highlighted Move's insistence throughout the panel selection process that an attorney chair the proceedings.[40] The court also noted that Move struck FINRA candidates who were not experienced attorneys because the company wanted a chairperson with legal experience to understand and interpret sophisticated securities law concepts.[41] Although Citigroup contended that there was no evidence that Frank influenced other members of the arbitration panel or that the outcome of the proceeding was affected by his participation, the court found this argument unavailing.[42] The court explained that there was simply no way to determine Frank's impact on the deliberative process.[43] Notwithstanding Citigroup's argument on whether the result was affected by Frank's participation, the panel explained that Frank's participation was itself prejudicial: "the parties' rights to [] a proceeding [before a panel of three qualified arbitrators as provided by FINRA's rules and regulations] were prejudiced by the inclusion of an arbitrator as chairperson who should have been disqualified from arbitrating the dispute in the first place."[44] Consequently, the court reversed the district court's denial of Move's motion to vacate.[45]

The Ninth Circuit's decision in *Move v. Citigroup* contains two important holdings. First, the court ruled that equitable tolling applies to the FAA. Second, the court held that where an arbitrator's purposeful and material deception results in his selection as chairperson of a panel, such misbehavior constitutes grounds for vacatur under § 10(a)(3) of the FAA. Although significant, the Ninth Circuit's pronouncement on equitable tolling is not especially surprising. Several district courts in the circuit, including the trial court in *Move*, had previously ruled that the FAA is subject to tolling. For example, in *Strobel v. Morgan Stanley Dean Witter*,[46] the U.S. District Court for the Southern District of California rejected an argument that the FAA's limitations period is jurisdictional and concluded that the statute's deadline is subject to equitable tolling. Likewise, the court in *Watermill Ventures, Ltd. v. Cappello Capital Corp.*,[47] ruled that the FAA's limitations period could be equitably tolled, stating that "the clear weight of authority holds that § 12 is a non-jurisdictional statute of limitations subject to tolling, waiver, and estoppel." Even though the court was merely putting its formal stamp of approval upon several trial court rulings, the Ninth Circuit's holding that the FAA's limitations period is subject to tolling is significant because it represents a divergence from Second Circuit precedent.

Second Circuit's Rejection of Equitable Tolling under FAA § 12

Courts in the U.S. Court of Appeals for the Second Circuit have steadfastly rejected the notion that the FAA's limitations period can be tolled. In *Florasynth, Inc. v. Pickholz*,[48] the Second Circuit reasoned that the FAA's time limitations could not be subject to a common-law exception such as equitable tolling because the statute created a cause of action unknown at common law:

> No exception to this three month limitations period is mentioned in the statute [9 U.S.C. § 12]. Thus, under its terms, a party may not raise a motion to vacate, modify, or correct an arbitration award after the three month period has run . . . . Further, there is no common law exception to the three month limitations period on the motion to vacate. The action to enforce an arbitration award is a creature of statute and was unknown at common law.

Since then, district courts within the Second Circuit, including the Eastern and Southern Districts of New York, have repeatedly cited to *Florasynth* for the proposition that the common law doctrine of equitable tolling does not apply to the FAA's three-month limitations period.[49]

In the Second Circuit, it is clear that the FAA's time restriction for a motion to vacate arbitration is "strictly applied."[50] The cases finding vacatur motions untimely are legion.[51] Interestingly, there is one case predating *Florasynth* in which a Second Circuit judge sitting by designation in the U.S. District Court for the District of Connecticut did not strictly apply the FAA's three-month limitations period. In *Holodnak v. Avco Corp.*,[52] an employee plaintiff filed a complaint against his former employer seeking, among other things, to vacate an arbitration award upholding his discharge. The plaintiff filed his action to have the arbitrator's award vacated six days before the three-month period expired.[53] Upon learning that a marshal might not be able to serve the complaint promptly because of "an overload of business in the United States Marshal's office," the plaintiff filed a motion with the court seeking to obtain a substitute means of effectuating service.[54] The court granted the motion, but the substitute process server perfected service one day after the expiration of the limitations period.[55] In denying the defendant's motion to dismiss the petition as untimely, the court excused plaintiff from compliance with 9 U.S.C. § 12 under the circumstances because of plaintiff's "due diligence" in securing a substitute means of effectuating service within the time limit and the absence of any prejudice to defendants as a result of the one-day delay.[56] In addition, the court explained that because the last day of the limitations period fell on a Sunday, service of defendant on Monday was timely.[57] The court reasoned that "the policy of liberality embodied in Fed. R. Civ. P. (6)(a)"—which stipulates that when the last day of a limitations period falls on a Sunday, the period is extended until the end of the following day—"should be applied [to the FAA] by analogy."[58]

In light of *Florasynth* and the surfeit of district court decisions heeding the admonition that "there is no common law exception to the three month limitations period," the precedential value of *Holodnak* is questionable. Moreover, several courts have posited that the *Holodnak* court rested its holding on the alternative ground that application of Rule 6(a) of the Federal Rules of Civil Procedure service rendered plaintiff's service timely.[59] Thus, in the view of some tribunals, *Holodnak* "need not be read as necessarily carving out a 'due diligence' exception to the time limitation established by 9 U.S.C. § 12."[60] One court, however, has read *Holodnak* as recognizing a "due diligence exception to 9 U.S.C. § 12."[61] Nonetheless, even if tolling were to apply to the three-month statutory deadline, the unique facts of *Holodnak* are easily distinguishable from the overwhelming majority of circumstances in which a plaintiff serves a motion to vacate arbitration after the limitations period has expired.[62] Consequently, *Holodnak* is the "rare (and distinguishable) instance[]" in which a court in the Second Circuit has found an exception to the FAA's three-month limitations period.[63]

"In light of Florasynth *and the surfeit of district court decisions heeding the admonition that 'there is no common law exception to the three month limitations period,' the precedential value of* Holodnak *is questionable."*

Conclusion

Of the 71 hearing venues offered by FINRA, New York and California are two of the most popular locations.[64] For this reason, New York practitioners, especially those who practice in the area of securities arbitration and litigation, should be cognizant of the Second Circuit and Ninth Circuit's position on equitable tolling of the FAA's time restriction for a motion to vacate arbitration. Although the Ninth Circuit has interpreted the FAA's three-month limitations period less rigidly than the Second Circuit, equitable tolling should not be considered a talismanic cure-all for litigants who miss the statutory deadline. As the Ninth Circuit in *Move v. Citigroup* stated, "a moving party would still need to meet the heavy burden of establishing its entitlement to equitable tolling for a court to vacate an award, and it would only be the rare case in which the three-month deadline for a motion to vacate would not apply."[65]

Likewise, it will be an even rarer case in which the three-month deadline would not apply in the Second Circuit. In the words of one Southern District New York court: "The Second Circuit has made clear that there is no exception to this three month limitation period."[66] Although a District of Connecticut court in *Holodnak* approved of an exception to the FAA's limitations period, this ruling has seemingly been abrogated by subsequent Second Circuit decisional law. However, one aspect of the *Holodnak* court's limitations ruling—that where the FAA's deadline to vacate an arbitration award falls on Sunday, a plaintiff has until the end of the next day to effectuate service—may retain some vitality.

Other courts, including the Fifth Circuit[67] and Delaware Court of Chancery,[68] have also rejected claims that tolling applies to the statutorily prescribed time period in the FAA.[69] Although not expressly rejecting the applicability of tolling to the FAA, some courts, including the Fourth[70] and Eighth Circuits,[71] have expressed reservations about the viability of such an exception.[72] In addition, many courts, including the First[73] and Sixth Circuits,[74] have refused to apply equitable tolling on the merits assuming, without deciding, that equitable tolling is permitted under the FAA.[75] Even if they have not had the opportunity to decide whether tolling applies to the limitations period under § 12, many courts strictly construe this statutory deadline. For example, in *Webster v. A.T. Kearney, Inc.*,[76] the Seventh Circuit agreed with the district court that a motion to vacate arbitration was time-barred where the plaintiff filed his motion one day before expiration of the three-month period, but did not serve defendant with notice of the motion until one day after the expiration of that period. Thus, other federal appellate courts have adopted an approach to the FAA's limitations period that is consistent with the Second Circuit's construal of § 12.[77]

The use of commercial arbitration to resolve a wide variety of disputes forms a significant part of the justice system. Parties may seek to challenge an arbitral award on the narrow grounds provided for under the FAA or a state statute. Although the procedural nuances of these statutes vary and are subject to different interpretations by the courts, those seeking to challenge an arbitration award should do so promptly regardless of the jurisdiction in which the action will be instituted. In offering guidance on this matter, the Seventh Circuit has aptly stated that "[a] party who is uncertain about the finality or appealability of an arbitration award should err on the side of compliance with the FAA § 12."[78] Because it will be the rare case in which a party's failure to adhere to the FAA's limitations period will be excused, litigants would do well to follow the Seventh Circuit's advice.

Endnotes

1. *See* Stephen K. Huber, *The Role of Arbitrator: Conflicts of Interest*, 28 Fordham Urb. L.J. 915, 930 (2001) (noting "the explosive growth of arbitration" and that "[a]rbitration is [almost] everywhere in the American economic scene"); Edward Brunet, *Toward Changing Models of Securities Arbitration*, 62 Brook. L. Rev. 1459, 1459 (1996) ("The 1987 *Shearson/American Express, Inc. v. McMahon* decision unleashed a remarkable growth in the arbitration of securities disputes between customers and brokers."); *see also* Jane K. Winn, *The Secession of the Successful: The Rise of Amazon as Private Global Consumer Protection Regulator*, 58 Ariz. L. Rev. 193, 205 (2016) ("The use of arbitration terms in consumer contracts is even more widespread in America in 2015 than it was in 2005.").
2. 9 U.S.C. §§ 10, 11; N.Y. CPLR 7511.
3. *See Shearson/American Express v. McMahon*, 482 U.S. 220, 226 (1987) ("The [Federal] Arbitration Act thus establishes a 'federal policy favoring arbitration,' requiring that 'we rigorously enforce agreements to arbitrate.'") (internal citation omitted); *Duferco Int'l Steel Trading v. T. Klaveness Shipping A/S*, 333 F.3d 383, 388 (2d Cir. 2003) ("It is well established that courts must grant an arbitration panel's decision great deference. A party petitioning a federal court to vacate an arbitral award bears the heavy burden of showing that the award falls within a very narrow set of circumstances delineated by statute and case law."); *accord Blue Tee Corp. v. Koehring Co.*, 754 F. Supp. 26, 31 (S.D.N.Y. 1990) ("[I]t is the Second Circuit's policy to read very narrowly courts' authority to vacate arbitration awards").
4. *Baravati v. Josephthal, Lyon & Ross, Inc.*, 28 F.3d 704, 706 (7th Cir. 1994).
5. For example, in *AT&T Mobility LLC v. Concepcion*, 563 U.S. 333 (2011), the U.S. Supreme Court held that the California Supreme Court's "*Discover Bank* Rule," which prohibited certain class action waivers in arbitration agreements, was preempted by the Federal Arbitration Act (FAA). After *Concepcion*, many California courts "developed novel strategies to limit the FAA's preemptive effect." Salvatore U. Bonaccorso, Note, *State Court Resistance to Federal Arbitration Law*, 67 Stan. L. Rev. 1145, 1148 (2015); *see, e.g.*, *Iskanian v. CLS Transp. L.A., LLC*, 327 P.3d 129 (Cal. 2014) (ruling that the FAA does not preempt the barring of arbitration agreements requiring waiver of Private Attorneys General Act claims); *Ajamian v. CantorCO2e, L.P.*, 137 Cal. Rptr. 3d 773, 804 n.18 (Ct. App. 2012) (holding arbitration provision unconscionable and noting that "the concerns expressed in [*Concepcion*] do not preclude the outcome here"). Recently, the U.S. Supreme Court in *DIRECTV, Inc. v. Imburgia*, 136, S. Ct. 463 (2015), "rebuked the California courts for giving insufficient weight to the FAA's preemptive reach." Caitlin J. Halligan & Gabriel Gillet, *New York Courts at the Forefront of Arbitration Law*, L.A. Daily J. (June 24, 2016), *available at* http://www.gibsondunn.com/publications/Documents/Halligan-Gillett-New-York-Courts-at-the-Forefront-of-Arbitration-Law-DJ-6-24-16.pdf (highlighting that "[i]n contrast with New York, California state courts frequently evinced hostility to arbitration agreements").
6. *Moncharsh v. Heily & Blase*, 832 P.2d 899, 903 (Cal. 1992).
7. *Wall Street Assocs., L.P. v. Becker Paribas Inc.*, 27 F.3d 845, 848 (2d Cir. 1994) (quoting 9 U.S.C. § 10(a)).
8. N.Y. CPLR 7511(b)(1)(i)-(iv).
9. 9 U.S.C. § 12 ("Notice of a motion to vacate, modify, or correct an award must be served upon the adverse party or his attorney within three months after the award is filed or delivered."). Under the CPLR, a motion to vacate an arbitration award must be filed within 90 days of the award's delivery to the moving party. N.Y. CPLR 7511(a) ("An application to vacate or modify an award may be made by a party within ninety days after its delivery to him."). *See Santos v. GE Co.*, No. 10 Civ. 6948 (JSR) (MHD), 2011 U.S. Dist. LEXIS 131925, at *8 n.5 (S.D.N.Y. Sept. 28, 2011) ("The distinction between these two sources of law is that under the FAA the movant must give notice of, or serve, her application within three months. In contrast, the New York statute refers to an application having been 'made' within 90 days (not three months), and the term 'made' contemplates filing rather than service"); *accord Levy v. Wells Fargo Advisors, LLC*, No. 16-171, 2016 U.S. Dist. LEXIS 144642, at *4 (E.D. Pa. Oct. 18, 2016) ("By its plain language, the [FAA] governs when *service* must be made and New York law governs when the motion must be *filed*.") (emphasis in original).
10. *Move v. Citigroup Global Mkts., Inc.*, No. 14-56650, 2016 U.S. App. LEXIS 19930, at *15 (9th Cir. Nov. 4, 2016).
11. *Id.* at *8.
12. *Id.* at *3. "FINRA is an independent organization authorized by Congress to regulate the U.S. securities markets and professionals who sell securities in the United States. 'FINRA is a self-regulatory organization [ ] that (among other things) sponsors an arbitration forum.'" *Credit Suisse Sec. (USA) LLC v. Tracy*, 812 F.3d 249, 253 (2d Cir. 2016).
13. *Move*, 2016 U.S. App. LEXIS 19930, at *3.
14. *Id.* at *4.
15. *Id.*
16. *Id.*
17. *Id.*
18. *Id.*
19. *Id.* at *5 ("It is now undisputed that Mr. Frank, who is 'James Hamilton Hardy Frank,' was impersonating retired California attorney 'James Hamilton Frank.'").
20. *Id.*
21. *Id.*
22. § 10(a)(3) of the FAA provides that courts may vacate an arbitration award upon finding that "the arbitrators were guilty of . . . any . . . misbehavior by which the rights of any party have been prejudiced."
23. Under § 10(a)(4), courts may vacate an arbitral award "where the arbitrators exceeded their powers."
24. *Move*, 2016 U.S. App. LEXIS 19930, at *5.
25. *Id.*
26. *Id.*

27. *Id.*

28. *Id.*

29. *Id.*

30. *Id.* at 6.

31. *Id.*

32. *Id.*

33. *Id.*

34. *Id.* at 6, 7-12.

35. *Id.* at 8.

36. *Id.* (citing, *inter alia*, *Garrett v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 7 F.3d 882, 883 n.1 (9th Cir. 1993); *Fradella v. Petricca*, 183 F.3d 17, 21 (1st Cir. 1999); *Taylor v. Nelson*, 788 F.2d 220, 225-26 (4th Cir. 1986); *Piccolo v. Dain, Kalman & Quail, Inc.*, 641 F.2d 598, 601 (8th Cir. 1981)); *see IKON Global Mkts. V. Appert*, No. C11-53RAJ, 2011 U.S. Dist. LEXIS 155108, at *9-10 (W.D. Wash. July 28, 2011) (assuming that the FAA's three-month limitations period was subject to equitable tolling for purposes of deciding the motion, but noting that the "Ninth Circuit has declined to decide whether Section 12 is subject to equitable tolling").

37. *Id.* (quoting *Young v. United States*, 535 U.S. 43, 49 (2002)).

38. *Id.* at 9-12.

39. *Id.* at 13, 15-16.

40. *Id.* at 14.

41. *Id.*

42. *Id.*

43. *Id.*

44. *Id.* at 15.

45. *Id.* at 16.

46. No. 04-cv-1069 BEN (BLM), 2006 U.S. Dist. LEXIS 89673, at *6-7 (S.D. Cal. Dec. 11, 2006) ("This Court finds that 9 U.S.C. § 12 is more appropriately viewed as a statute of limitations, and therefore is subject to equitable tolling.").

47. No. 2:14-cv-08182-CAS (PLAx), 2015 U.S. Dist. LEXIS 9185, at *14 (C.D. Cal. Jan. 15, 2015) (citing, *inter alia*, *Strobel v. Morgan Stanley Dean Witter*, 2006 U.S. Dist. LEXIS 89673, at *3); *cf. Fairmount Minerals, Ltd. v. Mineral Serv. Plus, LLC*, No. 14-cv-400-bbc2014, U.S. Dist. LEXIS 160436, at *7 (W.D. Wis. Nov. 13, 2014) ("The slight majority of courts addressing this issue, including the Court of Appeals for the Second Circuit, have found that equitable tolling does not apply.").

48. 750 F.2d 171, 175 (2d Cir. 1984) (internal citations omitted).

49. *See, e.g.*, *Pa. Eng'g Corp. v. Islip Res. Recovery Agency*, 710 F. Supp. 456, 461 n.1 (E.D.N.Y. 1989) ("[T]he [FAA] does not provide for exceptions to the three month limitation. 9 U.S.C. § 12. Therefore, these time limitations are not waivable.") (citing *Florasynth*, 750 F.2d at 175), *reh'g denied*, 714 F. Supp. 634 (E.D.N.Y. 1989) ("Whether or not plaintiffs were aware of the Arbitrator's potential conflict of interest is irrelevant. The [FAA]'s statute of limitations provisions recognize no common law exceptions. Therefore, plaintiffs cannot use a common law exception to circumvent the Act's strict time limitations."); *Triomphe Partners, Inc. v. Realogy Corp.*, 10 Civ. 8248 (PKC), 2011 U.S. Dist. 15626, at *7 (S.D.N.Y. Aug. 15, 2011) ("Equitable tolling does not apply in this case. First, 'there is no common law exception to the three month limitations period on the motion to vacate.'") (citing *Florasynth*, 750 F.2d at 175).

50. *Yadav v. Charles Schwab & Co.*, No. 89 CIV. 6799 (SWK), 1990 U.S. Dist. LEXIS 8880, at *6 (S.D.N.Y. July 18, 1990).

51. *See, e.g.*, *id.* (denying action to vacate arbitration award that was filed 21 days past three month deadline); *Colavito v. Hockmeyer Equipment Corp.*, 605 F. Supp. 1482, 1487 (S.D.N.Y. 1985) (holding petition to vacate arbitration award untimely when filed a year after award rendered); *Getty Oil Co. v. Norse Management Co.* (PTE), 711 F. Supp. 175, 176 (S.D.N.Y. 1989) (finding that vessel owner failed to challenge arbitral award within three months and was thus barred from doing so); *Ne. Sec., Inc. v. Quest Capital Strategies, Inc.*, No. 03 Civ. 2056 (RWS), 2003 U.S. Dist. LEXIS 20025, at *4 (S.D.N.Y. Nov. 7, 2003) (finding cross-petition to vacate arbitration award untimely, stating "[t]he period provided for [in 9 U.S.C. § 12] is a statute of limitations and the failure to bring a timely motion is an absolute bar to an application seeking vacatur or modification"); *Funcia v. NYSE Group*, No. 07 Civ. 1745 (RWS), 2007 U.S. Dist. LEXIS 88581, at *9-10 (S.D.N.Y. Dec. 3, 2007) (ruling plaintiff's motion to vacate arbitration award untimely and granting defendants' motion to dismiss); *Waveform Telemedia, Inc. v. Panorama Weather N. Am.*, No. 06 Civ. 5270 (CM) (MDF), 2007 U.S. Dist. LEXIS 15626 (S.D.N.Y. Mar. 2, 2007) (dismissing plaintiff's cross-petition to vacate an arbitration award that was served three days late); *Lobaito v. Chase Bank*, No. 11 Civ. 6883 (PGG), 2012 U.S. Dist. LEXIS 107344, *15-17 (July 31, 2012) (construing pro se plaintiff's complaint as a motion to vacate arbitration and dismissing it as untimely); *Degrate v. Broad. Music, Inc.*, No. 12 Civ. 1700 (RJS) (JLC), 2013 U.S. Dist. LEXIS 23957, at *10-11 (Feb. 20, 2013) (adopting magistrate judge's report recommending that motion to vacate be dismissed as time-barred); *Martin v. Deutsche Bank Sec., Inc.*, No. 1:15-cv-09292 (LLS), 2016 U.S. Dist. LEXIS 13681, at *4 (Feb. 8, 2016) (granting motion to dismiss where plaintiff's petition to vacate arbitration award was untimely).

52. 381 F. Supp. 191 (D. Conn. 1974) (Lumbard, J., sitting by designation), *rev'd in part on other grounds*, 514 F.2d 285 (2d Cir.), *cert. denied*, 423 U.S. 892 (1975).

53. *Id.* at 197.

54. *Id.*

55. *Id.*

56. *Id.*

57. *Id.* at 198.

58. *Id.*

59. *Piccolo v. Dain, Kalman & Quail, Inc.*, 641 F.2d 598, 601 n.5 (1981) (citing Fed. R. Civ. P. 81(a) and noting that the Federal Rules of Civil Procedure apply to proceedings under the FAA to the extent that matters of procedure are not provided for in the Act); *Franco v. Prudential Bache Sec., Inc.*, 719 F. Supp. 63, 64 (D.P.R. 1989) ("[T]he Court in *Holodnak* did not rely on the existence of a due diligence exception and in fact rested its holding on other grounds") (citing *id.*); *Hobet Mining v. Int'l Union, United Mine Workers*, 877 F. Supp. 1011, 1017 (S.D. W.Va. 1994) ("[T]he *Holodnak* decision rests as well on the alternative ruling that inasmuch as the last day of the limitations period fell on a Sunday, application of Rule 6(a) of the Federal Rules of Civil Procedure would result in a finding that the Section 12 notice was timely.") (citing *Piccolo*, 641 F.2d at 601 n.5); *Chase v. Nordstrom, Inc.*, No. CCB-10-2114, 2010 U.S. Dist. LEXIS 121523, at *6 n.3 (Nov. 17, 2010 D. Md.) ("The court in *Holodnak*, however, rested its decision on an alternative ground, concluding that because the last day of the limitations period fell on a Sunday, service upon the defendant was actually timely.") (citing *Piccolo*, 641 F.2d at 601 n.5 and *Hobet Mining*, 877 F. Supp. 1011); *see White v. Local 46 Metallic Lathers Union & Reinforcing Iron Workers*, No. 01 Civ. 8277 (RMB) (GWG), 2003 U.S. Dist. LEXIS 2613, at *15 n.9 (S.D.N.Y. Feb. 24, 2003) ("The *Holodnak* court also applied Federal Rules of Civil Procedure 6(a) which allows one more day of service when the last day of the limitations period falls on a Sunday.").

60. *Piccolo*, 641 F.2d at 601 n.5.

61. *Sargent v. Paine Webber, Jackson & Curtis, Inc.*, 687 F. Supp. 7, 9-10 (D.D.C. 1988), *remanded on other grounds*, 882 F.2d 529, 533 (D.C. Cir. 1989) (applying the doctrine of equitable tolling and holding pro se plaintiff's motion to vacate arbitration award not time-barred).

62. *White v. Local 46*, 2003 U.S. Dist. LEXIS 2613, at *15-16 (noting that *Holodnak*, 381 F. Supp. 191, and *Sargent*, 687 F. Supp. 7, "are readily distinguishable from the case at bar" and that no adequate basis for equitable tolling had been presented); *Piccolo*, 641 F.2d at 601

(questioning the existence of a "due diligence" exception and distinguishing factual circumstances of case from those of *Holodnak* in concluding that plaintiff's efforts to comply with the FAA's deadline would not qualify even if such an exception existed); *see Franco*, 719 F. Supp. at 64-65 ("Even assuming, as did the court in *Piccolo*, that a due diligence exception exists, [plaintiff] has alleged no facts to justify its application in this case."); *Pryor v. IAC/InterActiveCorp*, No. 6884-CS, 2012 Del. Ch. LEXIS 132, at *20 (Del. Ch. June 7, 2012) ("Even if, in the alternative, I were to assume that the three-month limitations period prescribed in the FAA could be equitably tolled, the circumstances here would not merit it."); *see also Triomphe Partners*, 2011 U.S. Dist. 15626, at *7 ("[E]ven if equitable tolling applied to the FAA's statute of limitations, the facts of this case would not warrant it . . . . Equitable tolling applies only in rare and exceptional circumstances.") (internal citations and quotation marks omitted).

63. *White v. Local 46*, 2003 U.S. Dist. LEXIS 2613, at *15.

64. *See* FINRA Hearing Locations Statistics, FINRA, http://www.finra.org/arbitration-and-mediation/hearing-location-statistics (last visited Dec. 10, 2016) (offering venues in Albany, Buffalo, New York City, and Syracuse in New York, and Los Angeles, San Diego, and San Francisco in California).

65. *Move,* 2016 U.S. App. LEXIS 19930, at *11-12 (recognizing the "high bar of equitable tolling"); see *supra* notes 63-64 and accompanying text.

66. *Kruse v. Sands Bros. & Co.*, 226 F. Supp. 2d 484, 486, (S.D.N.Y. 2002) (citing *Florasynth*, 750 F.2d at 175).

67. *Cigna Ins. Co. v. Huddleston*, No. 92-1252, 1993 U.S. App. LEXIS 40575, at *35 (5th Cir. Feb. 16, 1993) (per curiam) ("Our decision is based on the fact that there is no 'discovery rule' or 'equitable tolling' exception to the requirement in section 12 of the FAA that the defenses of fraud or impartiality be asserted within three months from the time that the arbitration award is filed or delivered."); *accord La. Health Serv. Indem. Co. v. Gambro A B*, 756 F. Supp. 2d 760, 765 (W.D. La. 2010) ("As noted by the *Cigna* court, other federal courts of appeals that have confronted pleas for extension of the deadline imposed by Section 12 have uniformly declined to grant such an extension.").

68. *Pryor v. IAC/InterActiveCorp*, 2012 Del. Ch. LEXIS 132, at *19-20 ("Consistent with respect for the statute's deadline, distinguished federal courts analyzing whether a motion to vacate an arbitration award is timely have long held that equitable tolling is not available under the FAA. I adhere to this authority.") (footnote omitted)

69. *Chilcott Entertainment L.L.C. v. John G. Kinnard Co., Inc.*, 10 P.3d 723, 726 (Colo. Ct. App. 2000) ("[T]he three-month limitations period in 9 U.S.C. § 12 is not subject to an equitable tolling exception").

70. *Taylor v. Nelson*, 788 F.2d 220, 225 (4th Cir. 1986) (declining to consider "whether due diligence or tolling rules are proper exceptions to the limitations period prescribed by the Federal Arbitration Act," but noting "[t]he existence of any such exceptions to § 12 is questionable") (citing *Florasynth*, 750 F.2d at 174-77 and *Piccolo*, 641 F.2d at 601).

71. *Piccolo*, 641 F.2d at 601 n.5 (explaining why "the existence of a 'due diligence' exception may be questioned"); *see Sanders-Midwest, Inc. v. Midwest Pipe Fabricators, Inc.*, 857 F.2d 1235, 1238 (8th Cir. 1988) ("No exceptions to the time for service of notice appear in the Federal Act . . . . We note other courts are skeptical that any exception to the service requirement exists.") (citing *Taylor*, 788 F.2d at 225 and *Piccolo*, 641 F.2d at 601).

72. *Belz v. Morgan Stanley Smith Barney, LLC*, No. 3:13-cv-636-J-34MCR, 2014 U.S. Dist. LEXIS 28906, at *24-25 (M.D. Fla. Mar. 6, 2014) ("In essence, this argument amounts to a request that the Court toll the deadline for serving notice under the FAA . . . the Trustee fails to cite to any authority in support of applying an equitable exception to the FAA's limitations period, and the Court questions whether any such exception exists").

73. *Fradella v. Petricca*, 183 F.3d 17, 21 (1st Cir. 1999) ("We need not consider whether the deadline prescribed in FAA § 12 is subject to such equitable tolling, since Fradella has not generated a trialworthy issue as to his entitlement to invoke tolling.").

74. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Spencer*, 92 Fed. Appx. 243, 245 (6th Cir. 2004) ("This court has not had occasion to decide whether arbitration vacatur motions are subject to equitable tolling . . . . However, we need not resolve this issue today, because the facts of this case clearly do not merit equitable tolling."); *see Ford Dealer Computer Servs. v. Highland Lincoln Mercury, Inc.*, No. 06-X-50344, 2008 U.S. Dist. LEXIS 25814 (E.D. Mich. Mar. 31, 2008) (Hood, J.) (opining that "[t]he doctrine of equitable tolling may be applicable to the FAA statute of limitation, although the Sixth Circuit has yet to rule on that issue in a published opinion," but finding that circumstances of the case did not warrant application of equitable tolling). At least one Sixth Circuit district court, however, has held that equitable tolling does apply to the FAA's three-month limitations period. *See Bauer v. Carty & Co.*, No. 04-2428, 2005 U.S. Dist. LEXIS 44082, *11-12, 13 (W.D. Tenn. Mar. 8, 2005) (denying defendant's motion to dismiss and "conclud[ing] that the equitable tolling doctrine is applicable to the time limit set forth in 9 U.S.C. § 12"); *see also Merrill Lynch v. Spencer*, 92 Fed. Appx. at 247-48 (Hood, J., concurring) (agreeing that defendants failed to make out a case for equitable tolling, but contending "that equitable tolling is applicable to the three month limitation period under 9 U.S.C. § 12"); *cf. Desousa v. Jabiru USA Sport Aircraft, LLC*, No. 4:08-cv-442011, U.S. Dist. LEXIS 101046, at *14 n.2 (E.D. Tenn. Sept. 6, 2011) (refusing to reconsider denial of motion to vacate arbitration award because plaintiff did "not show any good cause for his failure to act timely" and noting that "[w]hether the FAA limitations period is even subject to equitable tolling is unclear").

75. *See Fairmount Minerals, Ltd. v. Mineral Serv. Plus, LLC*, No. 14-cv-400-bbc, 2014 U.S. Dist. LEXIS 160436, at *8-9 (W.D. Wisc. Nov. 14, 2014) ("I am not persuaded that equitable tolling is a viable exception to the Federal Arbitration Act's limitations period in this circuit. Even if equitable tolling applied, the facts of this case would not warrant such tolling in this case."). In *Pfannenstiel v. Merrill Lynch, Pierce, Fenner & Smith*, the Tenth Circuit held that equitable tolling was unavailable where a plaintiff had "ample opportunity"—one month—to file a motion to vacate in a timely fashion, even though "he had no way of knowing about" the grounds for this motion until two months of the applicable three-month time limit had already elapsed. 477 F.3d 1155, 1158 (10th Cir. 2007). Yet, the panel in *Pfannenstiel* broadly stated that equitable tolling "should be applied unless Congress provides to the contrary." *Id.* Furthermore, the Tenth Circuit has considered 9 U.S.C. § 12 to be "in the nature of a statute of limitations, which is subject to waiver" and has disagreed with a defendant's characterization of the provision as a "jurisdictional prerequisite to a court action seeking to vacate an arbitration award." *Foster v. Turley*, 808 F.2d 38, 41 (10th Cir 1986). Accordingly, an argument may be made that equitable tolling of the FAA's three-month limitations period is available in the Tenth Circuit.

76. 507 F.3d 568, 571-72 (7th Cir. 2007); *cf. Glaser v. Legg*, 928 F. Supp. 2d 236, 239 (D.D.C. 2013) (finding petition to vacate arbitration untimely under the FAA where plaintiff served the motion after three months even though the plaintiff filed the motion within three months).

77. *Compare Florasynth*, 750 F.2d at 175 ("No exception to this three month limitations period is mentioned in the statute [9 U.S.C. § 12].") *with Olson v. Wexford Clearing Servs. Corp.*, 397 F.3d 488, 490 (7th Cir. 2005) ("The plain language of § 12 does not provide for any exceptions to the three-month window and says nothing about tolling.").

78. *Olson v. Wexford Clearing Servs. Corp.*, 397 F.3d at 492.

How Dewey & LeBoeuf Failed to Fore-WARN

By Stuart B. Newman and C. Tyler Silvey

All M&A, transaction, and private equity attorneys have their checklists: Due authorization? Check. Good standing? Check. Hart-Scott-Rodino clearance? Check. WARN Act notification? Check.

The Worker Adjustment Retraining Notification Act, better known as the WARN Act, permeates the practice of law, and the vast majority of attorneys have had to deal with the requirements of the federal WARN Act and its state law analogs in one way or another. One might assume, then, that advising a client as to when and how to send WARN Act notices would be routine practice. One might further assume that when a prestigious law firm was forced to close its own doors, those top-notch attorneys would have known how to follow the WARN Act's requirements for themselves. The reality is, however, that sometimes even simple requirements can be misconstrued or overlooked in the midst of the countless headaches experienced by a struggling business, or in this case, a struggling law firm. Indeed, during its recent and highly publicized troubles, Dewey & LeBoeuf LLP ("Dewey & LeBoeuf") failed to comply with the WARN Act's requirements at the time of its sudden demise in 2012. That failure gave rise to class-action claims by its former employees for lost wages during the statutory notice periods and ultimately cost the firm $4.5 million in the settlement of WARN Act claims by its former employees.

Statutory Requirements

The federal WARN Act requires covered employers to provide 60 days' advance notice before one of two covered events: a "plant closing"[1] or a "mass layoff."[2] An employer is covered by the WARN Act if it has 100 or more employees, excluding part-time employees, or 100 or more employees who, in the aggregate, work at least 4,000 hours per week, excluding overtime.[3] The Act requires that employers refrain from commencing a plant closing or mass layoff until 60 days after the employer provides written notice to either affected workers or their representatives (e.g., a labor union), to the state dislocated worker unit, and to the appropriate unit of local government.[4] (There are only three defined scenarios—discussed in the next section—in which an employer could reduce the notice period to less than 60 days: (1) the "faltering company" exception; (2) the "unforeseeable business circumstances" exception; and (3) the "natural disaster" exception.[5]) Failure to send the required advance notice can result in an employer's liability to its employees for back pay and benefits under the employer's employee benefit plan.[6]

The New York WARN Act mirrors the federal Act but differs in several ways, two of which are significant: The New York Act covers more businesses, as it defines "employer" as "any business enterprise that employs [fifty] or more employees, excluding part-time employees, or fifty or more employees that work in the aggregate at least two thousand hours per week," compared to the federal Act's threshold of 100 or more employees.[7] The New York WARN Act requires 99 days' advance notice, compared to the federal requirement of 60 days' advance notice.[8] Thus, the New York WARN Act covers more employers and requires more advance notice to employees. An employer that is subject to both Acts must comply with both accordingly. Moreover, in addition to the three federal exceptions, New York's statute also explicitly provides two additional exceptions—one for a temporary facility[9] and one for strikes or lockouts.[10]

Exceptions to the WARN Act

The statutory exceptions under both the federal and New York WARN Acts permit an employer to give shorter notice in certain extraordinary circumstances. In order for the employer to be afforded the protection of a statutory exception, whether by reason of one of the three federal, or the two additional New York exceptions, the employer must still provide "as much notice as is practicable" and, as required by New York State, include in the written notice "a brief statement of the basis for reducing the notification period" when such shortened notice is given.[11] In other words, even if a business finds itself in a circumstance that qualifies as one of the defined exceptions, that business must still send written notice as soon as possible *and*, in order to comply with New York law, the notice must include the reason why the notice is being sent later than statutorily required, i.e., with shorter advance warning. If the employer fails to include the reason for the shorter notice period in its lay-off communication to its employees, it will, as was the case with Dewey & LeBoeuf, be liable for back pay and benefits, regardless of the business's circumstances.

The exceptions for the occurrence of a natural disaster, a strike or lockout, or the closing of a temporary facility are fairly self-explanatory, but the exceptions for "faltering company" and "unforeseeable business circumstances" are less so.

Under the "faltering company" exception, an employer may shorten the notice period if it can establish that, at the time that 60- or 90-day notice would have been required, the employer was "actively seeking capital or business, which, if obtained, would have enabled the

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employer to avoid or postpone the shutdown" and that the employer acted reasonably and in good faith and "believed that giving notice would have precluded the ability to obtain the needed capital or business."[12] The employer must be able to demonstrate specific actions taken, a realistic opportunity to obtain the financing or business sought, sufficiency of the financing or business, and that a potential financing source or customer would have been unwilling to provide the financing or new business if notice had been given.[13]

The "unforeseeable business circumstances" exception provides an employer with relief if the closing or mass layoff was caused by "business circumstances that were not reasonably foreseeable" when the 60 or 90 days advance notice would have been required.[14] To qualify, the employer must establish the occurrence of a "sudden, dramatic and unexpected action or condition outside the employer's control."[15] One example provided by both the federal and New York Acts is "[a] government ordered closing of an employment site that occurs without prior notice."[16] The employer must exercise "commercially reasonable business judgment" in determining whether a business circumstance is reasonably foreseeable.[17]

Moreover, in addition to the statutorily defined exceptions, there is one court-created exception known as the "liquidating fiduciary principle." This exception to the WARN Act's advance notice requirement has been developed by the courts for the situation in which an employer has ceased doing business and has become a liquidating fiduciary.[18] In such a scenario, courts have found that "a liquidating fiduciary in a bankruptcy case does not fit the definition of an employer for the purposes of the WARN Act."[19] Thus, a liquidating fiduciary is not required to provide notice to terminated employees, but dismissing a case based on this principle would require a court to conclude as a matter of law that a debtor was already in the process of liquidating when the layoffs took place.[20]

Dewey & Leboeuf: A Costly Omission

The highly publicized demise of Dewey & LeBoeuf resulted in the prestigious law firm ultimately filing for bankruptcy on May 28, 2012.[21] More than 550 employees, both lawyers and non-lawyers, remained employed by the firm until their termination shortly before the bankruptcy filing.[22] Among the many disputes that arose from the firm's shutdown were class action claims under the federal, New York and California WARN Acts, alleging that the class of terminated employees was not provided statutorily required advance notice that their employment might be terminated.[23]

The law firm sent letters to all of its employees on May 4 and May 10, 2012.[24] The initial letter cautioned employees that the firm's "extraordinary difficulties" could "result in closure of the firm" and termination of employment, and the letter underscored that it was meant to serve as a WARN Act notice.[25] The second notice on May 10 confirmed that all employment with Dewey & LeBoeuf would terminate effective May 15th, 2012,[26] just five days later. By giving employees less than two weeks' notice of their eventual termination, the law firm's letters clearly fell short of any WARN Act advance notice requirement. But did the circumstances surrounding Dewey & LeBoeuf's sudden downfall enable the law firm to use one of the exceptions to the WARN Act, as described above?

> *"The 'unforeseeable business circumstances' exception provides an employer with relief if the closing or mass layoff was caused by 'business circumstances that were not reasonably foreseeable' when the 60 or 90 days advance notice would have been required."*

Very quickly, a class action claim was brought by employees who sought to recover the full amount of 60 days' wages and benefits from their former employer because they were terminated without either 60 days' advance notice, as required under the federal law and under the California WARN Act, or 90 days' advance notice, as required by the New York WARN Act.[27] Dewey & LeBoeuf argued that it was not liable to any of its former employees pursuant to any of the three WARN Acts at issue because it fell into the "faltering company" exception and/or the "unforeseeable business circumstances" exception.[28]

Dewey & LeBoeuf conceded that the content of its two notices did not fully satisfy New York's "brief statement requirement" because neither notice contained the requisite "reasonably specific facts . . . providing an adequate, specific explanation [of the shortened notice period] to affected workers."[29] Instead, the law firm tried to argue that it satisfied the "brief statement requirement" by supplementing the written notices with an electronic calendar invitation to a meeting where the law firm would explain to its employees the reasons for their imminent termination.[30]

The bankruptcy court, however, found that Dewey & LeBoeuf could not invoke either exception as an affirmative defense because the law firm did not follow the clear New York statutory requirements that would enable an employer to utilize one of the WARN Act exceptions—specifically, that an employer must explain to its employees *in writing in the notice itself* why an exception to the advance notice requirement applied.[31] The court stated, "[T]he necessary predicate for a defendant to be able to assert these affirmative defenses allowing for shortened notice is a showing that the shortened notice included a brief statement of the basis for the reduced notice period—'the employer must give as much notice as is practicable and at that time shall give a brief statement of the basis for reducing the notification period.'"[32] The letters that Dewey & LeBoeuf sent to its employees "lacked a brief statement describing the reasons for the shortened notice that would support application of either of the two affirmative defenses."[33]

Moreover, the court found that—beyond the fact that only 296 of the 429 class members actually attended the supplemental meetings—the "statutory, regulatory, and interpretive content all direct an employer delivering shortened WARN notice to provide the brief statement in that notice itself."[34] Despite the "practicality" of electronic calendar invitations, as the law firm highlighted in its arguments, the court found that such an approach "simply cannot trump the language of the statutes and the implementing regulations adopted by the Department of Labor."[35]

The court's ruling against Dewey & LeBoeuf ultimately resulted in the law firm entering a $4.5 million settlement agreement with its former employees to end the class action claims under the three applicable WARN Acts.[36] Ironically, the claim and the expense of resolving it could have been easily avoided by including just a few more sentences in its WARN Act notices, as required by the New York statute. Such a simple oversight with such an expensive price tag is a cautionary tale for all practitioners and businesses alike.

Conclusion

When a business is failing, and turmoil is a daily occurrence, senior management is pulled in countless directions and is under tremendous pressure. Sending proper WARN Act notices is not likely a high priority for anyone in that position. That is precisely when good counsel is most needed. When advising under such circumstances, attorneys must be detail oriented and precise even with respect to disarmingly simple tasks.

Endnotes

1. "Plant closing" is defined as "the permanent or temporary shutdown of a single site of employment, or one or more facilities or operating units within a single site of employment, if the shutdown results in an employment loss at the single site of employment during any 30-day period for 50 or more employees excluding any part-time employees." 29 U.S.C. § 2101(a)(2).
2. "Mass layoff" is defined as "a reduction in force which—(A) is not the result of a plant closing; and (B) results in an employment loss at the single site of employment during any 30-day period for—(i) (I) at least 33 percent of the employees (excluding any part-time employees); and (II) at least 50 employees (excluding any part-time employees); or (ii) at least 500 employees (excluding any part-time employees)." 29 U.S.C. § 2101(a)(3).
3. 29 U.S.C. § 2101(a)(1).
4. 29 U.S.C. § 2102(a).
5. 29 U.S.C. § 2102(b) & 20 C.F.R. § 639.9.
6. 29 U.S.C. § 2104(a).
7. N.Y. Labor Law § 860-a(3).
8. N.Y. Labor Law § 860-b(1).
9. "[T]he plant closing is of a temporary facility or the plant closing or mass layoff is the result of the completion of a particular project or undertaking, and the affected employees were hired with the understanding that their employment was limited to the duration of the facility or project or undertaking." N.Y. Labor Law § 860-c(d).
10. "[T]he closing or mass layoff constitutes a strike or constitutes a lockout not intended to evade the requirements of this article." N.Y. Labor Law § 860-c(e).
11. 29 U.S.C. § 2102(b)(3) & N.Y. Labor Law § 860-c(2).
12. *See* 29 U.S.C. § 2102(b)(1), 20 C.F.R. § 639.9(a), NY Labor Law § 860-c(1)(a) & 12 N.Y.C.R.R. § 921-6.2.
13. *See* 20 C.F.R. § 639.9(a) & 12 N.Y.C.R.R. § 921-6.2.
14. *See* 20 C.F.R. § 639.9(b) & 12 N.Y.C.R.R. § 921-6.3.
15. *Id*.
16. *Id*.
17. *Id*.
18. *See*, *e.g.*, *In re Dewey & LeBoeuf LLP*, 487 B.R. 169, 176 (S.D.N.Y. 2013).
19. *Id*. (internal citations omitted).
20. *Id*.
21. *In re Dewey & LeBoeuf LLP*, 507 B.R. 522, 526 (S.D.N.Y. 2014).
22. *Id*.
23. *Id*. at 527.
24. *Id*. at 526.
25. *Id*.
26. *Id*. at 526-27.
27. *Id*. at 527.
28. *Id*. at 528. It should also be noted that Dewey & LeBoeuf attempted to argue that they fell under the "liquidating fiduciary principle" exception at a previous hearing, which the bankruptcy court decided—in a separate decision—was an issue of fact that could not be resolved on a motion to dismiss. *See Dewey & LeBoeuf LLP*, 487 B.R. 169 (S.D.N.Y. 2013).
29. *Id*. at 527 (quoting *Grimmer v. Lord Day & Lord*, 937 F. Supp. 255, 258 (S.D.N.Y. 1996) (adopting the Ninth Circuit's interpretation of the WARN Act's brief statement requirement)).
30. *Id*. at 528-29.
31. *In re Dewey & LeBoeuf LLP*, 507 B.R. at 533.
32. *Id*. at 528 (quoting 29 U.S.C. § 2102(b)(3) and citing 12 N.Y.C.R.R. § 921-6.6).
33. *Id*. at 528.
34. *Id*. at 533.
35. *Id*. at 529.
36. Ivers, Dan, "Dewey & LeBoeuf to Pay $4.5M to Settle Suit Over Layoffs," Law360, June 12, 2014, *available at*: http://www.law360.com/articles/547560/dewey-leboeuf-to-pay-4-5m-to-settle-suit-over-layoffs.

November 2016 Amendments to the Not-For-Profit Corporation Law

By Fred Attea

The Nonprofit Revitalization Act of 2013 (“NPRA”) created numerous operational difficulties for New York nonprofit corporations, especially as it relates to corporate governance. The definition of “Independent Director,” which was new to the Not-For-Profit Corporation Law (N-PCL), had an adverse effect, especially in smaller communities, because it effectively removed from the potential panel of independent directors many persons who were employed by large institutions that were doing routine business with the nonprofit.

The NPRA’s definition of “Related Party Transaction” created confusion and interpretive difficulties because the definition had no materiality standard. Literally, a director of a hospital whose grandchild is to be treated in the hospital is involved in a “related party transaction” and technically is required to obtain Board approval in advance of the treatment. All related party transactions required approval by the audit committee or other committee of independent directors. The net result was that New York not-for profits were literally subjected to requirements totally out of proportion with the wrongs to be righted.

The problems generated by the NPRA were of such concern to the nonprofit community that remedial legislation was advocated by many constituencies.

As a result of coordinated efforts by the Lawyers Alliance for New York, the New York State Bar Association, the New York City Bar Association, the New York State Law Revision Commission and the Non-Profit Coordinating Committee of New York, legislation was approved by the New York State Legislature on June 16, 2016 and signed into law by Governor Cuomo on November 28, 2016. The legislation amended a number of provisions of the N-PCL introduced by the NPRA. To a great extent, these provisions address some of the unanticipated and pragmatic problems created by the corporate governance provisions of the NPRA. The legislation also included comparable amendments to parallel provisions of the Estates, Powers and Trusts Law.

Key Person

These amendments also introduce a new definition, “key person,” (N-PCL Section 102(a)(25)), which replaces the definition of “key employee.” A “key person” is defined as any person who is neither a director nor officer but who has:

> . . . responsibilities, or exercises powers or influence over the corporation as a whole similar to the responsibilities, powers, or influence of directors and officers … [or who] … manages the corporation, or a segment of the corporation that represents a substantial portion of the activities, assets, income or expenses of the corporation; or … [who] . . . alone or with others controls or determines a substantial portion of the corporation’s capital expenditures or operating budget.

This concept is a response to concerns over persons who exercise a controlling influence, as was the case in the infamous Soundview Health Center litigation where former State Senator Pedro Espada Jr. was convicted in federal court in 2012 for theft of funds from a charitable organization that he founded. The difficulty in prior state and federal investigations was that Mr. Espada was not subject to the N-PCL restraints because he was not an employee, officer or director of the organization. This new definition, although broad in scope, was carefully crafted so that supporting philanthropists who are not using their position to affect the management of the nonprofit corporation will not be considered key persons.

Independent Directors

The NPRA’s previous definition of “independent director” in N-PCL Section 102(a)(21) excluded a person who (among other things) was:

> a current employee of, or …[had] … a substantial financial interest in, … [or who] … had a relative who … [was] … a current officer of or … [has] … a substantial financial interest in, any entity that … [in any of the last three years] … made payments to, or received payments from, … [the non-profit corporation in excess of] . . . the lesser of twenty-five thousand dollars or two percent of the entity’s consolidated gross revenues.

Many nonprofits found this definition too stringent, adversely affecting their ability to recruit the needed number of independent board members. To alleviate the

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situation, the 2016 amendments introduced a scale of materiality by changing the standard for independence to exclude a person who

> … is not a current employee of or does not have a substantial financial interest in, and does not have a relative who is a current officer of or has a substantial financial interest in, any entity that has made payments to, or received payments from, the corporation or an affiliate of the corporation for property or services in an amount which, in any of the last three fiscal years, exceeds the lesser of twenty-five thousand dollars or two percent of such entity's consolidated gross revenues.

This amendment sets a lower barrier initially (i.e., $10,000 vs. $25,000), but the number of levels in the new materiality scale should provide some needed flexibility in order to allow a director to be independent even though he or she is employed by a bank, insurance company, utility or similar entity. In such cases, the board member's judgment would not reasonably be expected to be tainted by the relationship because the financial impact to the employing entity is minimal. This may be especially helpful in smaller communities where finding skilled directors would be difficult if all employees of large local employers are excluded from being independent directors.

Furthermore, "payment" does not include, among other things:

> … payments made by the corporations at fixed or non-negotiable rates or amounts for services received . . . [and that] …are available to individual members of the public on the same terms and such services received by the corporation are not available from another source.

This latter situation might be applicable to payments to utilities that have exclusive territories but does not seem to offer much additional relief.

Related Party Transactions

Perhaps some of the most significant and needed changes in the N-PCL are those changes made to the "related party transaction" definition in N-PCL Section 102(a)(24), which now excludes a transaction where:

> … (i) the transaction or the related party's financial interest in the transaction is de minimis, (ii) the transaction would not customarily be reviewed by the board or boards of similar organizations in the ordinary course of business and is available to others on the same or similar terms, or (iii) the transaction constitutes a benefit provided to a related party solely as a member of a class of the beneficiaries that the corporation intends to benefit as part of the accomplishment of its mission which benefit is available to all similarly situated members of the same class on the same terms.

This exclusion is similar to the Charities Bureau's guidance on Conflicts of Interest issued on April 24, 2015, and cures a problem of extreme concern to the not-for-profit community.

Eliminating de minimis transactions and those transactions that are not normally addressed by the board in the ordinary course of business from the "related party transaction" definition will rationalize the process of dealing with related party transactions. The change also eliminates routine situations which literally fell into the related party definition in the NPRA. This directly impacts concerns of board members of institutions involved in health care and education where a director or his or her family members utilize the services of such corporations.

Another relaxation of the related party transaction requirements is the provision of a defense to challenges by a third party (other than the Attorney General) that a related party transaction should be nullified because it was not properly approved under Section 715(a) or (b) of the N-PCL. The defense is that the transaction was fair and reasonable and in the corporation's best interests when it was approved by the corporation.

Because of the concern that related party transactions, due to the breadth of the previous definition, can inadvertently occur without following the procedures set out in N-PCL Section 715(a) and (b), the legislature opted to include a method to effectively ratify later-discovered transactions and thus provide a defense to a claim by the Attorney General provided that:

> … (1) the transaction was fair, reasonable and in the corporation's best interest at the time the corporation approved the transaction and (2) prior to receipt of any request for information by the attorney general regarding the transaction, the board has: (A) ratified the transaction by finding in good faith that it was fair, reasonable and in the corporation's best interest at the time the corporation approved the transaction; and, with respect to any related party transaction involving a charitable corporation and in which a related party has a substantial financial interest, considered alternative

> transactions to the extent available, approving the transaction by not less than a majority vote of the directors or committee members present at the meeting; (B) documented in writing the nature of the violation and the basis for the board's or committee's ratification of the transaction; and (C) put into place procedures to ensure that the corporation complies with paragraphs (a) and (b) of this section as to related party transactions in the future.

Executive Committee

The amendments also change Section 712 of the N-PCL to allow a board of directors' appointment of members to a committee of the board to be made by the typical majority vote at a meeting at which there is a quorum, instead of by a majority of the entire board. The requirement of approval by a majority of the entire board is retained for the executive committee. There is, however, a recognition that corporations with large boards of directors (30 or more members) may have difficulty in obtaining the vote of the majority of an entire board and, in such situations, the corporation may appoint members to an executive committee by a vote of three-quarters of the members of the board at a meeting at which a quorum is present.

The Section 712 list of actions that cannot be delegated to an executive (or other) committee has been expanded to include:

> … (6) the election or removal of officers and directors.
>
> (7) The approval of a merger or plan of dissolution.
>
> (8) The adoption of a resolution recommending to the members action on the sale, lease, exchange or other disposition of all or substantially all the assets of a corporation or, if there are no members entitled to vote, the authorization of such transaction [and]
>
> (9) The approval of amendments to the certificate of incorporation.

This is not a change in existing law but an attempt to bring together in one section all of the N-PCL's provisions that prohibit delegation of powers to an executive committee.

Conflicts of Interest and Whistleblower Policies

The amendments specify that it is the board, not merely someone acting on behalf of the corporation, that must adopt procedures for addressing conflicts of interest and whistleblower complaints. The amendments also remove the requirement that only independent directors may oversee implementation of, and compliance with, both policies. Prior to the 2016 Amendment, N-PCL Section 715(b) required the whistleblower policy be administered by the audit committee or a committee consisting solely of independent directors or, if no such committees existed, by the board. The amendments now permit administration of these policies by the board or any board committee (although in the case of the whistleblower policy, employees may not participate).

Employee as Board Chair

The NPRA Amendments ameliorate a problem that was set to begin January 1, 2017, when a provision of the original NPRA would have barred any employee of the corporation from serving as board chair (or the equivalent position). Under the amendments, an employee may serve in such a position upon approval by two-thirds of the entire board with a documentation of the basis for the approval, though that person cannot be considered an independent director. This amendment provides a solution for a serious governance issue that would have been presented for hundreds, possibly thousands, of nonprofits, such as churches whose ecclesiastical governing laws require the pastor to chair the church trustee board.

Miscellaneous

A provision in N-PCL Section 712(e) that purported to make non-board members on committees subject to the N-PCL provisions applicable to officers generally was deleted. This will eliminate the implication that volunteers are subject to the liabilities of officers when serving on committees of the corporation. In addition, N-PCL Section 712(a) will allow the by-laws to provide that the holders of certain positions have automatic placement as ex officio nonvoting members of specific committees.

Future Considerations

While there has been concern that the amendments do not go far enough, there is little doubt that they will remove some of the most vexatious problems created by the NPRA. There is also a realization among practitioners that there are many other areas of the N-PCL that could use updating and changes to bring them into conformity with what is considered to be good corporate practice.

A failure to continue the process that led to the 2016 NPRA Amendments could accelerate the tendency of New York-based not-for-profits to incorporate in other states.

Exes and the Attorney-Client Privilege

By C. Evan Stewart

Taylor Swift has never been shy about dissing her ex-boyfriends. For example, one of her biggest mega-hits is entitled "We Are Never Ever Getting Back Together."[1] Obviously, the message is quite clear that, in her world, there is a clear demarcation between the status of being a boyfriend and an ex-boyfriend. This article will explore the notion of whether—for purposes of the attorney-client privilege—there is (or should be) a similar demarcation between corporate clients and their ex-employees.[2]

The Starting Point

In 1981, the U.S. Supreme Court strongly affirmed the privilege in the corporate setting in *Upjohn v. United States*.[3] The *Upjohn* Court stressed the importance of there being "full and frank communications between attorneys and their clients," and that such communications are necessary to enable a lawyer to give "sound and informed advice." The Court also concluded that the privilege "promote[s] broader public interests in the observation of law and the administration of justice." As a consequence of these policies and interests, the Court barred from disclosure to the Internal Revenue Service corporate counsel's fact-oriented communications with employees regarding an investigation into questionable payments made to foreign government officials; and given an attorney's need to render "sound and informed advice," the Court specifically rejected prior precedent limiting the privilege to only certain employees.[4]

As important and as helpful as the Supreme Court's decision has been, one area the Court left open was whether the privilege extends to communication with ex-employees. Seven of the 86 people interviewed in the *Upjohn* investigation were no longer employees at the time of their interviews. Although *Upjohn* asked that the privilege also cover those individuals, the Court declined to extend the privilege to them because the lower courts had not addressed the issue.[5] Chief Justice Burger, in his concurrence, thought that the act of declining was regrettable, arguing that a former employee should also be covered when he or she "speaks at the direction of management with an attorney regarding conduct or proposed conduct within the scope of employment."[6]

Extending *Upjohn*

In the aftermath of *Upjohn*, a number of courts have decided to extend its rationale to former employees, so long as the privileged communications related to their tenure at the company (i.e., consistent with the Burger concurrence).[7] And the *Restatement* has also opined that communications with a former agent (a/k/a ex-employee) are privileged, *but only so long as* "the former agent has a continuing legal obligation to the principal organization to forward the information to the organization's lawyer."[8]

At the same time, several other courts have expressly declined to expand *Upjohn* to cover ex-employees.[9] And now another court has recently joined the latter's ranks, to a fair amount of brouhaha.

Washington Goes Rogue?[10]

On October 20, 2016, the Supreme Court of Washington—in an *en banc* decision, by a five to four vote—ruled that the attorney-client privilege does not extend to ex-employees. In *Newman v. Highland School District No. 203*,[11] a high school quarterback suffered a permanent brain injury in a football game; he (and his parents) thereafter sued the school district for negligence. Lawyers for the school district interviewed several former coaches and appeared on their behalf at their depositions. Plaintiffs moved to disqualify the lawyers on the ground of a conflict of interest. The trial court denied the motion, but also ruled the defense counsel could not "represent non-employee witness[es] in the future." Plaintiffs then sought discovery of communications between defense counsel and the former coaches during time periods when the coaches were unrepresented by defense counsel. The trial court granted that motion, ordering the school district to identify "exactly when defense counsel represented each former employee" and barring those lawyers from asserting the privilege with respect to any communications not encompassed by the representation period. At the same time, the trial court (i) did *not* rule that the communications during the representation period (i.e., the depositions) were *not* protected by the privilege; and, (ii) did *not* take issue with the notion that any communications with counsel *during* the coaches' employment were fully protected by the privilege.[12] The school district appealed the trial court's ruling to the Washington Supreme Court.

The majority decision for the *en banc* Washington Supreme Court started off by correctly noting that the U.S. Supreme Court expressly declined to resolve the ex-employee issue in *Upjohn*. It then ruled that the school district's argument to extend *Upjohn's* rationale was flawed "because former employees categorically differ

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from current employees."[13] Once the employer-employee agency relationship ends, "the former employee can no longer bind the corporation and no longer owes duties of loyalty, obedience, and confidentiality to the corporation."[14] And, as such, "a former employee is no different from other third-party fact witnesses to a lawsuit, who may be freely interviewed by either party."[15]

The *Newman* majority, in rejecting the extension/expansion of *Upjohn*, noted that some courts have in fact gone in a different direction, based upon "the corporation's perceived need to know what its former employees know."[16] But it found this argument "unpersuasive" because that concern is universal—not only would a defendant perceive such a need: "[s]o might a plaintiff, so might a government."

> *"The reaction to the* Newman *decision by various talking heads in the media was as breathless as it was wrong."*

The *Newman* dissent strongly disagreed with the majority's analysis and outcome. The entirety of the dissent's position, however, was based upon a false construct: the dissent repeatedly (at least fourteen times) invoked *Upjohn's* "flexible"/"functional" approach to the corporate attorney-client privilege. But such an approach is simply *not* what the U.S. Supreme Court did; rather, the Court (i) expressly ruled that *all* current Upjohn employees were covered by the privilege and (ii) expressly declined to extend the privilege to *any* ex-employees. The notion that the U.S. Supreme Court provided a "functional framework for lower courts" to decide the issue for ex-employees in the aftermath of *Upjohn* has no jurisprudential grounding whatsoever, and the *Newman* dissent provided none.[17]

To its credit, the *Newman* dissent did "acknowledge that *Upjohn's* policies and purposes do not require us to consider former employees exactly as we consider current employees"—i.e., no agency relationship, no duties of confidentiality, loyalty, etc. But, in the dissent's view, those considerations (and the *Restatement (Third) of the Law Governing Lawyers*) are "incorrectly framed statements of the law, and [. . .] are inconsistent with the functional framework of *Upjohn*."

The Immediate Aftermath of *Newman* (a/k/a "Fake News")

The reaction to the *Newman* decision by various talking heads in the media was as breathless as it was wrong.[18] One oft-quoted commentator called the majority's decision incorrect, inconsistent with *Upjohn*, and . . . "troubling": "the decision is a bad idea for Washington and bad for other courts to follow."[19] Another oft-quoted commentator similarly opined that the majority's decision is inconsistent with *Upjohn* and "takes the distinct minority view."[20] The foregoing punditry may constitute the "conventional wisdom" (at least at first blush), but what is the "straight scoop"?

The "Straight Scoop"

The "straight scoop" consists of at least two things. The first is the state of the law *vis-à-vis* ex-employees; and it is fair to say that there currently exist four states, three of which are on the right side of the privilege. As an initial matter, the *Upjohn* Court's decision not to extend the privilege to ex-employees is still what the Supreme Court's take is on this subject; *nothing* has happened over the last 36 years to change that state of affairs. Thus, it is simply incorrect factually to say that the *Newman* majority's decision is "inconsistent" with *Upjohn*.[21]

Next up, the *Restatement's* view is also undoubtedly correct. For example, if an ex-employee has—as a matter of fact—binding legal obligations to keep company information gained during his or her employment confidential and to cooperate with respect to said information with company counsel (obligations, for example, set forth in a severance agreement), then those "continuing legal obligations" should, of course, be binding and legally enforceable.

The third and fourth states of play (the conflicting courts) are opposite images of each other, and only one can be correct. The problem with those courts that have extended *Upjohn* to cover ex-employees is that they do not understand *Upjohn* or the basic building blocks of the privilege itself.[22] First off, the rationale proposed to justify the extension—the "need to know"—is not rooted anywhere in the privilege, and (quite frankly) is absurd on its face. As the *Newman* majority correctly noted, every party to a litigation has a "need to know"; that "need" does not constitute a basis to protect from disclosure information or communications (of whatever nature). Equally important (and also, as pointed out by the *Newman* majority) is the fact that at least one of the 5 Cs is missing; [23]—in the case of ex-employees, the missing C is that there is *no client*. Thus, the *Newman* majority was on the money in observing that (in the absence of anything else) "a former employee is no different from other third-party fact witnesses to a lawsuit, who may be freely interviewed by either party."

But while this last point is clearly correct, it is not the end of the inquiry concerning ex-employees and whether there *can be* instances where such individuals *could be* covered by the privilege. To understand this notion, it is necessary to point out how an indecipherable (and wrong) decision by the Washington trial court in *Newman* highlights the everyday process of corporate counsel representing the company *and* the legal interests of employees (both current and former). It is also necessary to identify a handful of courts that (like the Washington trial court) do not understand or like that everyday process.

The *Newman* trial court did *not* find that the school district's lawyers had a conflict in representing the coaches at their depositions, or that they had committed an ethical violation in doing so; indeed, it is well-established that "[a]ssuming there is no conflict of interest, defense counsel… may represent former employees."[24] At the same time, the trial court opined that the multiple representations reflected "a very poor decision," and ruled that the lawyers could not represent the coaches going forward. This seemingly Solomonic decision was simply wrong—either the earlier representation was wrong, unethical, and should have been sanctioned, or the earlier representation was not improper, not unethical, and could continue.[25]

So why did the *Newman* trial court err in this regard, an error that then teed up the ex-employee/privilege issue for the Washington Supreme Court? I believe it is because it is one of a handful of judicial decisions that reflect a fundamental misunderstanding of (and thus antipathy to) corporate counsel *also* representing individual employees (current and ex) when there is no conflict of interest by and between these multiple clients. The practice of representing corporations and individual employees (assuming no conflict of interest) goes on all the time, is perfectly hunky dory, and is employed by experienced lawyers of all stripes (including me).[26] But some courts do not like it, and lawyers who (like me) frequently engage in this practice need to be on notice of these outlier judicial decisions.

One such case is *Aspgren v. Montgomery Ward & Co.*,[27] in which a federal judge in Illinois wrote that a lawyer may "create an appearance of impropriety" by offering to represent a former employee gratis, "because such an offer may encourage a former employee to seize on the opportunity of free representation without evaluating the advantages of independent counsel." Of course, if that were correct—and it is *not*—the exact same "appearance of impropriety" would also cover offering to represent *current* employees as well.

In a somewhat related vein is the infamous case of *Rivera v. Lutheran Medical Center*.[28] While faithful readers of this august *Journal* may remember that I have (more than once) tried to take a two-by-four to this truly wacky decision,[29] and while there is judicial authority directly contrary to *Rivera*,[30] a brief reminder of that case is in order.

In *Rivera*, a prominent law firm was retained by a hospital to defend a sexual/employment discrimination claim. Shortly thereafter, the firm contacted current and former employees who had direct, first-hand knowledge of the facts. Assuring those individuals that the firm saw no conflict of interest between them and the hospital, the lawyers offered to represent each of them at the hospital's expense, and all the individuals agreed. In the early stages of discovery, the plaintiff's lawyer discovered the multiple representation arrangement and moved to disqualify the law firm from representing the individuals, citing purported ethical violations.

The Kings County (New York) trial judge did not agree that the firm had violated any conflict of interest rules (there was in fact no evidence that the multiple representations constituted a potential or actual conflict of interest). Instead, the judge found that the lawyers had violated the "non-solicitation" rule (which today is Rule 7.3). That rule bars attorneys from soliciting clients directly (e.g., in person) unless the prospective client "is a close friend, relative, former client or current client."

By its explicit rationale (*see* Comment 1 to ABA Model Rule 7.3), this rule has *no* application to the *Rivera* situation; the rule is expressly designed to prohibit ghoulish ambulance chasing. Unfortunately, on appeal, the Appellate Division, Second Department affirmed the trial judge's ruling in a terse, succinct, and short-winded opinion.

Rivera is, of course, dead wrong.[31] At the same time, however, it is obviously a precedent that plaintiff's counsel might try to latch onto to make life difficult for some defense lawyers in the future. And not only does *Rivera* threaten wholly proper multiple representations, its wacky reasoning also underscores hostility to the privilege attending to such representations. As Michael Corleone once implored, "Just when I thought I was out . . . they pull me back in."[32]

Endnotes

1. This song went quintuple platinum, and is one of the best-selling singles in the world. It appears on Swift's fourth album *Red* (Big Machine 2012) (written by T. Swift, M. Martin & Shellback). And in her prior album, *Speak Now* (Big Machine 2010), she trashed another former lover, John Mayer, with the thinly veiled song about their breakup: "*Dear John*" (written by T. Swift). That song "really humiliated" Mayer and "made [him] feel terrible." *Rolling Stone* (June 6, 2012). Mayer, of course, is not the only recipient of a "*Dear John*" song. *See, e.g.*, "*Dear John Letter*" by Whitney Houston (*Just Whitney* (Arista Records 2002) written by K. Briggs, D. Reynolds, P. Stewart & W. Houston); "*A Dear John Letter*"—the original single was by Jean Shepard and Ferlin Husky (Capitol Records 1953) written by B. Barton, F. Owens & L. Talley—this song has been covered by many artists, including Pat Boone, who had a #44 hit with it in 1960 (Dot Records).
2. Because of widespread confusion concerning the privilege—among practitioners, legal academics, and judges (with a few notable exceptions, e.g., Judge Pierre Leval)—I have been writing and speaking about the privilege for over 30 years. *See, e.g.*, "*Defending the Attorney-Client Privilege*," Case & Comment (1986); "*Whither the Attorney-Client Privilege?*" New York Law Journal (Oct. 22, 1990); "*The Corporate Attorney-Client Privilege: Is Nothing Sacred?*" The Corp. Crim. & Const. L.R. (April 5, 1991); "*Corporate Counsel and Privileges: Going, Going…*," New York Law Journal (July 11, 1996); "*The Attorney-Client Privilege: The Best of Time, the Worst of Times*," The Professional Lawyer (1999); "*The Attorney-Client Privilege and Email: Strange Bedfellows*?" The Computer and

Internet Lawyer (March 2007); "*Will Waiving the Privilege Save It*?," New York Business Law Journal (Spring 2007); "*Pandora's Box and the Bank of America*," New York Law Journal (Nov. 4, 2009); "*Attorney-Client Privilege: Ohio Takes a Bite Out of the Big Apple*," New York Law Journal (Sept. 7, 2012); "*Attorney-Client Privilege: Misunderestimated or Misunderstood*?," New York Law Journal (Oct. 20, 2014); "*The D.C. Circuit: Wrong and Wronger*," New York Business Law Journal (Winter 2015).

3. *See generally Upjohn v. United States,* 449 U.S. 383 (1981).

4. The Supreme Court subsequently reinforced the teachings of *Upjohn* in *Swidler & Berlin v. United States*, 524 U.S. 399 (1998). In *Swidler & Berlin*, the Court rejected the argument that the attorney-client privilege could be vitiated after the client's death in certain criminal proceedings. Citing the broad purposes of the privilege, the Court observed that "[k]nowing that communications will remain confidential even after death encourages the client to communicate fully and frankly with counsel" and that "[w]ithout assurance of the privilege's posthumous application the client may very well not have made disclosures to his attorney at all."

5. *See Upjohn,* 449 U.S. at 394, *supra* note 3.

6. *See id.* at 403.

7. *See, e.g., Amarin Plastics, Inc. v. Maryland Cup Corp.*, 116 F.R.D. 36 (D. Mass. 1987); *Denver Post Corp. v. Univ. of Colo.*, 739 F.2d 874 (Colo. 1987); *Allen v. McGraw*, 106 F.3d 582 (4th Cir. 1997); *United States v. Chen*, 99 F.3d 1495) (9th Cir. 1996); *Shew v. Freedom of Info. Comm'n*, 714 A.2d 664 (Conn. 1998); *Peralta v. Cendant Corp.,* 190 F.R.D. 38 (D. Conn. 1999); *Surles v. Air France*, 2001 U.S. Dist. LEXIS 10048, at *17 (S.D.N.Y. July 19, 2001); *United States ex rel. Hunt v. Merck-Medco Managed Care, LLC*, 340 F. Supp. 2d 554 (E.D. Pa. 2004); *Winthrop Res. Corp. v. CommScope, Inc. of N. Carolina*, 2014 WL 5810457, at *3 (W.D.N.C. Nov. 7, 2014).

8. *Restatement (Third) of the Law Governing Lawyers*, Section 123, comment e (2000). *See Shew v. Freedom of Info. Comm'n*, 714 A.2d 664 (Conn. 1998) (follows the *Restatement* standard).

9. *See, e.g., Clark Equipment Co. v. Lift Parts Manufacturing Co.,* 1985 U.S. District LEXIS 15457, at * 14 (N.D. Ill. Sept. 30, 1985); *Connolly Data Sys., Inc. v. Victor Techs., Inc.,* 114 F.R.D. 89 (S.D. Cal. 1987); *Infosystems, Inc. v. Ceridian Corp.,* 197 F.R.D. 303 (E.D. Mich. 2000). *See also* and *compare Connolly* (attorney's work product is not waived when shown to ex-employee) with *Clark Equipment* (attorney's work product is waived when shown to ex-employee).

10. The State of Washington often charts its own, idiosyncratic path. Witness the Electoral College vote of 2016 –Hillary Rodham Clinton won the State's popular vote, but four electors were "faithless": three voted for Colin Powell, and one voted for Faith Spotted Eagle! Other "faithless" electors in 2016 were one in Hawaii for Bernie Sanders; two in Texas—one for Ron Paul and one for John Kasich.

11. *See generally Newman v. Highland Sch. Dist. No. 203*, 186 Wash. 2d 769, 381 P.3d 1188 (2016). The intermediate Washington State Court, the Court of Appeals, declined discretionary review of the trial court's ruling; the entire Supreme Court, however, decided to weigh in.

12. There was no dispute between the parties on either of these two points. *Id.* at n.1. *See In re Coordinated Pretrial Proceedings in Petrol. Prods. Litig.*, 658 F.2d 1355, 1361 n.7 (9th Cir. 1981); *Peralta v. Cendant Corp.,* 190 F.R.D. 38, 41 (D. Conn. 1999). Nor was there any challenge to the trial court's ethical rulings. As such, the only issue up on appeal was whether the pre-representation period was immune from discovery.

13. The Washington Supreme Court was evaluating this issue not only in the context of *Upjohn* but also upon its own prior precedent, which tracks *Upjohn. See Youngs v. PeaceHealth*, 179 Wash.2d 645, 316 P.2d 1035 (2014).

14. For this proposition, the *Newman* majority cited (correctly) the *Restatement*.

15. For this proposition, the *Newman* majority cited the decisions identified, *supra* note 9.

16. The *Newman* majority cited the decisions identified, *supra* note 7.

17. The above-cited language from the dissent purports to have precedential authority. Such authority, however, is merely Chief Justice Burger's concurrence. *See* note 1 in the dissenting opinion. To the extent the *Upjohn* Court talked about a "case-by-case" basis, the decision said only this: "Needless to say, we decide only the case before us, and do not undertake to draft a set of rules which should govern challenges to investigatory subpoenas." 449 U.S. at 396. That off-hand commentary hardly invited lower courts to expand *Upjohn's* ruling to include ex-employees.

18. *See* J.C. Rogers, *No Privilege for Lawyer's Talks With Ex-Employees*, ABA/BNA Lawyer's Manual on Professional Conduct 627 (November 2, 2016).

19. This commentator is a lawyer who works for the Association of Corporate Counsel, Amar Sarwal. Readers of this space will know that my views and that of Mr. Sarwal are not terribly in sync. *See* C.E. Stewart, *The D.C. Circuit: Wrong and Wronger*!, New York Business Law Journal 33-34 n.19 (Winter 2015).

20. This commentator is a lawyer who has published a treatise on the attorney client privilege and work product doctrine, Thomas Spahn. Readers of this space will know that my views and that of Mr. Spahn are not terribly in sync and I do not rely upon his treatise. *See id*. at 34, n. 45.

21. *See supra* notes 17-20 and accompanying text.

22. Those decisions are set forth *supra* note 7.

23. It is well-settled, unambiguous law that there must be: (1) a client; (2) a communication; (3) confidentiality; (4) counsel (an attorney); and (5) counsel (the giving of legal advice by an attorney). *See* C.E. Stewart, "*Attorney-Client Privilege: Misunderestimated or Misunderstood*," New York Law Journal (October 20, 2014). All of the Five C's must be present for the privilege to exist.

24. *See* M. McRae, K. Smith, and A. Raimundo, *Scope of Employment*, Los Angeles Lawyers 23 (April 2013). Accord M.J. Dell, *Ethical Considerations in the Representation of Multiple Clients*, Practicing Law Institute (May 7, 2015); ABA Formal Opinion No. 08-450 (April 9, 2008). *See also Holloway v. Arkansas*, 435 U.S. 475, 482 (1978).

25. As noted earlier (*see supra* note 12 and accompanying text), this ruling was not challenged by the parties and was not an issue up before the Washington Supreme Court.

26. *See supra* note 24. Of course, if there *is* a conflict of interest between the corporate client and an individual employee (current or ex), the corporate lawyer must stand down from a multiple representation. *See* C.E. Stewart, *Thus Spake Zarathustra (and Other Cautionary Tales for Lawyers)*, New York Business Law Journal (Winter 2010).

27. *See Aspgren v. Montgomery Ward & Co.,* 1984 U.S. Dist. LEXIS 21892, at *10-13 (N.D. Ill. Nov. 19, 1984).

28. *See Rivera v. Lutheran Medical Center,* 22 Misc. 3d 178, 866 N.Y.S. 2d 520 (Sup. Ct. Kings Co. 2008), *aff'd*, 73 A.D. 3d 891, 899 N.Y.S. 2d 859 (2d Dept. 2010).

29. *See* C.E. Stewart, *Squaring the Circle: Can Bad Legal Precedent Just Be Wished Away?*, New York Business Journal (Winter 2014); C.E. Stewart, *Just When Lawyers Thought It Was Safe to Go Back Into the Water*, New York Business Law Journal (Winter 2011).

30. *Wells Fargo Bank, N.A. v. LaSalle Bank Nat'l Ass'n*, 2010 WL 1558554 (W.D. Okla. April 19, 2010); *FHFA v. Nomura Holding America Inc., et al.*, 11 Civ. 6201 (S.D.N.Y. March 4, 2015).

31. Beyond the articles cited *supra* in note 29, *see also* C.E. Stewart, *The Rivera Precedent: What You Don't Know Can Hurt You*, Business Law Today (May 2015); C.E. Stewart, *How a Bad Ruling Can Spoil a Whole Bunch of Cases*, New York Law Journal (January 8, 2009).

32. Unfortunately, this quote is from *Godfather Part III* (Paramount 1990), which is a terrible movie. On the other hand, all of life's important lessons can be learned from *Godfather* (Paramount 1972) and *Godfather Part II* (Paramount 1974).

Electronic Deposit of Checks—Tips to Avoid Problems

By Jay L. Hack

The good old-fashioned paper check as a method of paying bills may be on life support, but according to the Federal Reserve, there were still 5.5 billion paper checks, worth over $8.1 trillion, in the United States in 2015. If you are a pre-millennial, you probably still write a few checks every month, and your business probably still pays most of its debts by paper check. With the ease of using a smartphone to deposit checks as electronic images, you may ask yourself, "What stops the recipient (known legally as the payee) from photographing my check twice and depositing it twice?"

Nothing stops the payee from depositing the check twice. But your bank shouldn't pay it twice, and if the bank does, it must return the money to you so long as you let it know what happened promptly. Under state and federal law, your bank should pay each check you write only once.

Suppose you use a check written on your account at Bank X to pay the person who cleaned your gutters. He deposits it into his accounts at both Bank Y and Bank Z, both times using an electronic deposit app on his smartphone. The "checks" will eventually make it to Bank X for payment (known as presentment). The check that is presented first will be paid, and the second presentment should bounce.

What if Bank X pays both? You need to review your account statement promptly. If you see that the check was paid a second time, then you need to notify Bank X. You are entitled to get the money recredited to your account quickly. If the double deduction causes other checks to bounce, your bank may be liable for all damages directly caused by the wrongful bouncing of the check.

Does the first check to be presented always win the race? Not necessarily. It depends on a number of things, principally whether there are two electronic deposits or one paper deposit and one electronic deposit, but you don't care so long as the check is only paid once.

To avoid problems with checks you write, we recommend that you follow these procedures:

1. Review your bank account statements every month to make sure that no checks were paid twice. If you find any problems, notify your bank immediately.
2. If you do not buy your printed checks directly from your bank, make sure that the checks are printed by a reputable company, and that they include all the information that your bank requires, especially including your account number and the check number on the bottom line. You want to make sure that your check can be processed automatically and your bank has the data that it needs to reject any duplicate presentment.

There is a special variation on this fact pattern that has been used as a scam to target attorneys, especially with their escrow accounts. You issue an escrow account check payable to John Smith and give it to him. The next day, he comes back and says that you spelled his name wrong—the check should be payable to John Smythe. He hands you the original check. You issue a second check and take back the first check. Are you safe? Perhaps not, if the first check was electronically deposited. If you, the attorney, are responsible for putting both checks in circulation, a strong argument can be made that you are responsible for both checks as against a holder in due course.

The ethics lesson to learn is that you should not be in such a hurry to issue the second check. At a minimum, put a stop payment order on the first check and wait to make sure it was not electronically deposited before issuing a new check. The problem is that a sophisticated thief can delay the electronic deposit by delaying the submission of the electronic file that contains an image of the first check. Although we believe that if you stop payment and then wait, the electronic depositor should lose, you want to make sure that you can prove that you did not issue the second check until days (we recommend at least five business days) after the stop payment order is given and you have actual possession of the first check.

What if you are on the other side and you deposit a check using your smartphone? Make sure that you keep the original in a secure place. We recommend against destroying it because, although unlikely, you may need the original. You should also check your bank account to confirm that your electronic deposit was credited to your account. If your bank did not do so, notify it immediately and be happy that you kept the paper check.

There is one major disadvantage when you deposit a check using your phone instead of in person at a bank. Smartphone deposits do not have the benefit of Federal Reserve Regulation CC, the regulation that requires banks to make deposited funds available on a specified time table. Why? Because under Regulation CC, the electronic deposit, not being a piece of paper, is not a "check" governed by the rule. Although some authors disagree with this conclusion, we have confirmed our analysis in direct communications with the Federal Reserve. Your bank can hold the electronic deposit for as long as it wants, within reason. The Fed has been working on proposed changes to these rules on electronic deposits for more than five years, but the law continues to play catch-up as technology marches forward.

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Recent Employment Laws Impacting Private Employers in New York

By Sharon Parella

1. Introduction

Recently, the New York City Council and the New York State Legislature enacted two laws that significantly impact private employers and their workplaces. First, the New York City Council's amendment to the New York City Human Rights Law prohibits discrimination against caregivers. Second, the New York State Legislature's new paid family leave law provides substantial benefits for eligible employees. In addition, the New York City Commission on Human Rights has released a comprehensive Legal Enforcement Guidance on issues relating to discrimination based on gender identity and gender expression. Furthermore, the Equal Employment Opportunity Commission has issued an extensive resource document on employer-provided leave as a reasonable accommodation under the federal Americans with Disabilities Act.

A summary of these laws and guidelines is set forth below.

2. New York City Council

a. Prohibition of Discrimination Against Caregivers

Effective May 4, 2016, an amendment to the New York City Human Rights Law[1] prohibits workplace discrimination against employees based on their actual or perceived "caregiver status."[2] Under this new law, a "caregiver" is defined as a person who provides direct and ongoing care for (i) a child under eighteen (18) years of age, or (ii) a "care recipient."[3] In this connection, a "care recipient" is defined as a person who has a disability, relies on the caregiver for medical care or to meet the needs of daily living, and is:

(i) the caregiver's child of any age (including a biological, adopted or foster child, a legal ward or a child of a caregiver standing in loco parentis);

(ii) the caregiver's spouse;

(iii) the caregiver's domestic partner;

(iv) the caregiver's parent (including a biological, foster, step- or adoptive parent, legal guardian or a person who stood in loco parentis when the caregiver was a minor child);

(v) the caregiver's sibling (including half-siblings, step-siblings and siblings related through adoption);

(vi) the caregiver's grandchild;

(vii) the caregiver's grandparent;

(viii) a child of the caregiver's spouse or domestic partner;

(ix) a parent of the caregiver's spouse or domestic partner;

(x) a person who resides in the caregiver's household; or

(xi) a person in a familial relationship with the caregiver as designated by the rules of the New York City Commission on Human Rights ("NYCCHR").[4]

In its effort to eradicate employers' negative assumptions about a caregiver's commitment or ability as an employee, among the protections for caregivers under the law, the NYCCHR has particularly emphasized the issues of flexible scheduling and accommodations. Specifically, while the new law does not require employers to provide either flexible scheduling or accommodations (which may be available to caregivers under the New York City Earned Sick Time Act and/or the federal Family and Medical Leave Act), the NYCCHR has stated that "[e]mployers cannot provide certain benefits, like flexible scheduling, to some employees and refuse to provide the same benefits to employees who request them because of their caregiving responsibilities."[5] With respect to flexible scheduling, the NYCCHR has provided the following example that would likely constitute a violation under the new law:

> An employee works as a medical assistant for a small medical practice. Two months ago, the employee's husband was diagnosed with cancer. For the next six weeks, the employee's husband will be attending twice weekly chemotherapy appointments in the morning before the employee goes to work. The employee asked her office manager if she could arrive up to an hour late on the days when her husband goes to chemotherapy so that she can drive him home before coming to work. The office manager said no, explaining that the practice can't function if everybody doesn't arrive on time. A

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couple of weeks later, the employee notices another medical assistant arriving late and being greeted by the office manager. When she asked the medical assistant why she was late, the medical assistant explained that the office manager is allowing her to come late a couple of times a week while she trains for an upcoming marathon.[6]

Likewise, the NYCCHR has stated that employers cannot deny accommodations "to employees with caregiving responsibilities if they provide these benefits to other employees."[7]

3. New York City Commission on Human Rights

a. Prohibition of Discrimination Based on Gender Identity and Gender Expression

Recently, the New York City Commission on Human Rights (NYCCHR) issued a comprehensive Legal Enforcement Guidance regarding discrimination on the basis of gender identity and gender expression (which constitute gender discrimination under the NYCHRL).[8] In this Guidance, the NYCCHR provides several examples of conduct by employers which may constitute violations of the NYSHRL including:

(i) failing to use an employee's preferred name or pronoun. Specifically, the NYCCHR requires employers "to use an individual's preferred name, pronoun and title (*e.g.*, Ms./Mrs.) regardless of the individual's sex assigned at birth, anatomy, gender, medical history, appearance, or the sex indicated on the individual's identification." The Guidance further provides that employees "have the right to use their preferred name[s] regardless of whether they have identification in that name or have obtained a court-ordered name change, except in very limited circumstances where certain federal, state, or local laws require otherwise (*e.g.*, for purposes of employment eligibility verification with the federal government). Asking someone their preferred gender pronoun and preferred name is not a violation of the NYCHRL."

(ii) refusing to allow an employee to utilize single-sex facilities (such as bathrooms and locker rooms) or participate in single-sex programs consistent with the employee's gender, regardless of his or her sex assigned at birth. Pursuant to the Guidance, "the law does not require entities to make existing bathrooms all-gender or construct additional restrooms … Some people, including, for example, customers … or employees, may object to sharing a facility or participating in a program with a transgender or gender non-conforming person. Such objections are not a lawful reason to deny access to that transgender or gender non-conforming individual."

(iii) engaging in sex stereotyping—namely, discrimination based on any employee's failure to conform to sex stereotypes. For example, an employer may not have a policy that prohibits men from wearing jewelry or make-up at work or "[overlook] a female employee for a promotion because her behavior does not conform to the employer's notion of how a female should behave at work."

(iv) imposing dress codes or uniforms, or apply grooming or appearance standards, that contain different requirements for individuals based on sex or gender.

(v) providing employee benefits that discriminate based on gender. As set forth in the Guidance, to "be non-discriminatory with respect to gender, health benefits plans must cover transgender care [including hormone replacement therapy, voice training and surgery], also known as transition-related care. In no case, however, will an employer that has selected a non-discriminatory plan be liable for the denial of coverage of a particular medical procedure by an insurance company, even when that denial may constitute discrimination on the basis of gender."

(vi) considering gender when evaluating requests for accommodations. According to the Guidance, when an employer "grants leave requests to address medical or health reasons, it shall treat leave requests to address medical or health-care needs related to an individual's gender identity in the same manner as requests for all other medical conditions." Such health-care needs relating to gender transition include "medical leave for medical and counseling appointments, surgery and recovery from gender affirming procedures, surgeries and treatments."

(vii) engaging in discriminatory harassment based on an employee's actual or perceived gender identity or expression, including actual or threatened violence, verbal harassment, defacing or damaging real property and cyber bullying.

(viii) engaging in retaliation against an employee who opposes discrimination or requests a reasonable accommodation for a disability based on gender identity or gender expression.[9]

As set forth in the Guidance, the NYCCHR may impose civil penalties of up to $125,000 for violations, and up to $250,000 for willful violations.

4. New York State Legislature

a. Paid Family Leave

Effective January 1, 2018, the newly enacted New York State Paid Family Leave Law will require employers to provide eligible employees with paid, job-protected leave each year (i) to care for a new child, (ii) to care for a family member with a serious medical condition, or

(iii) when a family member is called to active military service.[10] This paid leave, which amends the New York State disability law and will be funded through nominal payroll deductions, applies to all full-time and part-time employees who have been working for their employers for at least twenty-six (26) weeks. Such employees may use paid leave to:

(i) bond with a new child (including an adopted or foster child) within the first twelve (12) months after the child's birth (or adoption or placement);

(ii) provide physical or psychological care when the employee's child, spouse, domestic partner, parent (including step-parent or legal guardian), parent-in-law, sibling, grandchild or grandparent is suffering from a serious health condition; or

(iii) address certain exigent needs when the employee's spouse, domestic partner, child or parent is called to active military service.

Beginning on January 1, 2018, an eligible employee may take up to eight (8) weeks of paid leave, and will be paid at the rate of fifty percent (50 %) of the employee's average weekly wage (capped at fifty percent (50 %) of the statewide average weekly wage). On January 1, 2019, the paid leave period will increase to ten (10) weeks, and the pay rate will increase to fifty-five percent (55%); on January 1, 2020, the pay rate will increase to sixty percent (60 %) (both pay rate increases will be capped at the respective statewide average weekly wage). Finally, on January 1, 2021, an eligible employee may take up to twelve (12) weeks of paid leave at the rate of sixty-seven percent (67%) of the employee's average weekly wage (capped at sixty-seven percent (67%) of the statewide average weekly wage).

Under the new law, employees who elect to take family leave are entitled to guaranteed job protection and continued health care benefits during the leave period. Moreover, the law prohibits retaliation against any employee who exercises his or her rights to take paid family leave under the program.

5. Federal Law

a. Employer-Provided Leave and Reasonable Accommodation

On May 9, 2016, the Equal Employment Opportunity Commission (EEOC) released a new resource document on employer-provided leave as a reasonable accommodation under the Americans with Disabilities Act (ADA).[11] These new guidelines provide, among other things, as follows:

(1) A reasonable accommodation may include making modifications to existing leave policies (including to extend the amount of available leave time) and also providing leave for a disability even where an employer does not offer leave to other employees (unless such modifications or leave would cause undue hardship). Such leave may be required despite the fact that the employer does not offer leave, the employee is not eligible for leave under the employer's policy or the employee has already exhausted all available leave. The employer need not, however, provide paid leave beyond what the employer normally provides as part of its paid leave policy, if any.

(2) Employees with disabilities must be provided with access to leave on the same basis as all other similarly situated employees. For example, if an employer provides five (5) days of "paid time off" and does not set any conditions on its use, the employer cannot require that an employee who uses paid time off due to a disability must provide a note from his or her health care provider.

(3) An employer who had granted leave with a fixed return date may not ask the employee to provide periodic updates. The employer may, however, contact an employee on an extended leave to check on the employee's progress.

(4) An employee on leave for a disability may request reasonable accommodation in order to return to work. This request may be made by the employee, or in a health care provider's note releasing the employee to return to work with certain restrictions. As set forth in the guidelines, an "employer will violate the ADA if it required an employee with a disability to have no medical restrictions—that is be '100%' healed or recovered—if the employee can perform her job with or without reasonable accommodation unless the employer can show providing the needed accommodations would cause undue hardship."[12]

Endnotes

1. N.Y.C. Admin. Code §§ 8-102 *et seq.*
2. *Id.* at §§ 8-101 & 8-107(a).
3. *Id.* at § 8-102 (30) (a) & (j).
4. *Id.* at § 8-102 (30) (b) – (i).
5. *FAQ's for Caregiver Protections,* NYC Commission on Human Rights, at www.nyc.gov/html/cchr/downloads/pdf/materials/Caregiver_FactSheet-Employer.pdf.
6. *Protections for Workers with Caregiving Responsibilities,* NYC Commission on Human Rights, 26 Apr. 2016 at www.nyc.gov/html/cchr/downloads/pdf/materials/Caregiver_FAQ.pdf.
7. *Id.*
8. *Gender Identity/Gender Expression: Legal Enforcement Guidance,* NYC Commission on Human Rights, 21 Dec. 2015 at www.nyc.gov/html/cchr/html/law/gender-identity-legalguidance.shtml.
9. *Id.*
10. Assemb. 09006, 2016 Leg. Gen. Assemb. (N.Y. 2016).
11. *Employer-Provided Leave and the Americans with Disabilities Act,* Equal Opportunity Employment Commission, at www.eeoc.gov/eeoc/publications/index.cfm.
12. *Id.*

Inside the Courts

An Update from Skadden Securities Litigators

Class Actions—Class Certification

Southern District of Ohio Grants Institutional Investors' Motion for Class Certification and Appointment as Lead Plaintiffs in Securities Fraud Class Action

Willis v. Big Lots, Inc., No. 12-cv-604 (S.D. Ohio Mar. 17, 2017

Judge Michael H. Watson granted the plaintiffs' motion for class certification and appointed two institutional investors as lead plaintiffs in a securities fraud class action brought against a closeout retailer and its officers under Sections 10(b) and 20(a) of the Securities Exchange Act and Securities and Exchange Commission Rule 10b-5. The plaintiffs alleged that the company provided false and misleading information to investors regarding the retailer's performance and prospects during the class period, which artificially inflated the retailer's stock price. The defendants opposed class certification, arguing that the institutional investors did not have claims typical of all class members, they were not adequate representatives for the class, and individual damages and reliance issues would predominate over class-wide issues.

The court rejected the defendants' argument against typicality, reasoning that the plaintiffs' claims—which depended on the fraud-on-the-market reliance theory—were typical of the class, and the institutional investors—who used investment advisers—were not subject to any unique non-reliance defenses because investment advisers still rely on publicly available information, including a stock's market price. Because all class members had an interest in proving the retailer's stock was artificially inflated during the class period regardless of their specific purchase and sale dates, the court rejected the defendants' argument that the institutional investors were inadequate class representatives because they sold their interests prior to the end of the class period. The court swiftly dismissed the defendants' other adequacy arguments, pointing to the institutional investors' active commitment to the case.

Finally, the court concluded that individual inquiries regarding reliance and damages would not predominate. Because the plaintiffs advanced a methodology for calculating damages on a class-wide basis that was consistent with their theory of liability, the court found that individual damages issues would not predominate over class-wide issues. The court also determined that plaintiffs could invoke the rebuttable presumption of reliance set forth in *Basic v. Levinson*, 485 U.S. 224 (1988). The defendants attempted to rebut this presumption, arguing that the company's stock price was inefficient because it did not increase in a statistically significant manner at the time of the alleged misrepresentations. Citing the U.S. Supreme Court's statement in *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398 (2014), that price impact may be rebutted with "evidence that the misrepresentation (or its correction) did not affect the market price of the defendant's stock," the court adopted the "price maintenance theory," reasoning that a misrepresentation may also have a price impact by maintaining a stock's artificially inflated price. The court concluded that the defendants failed to rebut the basic presumption because they failed to show that there was no statistically significant price impact following the corrective disclosures. Accordingly, the court certified the class and appointed the institutional investors as class representatives.

ERISA

Sixth Circuit Affirms Dismissal of Plaintiffs' ERISA Claims Against ESOP Fiduciaries

Saumer v. Cliffs Nat. Res. Inc., No. 16-3449 (6th Cir. Apr. 7, 2017)

The Sixth Circuit affirmed the district court's dismissal of an Employee Retirement Income Security Act (ERISA) class action brought against the fiduciaries of a mining company's employee stock ownership plan (ESOP). The plaintiffs, participants in the ESOP, alleged that the fiduciaries breached their duty of prudence under ERISA by retaining the company's stock as an investment option because (1) the company's risk profile and business prospects dramatically changed due to the collapse of iron ore and coal prices during the class period, and (2) the defendants possessed inside information, which showed that the company's stock was overvalued. The district court granted the defendants' motion to dismiss.

Relying on the U.S. Supreme Court's opinion in *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459 (2014), the Sixth Circuit affirmed the dismissal. Because "*Dudenhoeffer* plainly holds that a fiduciary may rely on market price as an unbiased assessment of a security's value," the court disposed of the plaintiffs' argument that the company's risk profile would be determinative of the company's stock value. The court rejected the plaintiffs' argument that a "special circumstance" rendered reliance on the market price imprudent in this case because *Dudenhoeffer* also stated that "fiduciaries may prudently 'assume' that stock markets provide the best estimate of a security's value." Finally, the court rejected the plaintiffs' non-public information claims, concluding that the plaintiffs failed to allege an alternative action that a prudent fiduciary in the same circumstance "would not have viewed as more likely to harm the fund than to help it." Instead, the alternative actions that were alleged—disclosing the nonpublic information or ceasing investment in the company's stock—could have caused a further collapse in the company's stock price, the court concluded.

S.D.N.Y. Dismisses ERISA Excessive-Fee Claims With Prejudice

Walker v. Merrill Lynch & Co., Inc., No. 15-cv-1959 (PGG) (S.D.N.Y. Mar. 31, 2017)

Judge Paul G. Gardephe dismissed breach of fiduciary claims under Section 404 of ERISA against Merrill Lynch for the second time, this time with prejudice. The plaintiff was a participant in Clifford Chance LLP's 401(k) plan (the Plan) and alleged that Merrill Lynch, a service provider to the Plan, breached its fiduciary duties in structuring the Plan to offer predominantly high-fee, actively managed mutual fund investment options and collecting excessive service fees from the mutual funds, some of which were managed by Merrill. The court held that the complaint did not adequately allege that Merrill was an ERISA fiduciary with respect to the plan because there was no allegation that Merrill had discretionary authority over the Plan's assets. While Merrill had in the past acted as the Plan's investment adviser, Merrill had ceased serving in that role before the class period began. Merrill's current role was limited to providing individualized investment advice to participants rather than selecting funds for the Plan. Thus, it was the Plan trustees, not Merrill, that had fiduciary authority over the challenged decision to include allegedly high-cost, actively managed funds in the Plan. Further, Merrill's agreement with the Plan expressly provided that it was not the fiduciary responsible for the selection of the investment options available under the Plan. The court further rejected the argument that Merrill was a fiduciary because it had the power to set its own compensation, reasoning that it did not control the Plan's negotiation and approval of those terms—the Plan sponsor was free to take or leave Merrill's services.

Fiduciary Duties—Mergers and Acquisitions

Delaware Court of Chancery Dismisses Stockholders' Challenge in Transaction With Gold and Silver Producer

In re Paramount Gold and Silver Corp. Stockholders Litig., No. 10499-CB (Del. Ch. Apr. 13, 2017)

Former stockholders of Paramount Gold and Silver Corporation sued members of its board of directors, challenging a transaction that Paramount entered into with Coeur Mining. Paramount, which owned two mining projects, spun one off into a separate entity and distributed approximately ninety-five percent of the new entity's shares to Paramount's stockholders. Paramount also agreed to a merger that would then hold a second mining project. In connection with that merger agreement, Paramount entered into a royalty agreement that gave Coeur a 0.7 percent royalty interest in the second mining project in exchange for $5.25 million.

The plaintiffs' primary argument was that *Unocal* enhanced scrutiny should apply to the transactions because the royalty agreement, when combined with the termination fee provision in the merger agreement, constituted an unreasonable deal protection device. In granting the defendants' motion to dismiss, the court disagreed, finding that (1) the terms of the royalty agreement did not prevent any interested party from making a competing bid for Paramount; and (2) the termination fee in the merger agreement (3.42 percent of the estimated merger value) was itself concededly reasonable. The court also concluded that because the stockholder vote approving the transaction was fully informed, under *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015), the business judgment rule protected the Paramount board's decision to approve the merger agreement. The court further held that even if *Corwin* did not apply, the plaintiffs failed to state a non-exculpated claim for breach of fiduciary duty against the defendants.

Delaware Court of Chancery Holds That Plaintiff Adequately Pleaded Bad Faith, Breach of Duty of Loyalty in Merger Challenge Involving Large Cash Payments for Directors

In re Saba Software, Inc. Stockholder Litig., C.A. No. 10697-VCS (Del. Ch. Apr. 11, 2017)

In a challenge of the merger of Saba Software with Vector Capital Management, after the SEC alleged that former Saba executives had engaged in a fraudulent scheme to inflate Saba's earnings, Saba agreed to restate its financials but announced it would not complete the restatement before the SEC's deadline. The board subsequently pursued a sale process and approved Vector's offer. The SEC then issued an order to deregister Saba's stock, and by the time the stockholders voted to approve the merger, Saba's shares had been deregistered. When the board approved the merger, the directors granted themselves equity awards that would be cashed out upon consummation of the merger in the place of prior awards that had been canceled due to the deregistration.

The court denied the directors' motion to dismiss. First, the court rejected the defendants' argument that *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015) applied because the complaint adequately pleaded that the stockholder vote approving the merger was coerced and not fully informed. The court found that Saba's proxy disclosures contained two material omissions and that the vote was coerced because the stockholders faced the "Hobson's choice" of "keeping their recently deregistered, illiquid stock or accepting the Merger price" and thus had "no practical alternative but to vote in favor of the Merger." Because *Corwin* was inapplicable, the court determined that *Revlon* enhanced scrutiny would apply. This case appears to be the first in which the Court of Chancery refused to apply *Corwin* to dismiss at the pleading stage a post-merger deal case for money damages that would otherwise invoke *Revlon*. Having found that *Revlon* applied, the court held that the plaintiff adequately pleaded bad faith and a breach of the duty of loyalty by alleging that the directors rushed the sale process and stockholder vote and awarded themselves large cash payments.

Initial Public Offerings

E.D.N.Y. Dismisses Claims That Online Retail Company Violated Securities Laws in Connection With IPO

Saleh Altayyar, et al. v. Etsy Inc., et al., No. 15-cv-2785-AMD (E.D.N.Y. Mar. 16, 2017)

Judge Ann M. Donnelly dismissed with prejudice claims that an online peer-to-peer commerce company violated Section 10(b) of the Securities Exchange Act by making material misstatements and omissions in connection with the company's April 16, 2015, initial public offering (IPO). The company's share price allegedly dropped after the company's quarterly earnings disclosures and an analyst report suggesting that the company's growth was harmed by counterfeit goods being sold through the company's online platform as well as by increased competition. The plaintiffs alleged that, although the company's registration statement and previous periodic filings emphasized the company's commitment to providing a platform for artisans and small-batch manufacturers and preventing counterfeit manufacturers, certain confidential witnesses purportedly stated that the company failed to implement adequate controls for preventing mass-produced and counterfeit goods.

The defendants argued that the plaintiffs had failed to sufficiently plead fraud and scienter under the applicable heightened standards. The court agreed, finding that although the "allegations might show that [the company's] compliance practices were imperfect [. . .] and that its managers knew of ongoing infringement problems," the plaintiffs failed to "establish that the challenged values statements were objectively false or disbelieved when [the company] made them." Further, the court found that the company's statements about its values and counter-infringement policies were aspirational and accompanied by sufficient cautionary language about the limits of preventing infiltration by purveyors of counterfeit goods.

Misrepresentations

Ninth Circuit Holds That CEO's Conduct in Violation of Corporate Code of Ethics Is Not Actionable Securities Fraud

Retail Wholesale & Dep't Store Union Local 338 Ret. Fund v. Hewlett-Packard Co., No. 14-16433 (9th Cir. Jan. 19, 2017)

In an issue of first impression, the Ninth Circuit held that a CEO's violation of the corporate code of ethics he publicly touted did not give rise to an actionable claim for securities fraud.

After 2006, the CEO of Hewlett-Packard (HP) spearheaded a revision of HP's ethical standards. According to the complaint, "HP reinforced the importance of its corporate code of ethics, the Standards of Business Conduct (SBC)," and the CEO "took many opportunities to proclaim HP's integrity and its intention to enforce violations of the SBC." Notwithstanding these reinforcements and proclamations, the CEO allegedly was forced to resign in 2010 after an investigation revealed that he had covered up a "very close personal relationship" with an adult film actress, including doctoring expense reports to hide their relationship. The actress allegedly also claimed that the CEO had disclosed confidential information to her about an impending merger. Following the CEO's resignation, HP's stock price dropped, resulting in an alleged loss of $10 billion to shareholders.

The putative class action raised two theories: (1) the defendants' public statements about business ethics and the SBC were material misrepresentations, given the CEO's conduct, and (2) the defendants' failures to disclose the CEO's conduct constituted a material omission.

In affirming the dismissal of the action, the panel first determined that the defendants' affirmative statements during the class period were not false or misleading because they were not "objectively verifiable statements." Rather, the statements were "inherently aspirational." The court reasoned that a "contrary interpretation [. . .] is simply untenable, as it could turn all corporate wrongdoing into securities fraud." Second, the court concluded that, even if the statements were misleading, they were not material because "[i]t simply cannot be that a reasonable investor's decision would conceivably have been affected by HP's compliance with SEC regulations requiring publication of ethics standards."

Finally, with regard to the plaintiffs' omission theory, the court held that there could not have been a material omission because there was no duty to disclose the CEO's conduct. As the panel explained, the "promotion of ethical conduct at HP did not reasonably suggest that there would be no violations of the SBC by the CEO or anyone else." Absent an impression that everyone at HP was in full compliance with the ethical standards, the defendants were under no duty to disclose the CEO's conduct, even if it violated HP's ethical code.

District of Colorado Grants Dismissal of Claims Against Food Distributor

Okla. Police Pension & Ret. Sys. v. Boulder Brands Inc., No. 15-cv-00679-MSK-KMT (D. Colo. Mar. 28, 2017)

Judge Marcia S. Krieger dismissed claims that a food manufacturer and distributor violated Section 10(b) of the

Securities Exchange Act by allegedly making false and misleading statements regarding the company's promotional efforts to increase sales of its high-margin products, such as margarines, oils and spreads, as opposed to its low-margin products, such as gluten-free and other "natural" products. The plaintiffs also alleged that the company failed to disclose various operational difficulties it was experiencing in fulfilling orders and meeting customer demands. The company allegedly led investors to believe that it was committed to maintaining strong profits from its high-margin product business when it was actually decreasing promotional spending on that product line.

The court found that these allegations did not demonstrate a misrepresentation because the company had previously told investors that it was decreasing promotional spending on those products. Further, the company's statement that it was decreasing support was indefinite as to the extent and timing of the change and did not demonstrate an actual change had taken place at the time the statement was made. The court also found that that the plaintiffs failed to adequately plead that the company had misled investors about its operational abilities. The court reasoned that the complaint did not show that the company's statements about improving its margin were rendered misleading by failing to disclose warehouse problems because the company could have conceivably improved margins even without fixing the warehouse problems. The company's statements about its improved customer service capabilities also were not inconsistent with its operational difficulties and were in any event an "accurate reporting of historical successes." Lastly, the company's statements regarding its profit projections were not actionable because the plaintiffs failed to allege that those projections were false at the time they were made or that the company's expectations were unrealistic.

S.D.N.Y. Upholds Some Securities Fraud Claims Arising From Alleged Bribery Abroad

In re Eletrobras Sec. Litig., No. 15-cv-5754 (S.D.N.Y. Mar. 25, 2017)

Judge John G. Koeltl upheld some securities fraud claims brought by purchasers of U.S. exchange-traded securities of Centrais Eletricas Brasileiras S.A. arising from the company's alleged involvement in bribery and other corruption, but dismissed others against an individual defendant. As an initial matter, the court held that the class could include both holders of American depositary shares (ADS) and bonds because "[w]hile the accompanying levels of risk between ADSs and bonds do differ," the difference was not sufficient to defeat certification. As to claims under Section 10 of the Securities Exchange Act, the court held that the plaintiffs had adequately alleged that the company had made misstatements about its code of ethics. The company allegedly cited its code of ethics to demonstrate "the strength of its internal controls and its commitment to transparency and ethical conduct," but the court found those statements to be misleading because the comments stood in "stark contrast" to explanatory notes in subsequent annual reports, which purportedly demonstrated "bribery and bid-rigging" and "a lack of effective internal controls over its corruption prevention program."

The court also held that the plaintiffs had plausibly alleged that the company's annual reports contained misstatements regarding the company's financial condition. Although these misstatements may have been small numerically and immaterial by quantitative standards, the court held that they were qualitatively material because some of the company's officers had suffered criminal consequences in connection with the allegedly illegal activity, the company overhauled its governance system thereafter—entirely replacing its board of directors and management—and management attempted to downplay the purported misconduct in the wake of media reports regarding the illegal activity.

However, the court granted one individual defendant's motion to dismiss because the plaintiffs had not adequately pleaded scienter. This officer had publicly stated that he signed the code of ethics and was involved only with one of the company's smaller subsidiaries, in contrast to other defendants who signed the company's annual reports, were aware of the internal audit purportedly revealing significant lack of controls within the company and held positions more proximate to the alleged corruption. The court also dismissed claims based on scheme liability against three of the officers but maintained the claim against the company. Scheme liability requires that a defendant commit a deceptive act in furtherance of an "alleged scheme to defraud" that is distinct from any alleged misstatements. The court dismissed this claim against three of the officers because the plaintiffs had not pleaded that they participated in an "inherently deceptive" act separate to the misrepresentations at issue. However, the court held that the plaintiffs had adequately pleaded that a fourth officer had participated in bribery, and the court also imputed this action to the company. Although the company argued that it had not benefited from the actions of the officer—and thus intent should not be imputed pursuant to the "adverse interest exception"—the court found that the company had "likely benefitted at least in part from the alleged deceptive scheme by receiving political advantages derived from such illicit payments."

In a related case involving bribery allegations, *In re Braskem S.A. Securities Litigation*, No. 15-cv-05132 (S.D.N.Y. Mar. 30, 2017), the court granted a motion to dismiss, in part, finding that alleged misstatements regarding the company's culture and ethics were not actionable because the statements were made in routine filings and not to "fend off inquiries about wrongdoing." However, the court denied the motion to dismiss with respect to representations regarding the pricing of certain petroleum products in light of an alleged bribery scheme permitting the company to obtain the products at below-market prices.

PSLRA

First Circuit Affirms Dismissal of Putative Securities Class Action Against Biogen Inc.

In re Biogen Inc. Sec. Litig., No. 16-1976 (1st Cir. May 12, 2017)

The First Circuit affirmed the dismissal of claims under Section 10(b) of the Securities Exchange Act alleging, according to confidential witnesses, that Biogen and certain of its current and former officers intentionally misled the public regarding the impact on drug sales resulting from the company's earlier announcement that a patient treated with the drug had died from complications associated with the rare neurological disease progressive multifocal leukoencephalopathy (PML). The First Circuit held that the complaint failed to meet the rigorous pleading standards for allegations of scienter under the Private Securities Litigation Reform Act. The court observed that the statements attributed to confidential witnesses "are so lacking in connecting detail that they cannot give rise to a strong inference of scienter" and that "[t]he statements do not even begin to quantify the magnitude of the sales decline at the company level," nor do they "explain with any precision whether the sales decline resulted from higher discontinuations, fewer new starts, changes in the market, or some combination of these factors." The First Circuit concluded that "the confidential witness statements are consistent with the defendants' public disclosures," which "repeatedly returned to the PML incident as one factor impacting [the drug's] performance."

Registration Statement Liability

Safe Harbor Provision of Regulation D's Rule 508(a) Available to Defendant in SEC Enforcement Action

SEC v. Levin, No. 15-14375 (11th Cir. Feb. 23, 2017)

The Eleventh Circuit reversed in part the district court's grant of summary judgment to the SEC, holding that the safe harbor provision of Regulation D's Rule 508 is available to defendants in SEC enforcement actions. The defendant allegedly became involved in a Ponzi scheme, wherein investors were solicited to purchase fake settlement agreements supposedly reached in sexual harassment and whistleblower suits. The defendant allegedly issued promissory notes stemming from this Ponzi scheme to ninety investors. The promissory notes were not registered with the SEC.

The SEC brought an enforcement action, alleging, among other things, that the defendant sold unregistered securities in violation of Sections 5(a) and (c) of the Securities Act. The defendant argued that the promissory notes were exempt from registration because they were protected by the safe harbor provision of Rule 508(a) of Regulation D. The SEC countered that the provision was available only in private actions.

The district court granted summary judgment for the SEC, and the Eleventh Circuit reversed. Relying on "the plain language of the regulation and regulatory history," and employing various canons of statutory construction, the court held that Rule 508(a) "preserves the safe harbor in SEC enforcement actions." Moreover, because there were disputes of fact as to whether the defendant was entitled to the protections of the safe harbor provision under the circumstances, the court remanded the case for further proceedings.

S.D.N.Y. Dismisses Claims Against Chinese-Based Steel Processing Company

Pehlivanian, et al., v. China Gerui Advanced Materials Grp., et al., No. 14 Civ. 9443 (S.D.N.Y. Mar. 29, 2017)

Judge Edgardo Ramos dismissed claims that a Chinese-based steel company violated Section 10(b) of the Securities Exchange Act and Sections 11 and 12 of the Securities Act by allegedly misrepresenting the terms of a land acquisition transaction and the acquisition of a collection of antique porcelain. The plaintiff alleged that statements regarding the company's land acquisition were "a complete fraud" because the land use rights were never transferred to the company; that the statements regarding the porcelain transaction contained material omissions, such as the provenance of the collection and what steps were being taken to liquidate it; and that the company had failed to file financial statements with the SEC since January 2015, even though the company had made filings with a Chinese regulator, purportedly demonstrating that the company had prioritized its requirements under Chinese law over U.S. requirements. In turn, the defendants argued that the complaint was merely an attempt "to improperly disguise corporate mismanagement allegations as securities fraud allegations."

The district court ruled that the complaint failed to "identify specifically which of Defendants' statements are false or misleading" because the company's annual reports made clear that the transaction was still in progress. Regarding the porcelain transaction, the court determined that the defendants had no duty to disclose the allegedly omitted details. Finally, regarding the claim that the company's Securities and Exchange Commission (SEC) filings were false and misleading, the court found that even if the company did prioritize its regulatory filings in China after January 2015, the company's statements in previous SEC filings could not be false or misleading based solely on that fact because "[t]he truth of a statement made in the registration statement is adjudged by the facts as they existed when the registration statement became effective." The court dismissed the Securities Exchange Act claims because there were no adequately pleaded materially false or misleading statements, and it dismissed the Securities Act claims because the plaintiff failed to adequately plead that the registration statements at issue (from 2009 through 2013) were false and misleading.

Reliance

E.D.N.Y. Dismisses Claim Against Attorney in Connection With Allegedly Misleading Opinion Letters

Orlan et al. v. Spongetech Delivery Sys., Inc., et al., No. 10-CV-4093 (E.D.N.Y. Mar. 24, 2017)

Judge Dora L. Irizarry dismissed claims by investors of a sponge company alleging that an attorney violated Section 10(b) of the Securities Exchange Act by writing more than 90 opinion letters containing materially false and misleading statements and omissions regarding the removal of restrictive legends from shares of the company. The plaintiffs alleged that once the restrictive legends were removed, the shares flooded the market, diluting the value of their share prices. The plaintiffs further alleged that the attorney misleadingly advised the stock transfer agent that the restrictive legends could be removed by either improperly representing (1) that certain entities affiliated with the company had held the securities for six months or longer when they had not, or (2) that certain affiliated entities were nonaffiliated entities. The district court dismissed the claims because the plaintiffs did not sufficiently allege that they considered or relied on his opinion letters when deciding whether to invest in the company (or were even aware of the opinion letters at the time of purchase). Although the defendant had allegedly admitted some of the alleged conduct before the SEC, the court found that "the admissions were not pled with particularity as Plaintiffs failed to attach the actual SEC record of testimony or specific citations thereto." Because the plaintiffs had failed to plead reliance, the court determined that the plaintiffs had failed to plead materiality and loss causation.

Sanctions

S.D.N.Y Denies Motion for Sanctions in "Abusive Litigation" Case

Zagami v. Cellceutix Corp., No. 15 Civ. 7194 (S.D.N.Y. Mar. 29, 2017)

Judge Katherine Polk Failla denied a motion pursuant to Fed. R. Civ. P. 11 for sanctions against the plaintiff in a lawsuit that defendants argued amounted to "abusive litigation." The court had previously dismissed the plaintiff's case in its entirety. Pursuant to the Private Securities Litigation Reform Act, sanctions are mandatory if Rule 11 is violated and a violation occurs whenever the non-frivolous claims that are joined with frivolous ones are insufficiently meritorious to save the complaint as a whole from being abusive. In this case, the court found that the "[p]laintiff raised several claims with legitimate, if ultimately unavailing, legal arguments." The court credited certain allegations regarding the misrepresentation of a key individual's educational background and certain public statements made by that person. The court also credited allegations that the defendant had misstated the effectiveness of one of its drugs, and it stated that the claim had "failed largely for pleading insufficiencies." Further, the court found that the plaintiff's claims regarding certain scientific terminology "were permissible attempts to seek clarity in the law" and stated that the plaintiff's argument regarding the need for additional disclosures was not "objectively unreasonable." Likewise, the court held that it was not unreasonable for the plaintiff to rely, in part, on a lengthy and detailed internet post, even though the source was anonymous. In addition, the court noted that consideration of the iterations of the three complaints filed in the action demonstrated that the plaintiffs had attempted to plead a cognizable claim.

SEC Enforcement Actions

'Relief Defendants' May Not Defeat Jurisdiction by Merely Asserting a Claim of Entitlement to the Disputed Funds

SEC v. Messina, No. 15-55325 (9th Cir. Mar. 21, 2017)

In an issue of first impression, the Ninth Circuit held that "relief defendants" cannot defeat jurisdiction in federal court simply by asserting an ownership interest in disputed money.

The SEC is authorized to bring civil enforcement actions seeking equitable relief against those violating the Securities Exchange Act. In these actions, federal courts may order disgorgement from non-violating third parties who have received proceeds of others' violations to which the third parties have no legitimate claim. These non-violating third parties are "relief defendants." For a court to exercise jurisdiction over relief defendants (and ultimately obtain disgorgement), the SEC must show that the relief defendants (1) received ill-gotten funds and (2) do not have a legitimate claim to those funds.

Vincent J. Messina, a lawyer, had a client who was allegedly engaged in a worldwide pyramid scheme that defrauded investors out of $57 million through unregistered securities offerings. The SEC claimed that Messina received $5 million from his client's unlawfully obtained funds and sought to disgorge that money from him. Messina maintained that the $5 million was merely a loan from his client, not the proceeds of illegal activity. Messina argued that the district court did not have jurisdiction over him to order disgorgement because he asserted a "facially colorable" claim to the disputed funds as a loan.

After a two-day evidentiary hearing, the district court granted the SEC's motion for disgorgement, holding that it had jurisdiction over Messina because Messina did not have a legitimate claim to those funds. The Ninth Circuit affirmed, holding that relief defendants may not divest a district court of jurisdiction to proceed against them simply by asserting a "facially colorable" claim of entitlement to the disputed funds. Rather, the relief defendant must demonstrate "an interest both 'recognized in law' and 'valid in fact.'" Here, Messina failed to make that showing, given the district court's factually supported finding that the $5 million "loan" was a sham.

Securities Fraud Pleading Standards

S.D.N.Y. Dismisses Putative Class Claims Against Fast-Food Retailer

Ong v. Chipotle Mexican Grill, Inc., No. 16 Civ. 141 (KPF) (S.D.N.Y. Mar. 8, 2017)

Judge Katherine Polk Failla dismissed claims that a fast-food retailer specializing in Mexican food violated Section 10(b) of the Securities Exchange Act by allegedly failing to disclose certain conduct related to the company's food handling processes that led to several E. coli outbreaks at restaurants across the United States and a related investigation by the Centers for Disease Control and Prevention (CDC). The plaintiffs specifically alleged that the company failed to disclose (1) its transition from using central commissary kitchens to prepare and process food to in-store processing and the increased risk of food-borne illness outbreaks resulting from that change; (2) the existence (and extent of) certain E. coli outbreaks that occurred at the company's restaurants and the status of the CDC's subsequent investigations into the outbreaks; and (3) the associated changes in the company's risk factors and the impact of the outbreaks on the company's financial performance and future.

Judge Failla concluded that the plaintiffs did not adequately plead that the company failed to disclose a heightened risk from the company's transition to in-store preparation because the company had transitioned to in-store production well before the first E. coli outbreak, suggesting that the transition did not actually heighten the company's risk. The court also reasoned that the company's generalized statement regarding its food-safety programs were inactionable puffery.

As to the company's statements that health officials had concluded that there was "no ongoing risk" related to the E. coli outbreak, the court concluded that the statements may have been "half-truths" at the time they were made in light of the ongoing CDC investigation. Likewise, the court found that the company's representation that there had been no material changes in its risk factors also may have been misleading in light of four E. coli outbreaks identified at the time. The court also determined that the company had not disclosed the potential impact on financial performance as a result of the outbreaks. However, the court expressed skepticism that any of the statements above was material and would have "altered the total mix of information available" to investors in light of the highly publicized nature of the outbreaks. Further, the court held that the plaintiffs had failed to adequately plead a strong inference of scienter. The court noted that stock sales by the company's executives did not indicate motive because the transactions were several months before the outbreaks occurred, and the more compelling explanation was that the executives sold their stock because they were receiving decreased salaries from the company. Further, the company's statement that there was "no ongoing risk" related to the E. coli was forward-looking and not inconsistent with the CDC's backward-looking statement that it was still investigating the causes of the outbreak and the infected persons. In addition, the court determined that the company did not need to make specific disclosures regarding the impact of the outbreaks on future financial performance in light of its other disclosures regarding the outbreaks.

Scienter

Sixth Circuit Affirms Dismissal of Securities Fraud Class Action Brought Against Officers, Directors, and Principal Shareholders of Kitchenware Company and Its Underwriters

IBEW Local No. 58 Annuity Fund v. EveryWare Global, Inc., No. 16-3445 (6th Cir. Feb. 21, 2017)

The Sixth Circuit affirmed the dismissal of claims brought under Sections 10(b) and 20(a) of the Securities Exchange Act, SEC Rule 10b-5, and Sections 11, 12(a)(2) and 15 of the Securities Act against officers, directors and principal shareholders of a now-bankrupt kitchenware company and its underwriters. The plaintiffs claimed that the defendants made material misrepresentations and omissions in the company's 2013 earnings projections, investor presentations, registration statement and prospectus as part of a so-called "pump and dump" scheme.

The Sixth Circuit affirmed the dismissal, concluding that the plaintiffs' Securities Exchange Act claims failed to meet the heightened pleading standard for scienter and that their Securities Act claims failed to plausibly allege any material misrepresentations by the defendants. The Sixth Circuit adopted the district court's reasoning that the plaintiffs failed to plead particularized facts giving rise to a strong inference of scienter because they failed to plead that (1) the CEO had actual knowledge that the 2013 earnings projections were false or misleading, or (2) the defendants acted with "a mental state embracing intent to deceive, manipulate, or defraud." The Sixth Circuit also adopted the district court's reasoning that the plaintiffs failed to plausibly plead facts showing that the company's registration statement and prospectus contained material misrepresentations.

Northern District of Illinois Denies Motion to Dismiss Misrepresentation Claims Against Biopharmaceutical Company and CEO

Rubinstein v. Gonzalez, No. 14-cv-9465 (N.D. Ill. Mar. 10, 2017)

Judge Robert M. Dow, Jr. denied a motion to dismiss a class action brought against a biopharmaceutical company and its CEO for alleged violations of Sections 10(b) and 20(a) of the Securities Exchange Act and SEC Rule 10b-5. The class action plaintiffs alleged that the defendants acted at least recklessly in misrepresenting that the primary rationale for a failed merger involving a corporate tax inversion was strategic, rather than to obtain favorable tax treatment. The plaintiffs identified three statements as misleading or containing omissions of material fact: (1) comments by the CEO on an investor call that tax benefits were not the primary rationale for the transaction; (2) statements in an SEC filing that listed tax benefits as one of 10 strategic benefits of the merger; and (3) statements by the CEO in a letter to employees of the target company, after U.S. tax authorities had taken actions to prevent corporate inversions, that the biopharmaceutical company planned to pursue the merger. Because the merger was abandoned after U.S. tax authorities acted to limit inversions, the plaintiffs alleged that these statements understated the importance of the merger's tax benefits.

The district court determined that the plaintiffs failed to plead that the comments on the investor call and statements in the SEC filing were misrepresentations because the tax benefits did not have to be the primary rationale for the transaction for the company to terminate the transaction after those benefits were eliminated. The district court also reaffirmed its prior ruling that the plaintiffs adequately pleaded that the letter to the target employees was a misrepresentation. The district court next concluded that the plaintiffs adequately pleaded that the defendants acted with scienter based on allegations the defendants acted recklessly in issuing the letter before performing a detailed consideration of the change in U.S. tax rules and its effect on the transaction. In support of this conclusion, the court cited a later statement from a board member that the letter was issued to calm employee unrest at the target.

Whistleblower Protections

Ninth Circuit Joins Second Circuit in Expanding Dodd-Frank Whistleblower Protections

Somers v. Dig. Realty Trust Inc., No. 15-17352 (9th Cir. Mar. 8, 2017)

A divided Ninth Circuit panel joined the Second Circuit in expanding Dodd-Frank whistleblower protections to apply not only to those who disclose potential violations to the SEC but also to employees who report internally. The Ninth Circuit's decision deepens a circuit split, after the Fifth Circuit in 2013 held that the Dodd-Frank anti-retaliation provisions protect only whistleblowers who report to the SEC.

The plaintiff allegedly made several complaints to senior management at his employer, the defendant, regarding possible securities law violations. The plaintiff did not report any of his concerns to the SEC. He was subsequently fired.

The plaintiff brought suit against his former employer, alleging violation of Section 21F of the Exchange Act, the anti-retaliation provision of the Dodd-Frank Act. The defendant moved to dismiss on the grounds that, under Dodd-Frank, a "whistleblower" is defined only as someone who reports to the SEC. The district court denied the defendant's motion to dismiss, and the Ninth Circuit affirmed.

"The court reasoned that the definition of 'whistleblower' found in Dodd-Frank—which includes only those employees who report potential wrongdoing 'to the Commission'—is not dispositive."

The court reasoned that the definition of "whistleblower" found in Dodd-Frank—which includes only those employees who report potential wrongdoing "to the Commission"—is not dispositive. Rather, as the U.S. Supreme Court stated in *King v. Burwell*, 135 S. Ct. 2480 (2015), "[t]he use of a term in one part of a statute 'may mean a different thing' in a different part, depending on context." That is so even where the statute contains a "definitional provision" specifically defining the term. On this point, the court also relied on a 2011 regulation issued by the SEC interpreting Section 21F, which defines the term "whistleblower" to include those who report potential wrongdoing internally. That regulation and interpretation, the court stated, was "entitled to deference."

Finally, the court explained that provisions of "Sarbanes-Oxley and the Exchange Act mandate internal reporting before external reporting," and "[l]eaving employees without protection for that required preliminary step would result in early retaliation before information could reach the regulators." Such a result would cut against legislative intent to safeguard investors in public companies and the whistleblowers themselves.

The plaintiff's petition for a writ of certiorari was granted by the Supreme Court on June 26, 2017.

Department of Labor Fiduciary Rules

By Elena Dain

Introduction

On February 3, 2017, President Donald Trump ordered the Department of Labor (DOL) to review its Fiduciary Duty Rule, which was scheduled to be phased in between April 10, 2017 and January 1, 2018,[1] to determine "whether it may adversely affect the ability of Americans to gain access to retirement information and financial advice."[2] Through his Presidential Memorandum, President Trump also directed the Department to prepare an updated economic and legal analysis regarding the impact of the rule, while taking into account several enumerated considerations.[3] If the Department finds that the fiduciary duty rule runs contrary to any of the considerations in the Memorandum, the Department must "publish for notice and comment a proposed rule rescinding or revising the Rule, as appropriate and consistent with law."[4] After a 15-day public comment period, during which the Department received about 193,000 comment letters, with nearly 178,000 opposing a delay, the Department sent its rule regarding the delay to the Office of Management and Budget (OMB) for review.[5] After the review by the OMB, the Department publicly released an official 60-day delay to the Fiduciary Rule's applicability date from April 10, 2017, to June 9, 2017.[6]

This article discusses the Department of Labor's Fiduciary Duty Rule, reviewing the background of the Rule and analyzing current arguments for and against it. The article then argues that although the Rule has potential in preventing financial advisers from benefiting at the expense of their customers' returns, the Rule presents risks to low-and moderate-income investors of losing their access to financial advice and creates a compliance conflict for investment advisers and broker-dealers under other federal laws. The article also proposes that the current version of the Rule should be amended by either lessening the proposed fiduciary standard or by creating a uniform fiduciary standard for all professionals who give financial advice.

Background of the Fiduciary Duty Rule

The Fiduciary Rule dates back to the 1970s.[7] In response to notable pension failures and shortfalls in payments to beneficiaries, Congress passed the Employee Retirement Income Security Act of 1974 (ERISA), which mandated a fiduciary standard for those who manage or advise pension plans.[8] Under Section 3(21)(A)(ii) of ERISA, an individual was a "fiduciary with respect to a plan or an individual retirement account to the extent that the individual provided investment advice for a fee or direct or indirect compensation."[9] In 1975, the Department of Labor significantly narrowed the definition of "investment advice" by creating a five-part test,[10] all parts of which had to be satisfied before an individual could be considered to render investment advice.[11] Under that 1975 regulation, a person was only considered to be a fiduciary if the person:

> [. . .] rendered advice to a plan as to the value of securities or other property, or made recommendations as to the advisability of investing in, purchasing, or selling securities or other property and rendered such advice on a regular basis to a plan pursuant to a mutual agreement, arrangement or understanding, written or otherwise, between such individual and the plan or a plan fiduciary, that such services would serve as a primary basis for investment decisions with respect to plan assets, and that such individual would render individualized investment advice to the plan based on the particular needs of the plan regarding such matters as investment policies or strategy, overall portfolio composition, or diversification of plan investments.[12]

As a result, most advisers, brokers, consultants and other service providers could "avoid fiduciary status when advising on IRA investments because they did not provide investment advice on a regular basis or because the advice provided was not given pursuant to a mutual agreement that the advice would be used as the primary basis for making an investment decision."[13]

On February 23, 2015, former President Barack Obama called on the Department of Labor to update the rules and requirements related to the quality of financial advice surrounding retirement under ERISA. In response, on April 14, 2016, the DOL proposed, and the Obama administration later endorsed, a Fiduciary Duty Rule, which expanded the "fiduciary" definition under ERISA to include all financial professionals who work with IRAs and retirement plans, such as 401(k)s and 403(b)s, as fiduciaries.[14]

Under the existing ERISA definition of "fiduciary," a person is considered a fiduciary "if the person provides investment advice to a plan or IRA (i) on a regular basis, (ii) pursuant to a mutual agreement, arrangement or understanding, written or otherwise, (iii) that the advice will serve as a primary basis for investment decisions, and (iv) that the advice will be individualized based on the particular needs of the plan or IRA."[15] Additionally, currently only registered investment advisers have a fidu-

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ciary responsibility to their clients pursuant to the Investment Advisers Act of 1940,[16] which provides that advisers "must put the [clients'] interests over their own."[17] Consequently, brokers, insurance agents and other persons selling investment products to plans and IRAs are not fiduciaries.

In contrast, the proposed Fiduciary Rule defines "fiduciary" broadly to include:

> any person who provides to a plan, a plan fiduciary, plan participant or beneficiary, IRA or IRA owner, the following types of advice in exchange for a fee, whether direct or indirect:
>
> (i) a recommendation of the advisability of acquiring, holding, disposing or exchanging securities or other property, including a recommendation to take benefits from a plan or IRA, or a recommendation as to the investment of securities or other assets to be rolled over or otherwise distributed from a plan or IRA;
>
> (ii) a recommendation as to the management of securities or other property, including recommendations as to the management of securities or other property to be rolled over or otherwise distributed from the plan or IRA;
>
> (iii) an appraisal, fairness opinion or similar statement whether verbal or written concerning the value of securities or other property if provided in connection with a specific transaction; or
>
> (iv) a recommendation of a person who is also going to receive a fee or other compensation for providing any of the types of advice described in (i) to (iii) above.[18]

In other words, the definition has been expanded to include *any* person, including brokers and insurance agents, who makes recommendations for direct or indirect compensation pursuant to an agreement, arrangement or understanding with the advice recipient that the advice is individualized to, or specifically directed to, plan or account assets.[19]

The main difference between the current ERISA rule and the DOL's proposed Rule is that the ERISA rule requires the advice to be given on a "regular basis" in order to become fiduciary in nature, and that the advice be provided pursuant to an understanding that such advice would be a "primary" basis for investment decisions.[20] The DOL' s proposed Rule eliminated both of these requirements, and thus it is intended to allow advisers to provide advice, even on a one-time basis, without any expectation that the advice would serve as the primary basis for the decision.

New Accountability Standard

In addition to the broader definition, the proposed Rule demands a higher level of accountability from anyone who advises investors on their retirement funds. Currently, broker-dealers are held to a suitability standard, which requires them to provide guidance and offer investments that are suitable for the needs of the individual client.[21] If a financial adviser provides unsuitable products or advice based on the individual needs of the investor, the investor has a cause of action against the adviser and can recover his losses.[22] But the current version of the Rule would heighten the legal standard from one of suitability to that of a fiduciary, which will demand that the advisers provide advice in the best interest of their retirement investors. Thus, financial advisers will have to provide advice and products that they themselves would buy if they were in the investor's position.[23] Thus, with the expanded "fiduciary" definition, financial professionals such as brokers, planners, and insurance agents, who work with retirement plans and accounts, including recommendations for a rollover[24] or a distribution, will be legally obligated to put their clients' best interest first, rather than simply finding "suitable" investments.

"The main difference between the current ERISA rule and the DOL's proposed Rule is that the ERISA rule requires the advice to be given on a 'regular basis' in order to become fiduciary in nature, and that the advice be provided pursuant to an understanding that such advice would be a 'primary' basis for investment decisions."

Best Interest Contract Exemption and Other Carve-Outs

Subject to the heightened standard of accountability under the proposed Rule, financial advisers will be prohibited from recommending that their clients either: (i) shift from a 401(k); or (ii) an IRA account with a lower fee into a new IRA with a higher fee; (iii) rolling over to an IRA that would allow the advisers to earn a fee that they were not previously earning; and (iv) switching the clients from a commission-based account to a fee-based wrap account (for which the advisers would earn ongoing fee revenue that wasn't previously being earned).[25] But to allow financial advisers to still engage in the above prohibited transactions, the DOL has created the Best Interest Contract Exemption (BICE),[26] which provides that advisers may still engage in and be compensated for such recommendations.

Specifically, under the BICE, advisers will be allowed to earn reasonable compensation and will be required to commit to putting their clients' best interests first, disclosing any potential conflicts of interest that could affect their best judgment as fiduciaries rendering advice, adopting anti-conflict policies and procedures, and releasing details on the services they will provide and the associated fees.[27] Particularly, advisers will have to execute a contract with each client, attesting to the fact that any recommendations will not be biased in any way. Any violation of this contract or omission of disclosure requirements of the BICE could lead to a breach of contract claim against the adviser and the firm. The exemption also permits financial institutions and advisers to receive many forms of compensation that would otherwise be prohibited, including, "inter alia, commissions, trailing commissions, sales loads, 12b-1 fees, and revenue-sharing payments from investment providers or other third parties to Advisers and Financial Institutions."[28]

Moreover, the Rule contains additional carve-outs, including exceptions for advice provided by swap counterparties, advice provided by employees of a plan sponsor for no additional consideration beyond their regular compensation, advice provided to participant-directed plans by service providers that offers a platform or selection of investment vehicles, including general information, but not recommendations, about the investment choices, certain appraisals and valuation reports including appraisals for investment funds and appraisals or valuation reports for purposes of plan reporting and disclosure; and advice that constitutes "investment education."[29]

Furthermore, for plans that have at least 100 participants or for plans with at least $100 million in assets, the proposed Rule includes a "seller's carve-out" that permits a "counterparty" to provide advice or recommendation to a plan in connection with a sale, purchase, loan or other bilateral contract with the plan.[30] To qualify for the carve-out, the counterparty must obtain a written representation from an independent fiduciary for the plan that the fiduciary is not relying on the counterparty to act in the best interest of the plan, to give impartial advice or to give advice as a fiduciary.[31] For plans that have at least 100 participants but do not have $100 million in assets, the counterparty must also know or reasonably believe that the independent plan fiduciary has sufficient expertise to evaluate the transaction and to determine whether it is prudent and in the best interest of participants.[32] The counterparty may not receive a fee from the plan or plan fiduciary for providing investment advice in connection with the transaction.[33] If this exception applies, merely pitching to a prospective plan client that is at or above the size thresholds—and receiving fees from the investment—will not result in fiduciary status for the counterparty.[34]

Proponents of the Rule

Many industry groups, including the CFP Board, the Financial Planning Association (FPA), and the National Association of Personal Financial Advisors (NAPFA), are certain that the Rule is needed to protect retirement savers from paying unnecessarily high commissions on investment products and from making decisions that are not in their best interest.[35] The Rule will force advisers to give straightforward advice and empower investors with information to make better decisions. Supporters believe that the Rule "should increase and streamline transparency for investors, make conversations easier for advisers entertaining changes," and most importantly, "prevent abuses on the part of financial advisers," such as excessive commissions.[36] According to a 2015 report by the White House Council of Economic Advisers, based on biased advice, "retirement savers lose $17 billion a year just in fees paid to advisers and funds."[37]

Moreover, with respect to the suitability standard, under which investments are simply appropriate for a client's investing objectives, age and risk tolerance, proponents believe that the standard invites conflicts of interest pertaining to compensation, sales goals or other incentives that encourage them to push financial products that are not best for clients.[38] In contrast, the fiduciary standard will require advisers, acting in a fiduciary capacity, to provide advice in the best interest of their retirement investors and thus will establish a more personal connection with them.

Furthermore, supporters argue that the fiduciary standard is beneficial to retirement savers, especially when they (after accumulating some savings in their 401(k) plan) have to decide either to leave their money in the current plan, move it into their new company's plan, or roll it into an Individual Retirement Account.[39] Under the current rule, recommendations regarding rollovers and benefit withdrawals are not considered fiduciary retirement investment advice, so financial firms can encourage savers to roll over their money when they would be better off staying put. But the proposed Rule will require financial advisers to put their clients' best interests ahead of their own profits when making recommendations of whether to roll over and of what to invest in. Thus, the Rule reduces the chances that advisers will recommend an unnecessary rollover.

Opponents of the Rule

The Rule, however, has met with staunch opposition from the financial services industry, especially from brokers and planners. Opponents of the Rule maintain that many financial advisers would see their profits drop, leading to higher fees and fewer options for investors.[40] Indeed, Goldman Sachs predicts that the costs associated with revising procedures and retraining staff to comply with the Rule "will be more than $13 billion in upfront costs and more than $7 billion in annual costs."[41] Large broker-dealers and advisory firms that want to work with retirement plans will have spent "millions of dollars" to comply with the fiduciary rule because they will have to adjust processes and workflows, modify platforms, and develop educational materials for financial professionals working in the retirement space.[42]

Additionally, the Rule could be tough on smaller, independent broker dealers and registered investment advisers firms because "they may not have the financial resources to invest in the technology and the compliance expertise to meet all of the requirements."[43] As a result, some smaller firms could disband or be acquired. In fact, the brokerage operations of MetLife Inc. and American International Group have been sold off already in anticipation of the Rule and the related costs.[44] Also, advisers "earn .54 percent on commission-based accounts versus 1.18 percent on fee-based accounts." "With nearly $7.3 trillion of assets in IRAs, [that is] a difference between consumers paying a total of $39.4 billion or $86 billion in fees each year— "an average of $813 per IRA account holder—an unaffordable amount for many."[45] Thus, the impact of the fiduciary duty rule will be felt almost exclusively by moderate- and low-income Americans precisely because they have only moderate and low incomes.[46]

Lawsuits Against the Rule

Six lawsuits have been filed in four federal courts against the Department of Labor that seek to vacate the new Fiduciary Rule in whole or in part. The first suit was filed by the National Association of Fixed Annuities in the U.S. District Court for the District of Columbia, which rejected the plaintiff's position.[47] Then, Market Synergy Group filed a suit in the U.S. District Court for the District of Kansas, but Judge Daniel Crabtree rejected the suit's request for a preliminary injunction against the fiduciary rule.[48] And three lawsuits—one by the U.S. Chamber of Commerce, teamed up with the Financial Services Institute, the Financial Services Roundtable, the Insured Retired Institute, and the Securities Industry and Financial Markets Association; another by the American Council of Life Insurers, the National Association of Insurance and Financial Advisors; and another one by the Indexed Annuity Leadership Council, together with the Life Insurance Company of the Southwest, Midland National Life Insurance and North American Company for Life and Health Insurance—were filed in the U.S. District Court for the Northern District of Texas.[49] Chief Judge Barbara Lynn for the U.S. District Court for the Northern District of Texas upheld the Rule.[50] The last suit, currently pending, was filed by Thrivent Financial for Lutherans in the U.S. District Court for the District of Minnesota.

The suits have the same legal objective—to seek an injunction that will prevent the DOL from enforcing the proposed Rule. The major arguments the plaintiffs made against the Rule included: failure to comply with the procedure required by the Administrative Procedure Act of 1946 that governs agency rulemaking; expansion of the rulemaking authority granted to the Department by Congress; unlawful creation of a private cause of action; and a violation of the First Amendment's right to free speech by impermissibly burdening truthful commercial speech.[51] So far, the Rule has been successful in surviving court challenges.

"In its current version, the Rule presents risks to moderate and low-income investors of losing access to financial advice and creates an undue compliance burden for investment advisers and broker-dealers under other federal laws."

Discussion

While imposing stricter rules on retirement financial advisers who steer investors into particular retirement products because they offer the highest commissions is a good idea, the proposed Fiduciary Rule will not likely do the job. In its current version, the Rule presents risks to moderate and low-income investors of losing access to financial advice and creates an undue compliance burden for investment advisers and broker-dealers under other federal laws. Therefore, the Rule should be amended by either lessening the proposed fiduciary standard or by generating a uniform fiduciary rule applicable equally to all professionals in the financial services industry.

First, retirement savers, especially moderate- and low-income investors, might lose the access they currently have to financial advice because they will no longer be attractive to financial advisers. The problem is not that advisers might have to incur additional expenses, although this is a persuasive argument against the Rule that was described earlier. The real problem is that advisers might decide that the extra expense and efforts are not worth it. Indeed, for clients who already pay flat fees or a percentage of assets managed, very little may change in the relationship with their advisers. But clients whose advisers wish to continue working on commission will be adversely affected. The average retirement account holds about $5,000. Complying with the BICE, advisers will have as much work managing such an account as they would have managing that of a $50 million account. Given their approximately one-percent fee and the pile of paperwork required by the BICE, advisers will earn less money from the $5,000 account than from the $50 million account. This is just simple math, and advisers will definitely be aware of it. What with this argument and the opposition's argument that the Rule will cause advisers to incur additional expenses, analysis of the Rule suggests that advisers will pay more attention to big accounts than to smaller accounts. Additionally, commission-based advisers do not require their customers to pay upfront for their service, whereas with a flat, upfront fee, investors will have to pay for advice, that they either might not like or refuse to utilize later on.

Also, the BICE on its face does not seem to protect investors because the exemption entails a lot of paperwork, which could be a great place for advisers to hide a scam. After all, investors consult financial advisers because they do not understand, nor can they discern among, multiple investment options. Even when they read the forms and agreements they sign, most of them are not sophisticated. Adding the voluminous disclosures required under BICE will likely make investors more confused, and thus enable advisers to potentially cheat their clients under this Rule.

Second, financial advisers might ignore the proposed Fiduciary Rule, if implemented, by solely complying with the Securities and Exchange Commission's (SEC) fiduciary standard. According to the Investment Advisers Act of 1940, an investment adviser is "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities."[52] The Act expressly excludes from the definition of investment adviser "any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor."[53] The Act also provides the manner in which investment advisers are obligated to register with the SEC, specifies the laws that must be followed by investment advisers, and makes it illegal for both registered and unregistered investment advisers to act fraudulently toward any investors. Once registered with the SEC, investment advisers must comply with the SEC's own standard on the topic of investment advisers as fiduciaries:

> As an investment adviser, you are a "fiduciary" to your advisory clients. This means that you have a fundamental obligation to act in the best interests of your clients and to provide investment advice in your clients' best interests. You owe your clients a duty of undivided loyalty and utmost good faith. You should not engage in any activity in conflict with the interest of any client, and you should take steps reasonably necessary to fulfill your obligations. You must employ reasonable care to avoid misleading clients and you must provide full and fair disclosure of all material facts to your clients and prospective clients.[54]

The SEC's fiduciary standard seems to be about protecting client assets, documenting the investment process, and avoiding conflicts of interest. Similarly, the DOL's Rule[55] binds investment advisers to the same requirements. Namely, under the BICE, financial professionals who give advice on retirement accounts must act as fiduciaries for their clients and disclose any conflicts of interest and their forms of compensation. Thus, since the SEC's definition of a fiduciary is similar to the definition the DOL is proposing, advisers will likely not comply with the DOL's fiduciary standard because the standard requires advisers to put their clients' best interests ahead of their own financial gain, whereas the SEC's standard only asks advisers to take "reasonable steps" in this regard.

Moreover, the SEC's own fiduciary standard is similar to the current ERISA suitability standard and thus will be more appealing to advisers since they are already used to not being under strict obligations. In fact, advisers can argue that the DOL's Rule applies only to those who make investment recommendations in relation to retirement plans, whereas the SEC's standard pertains to "any person who makes an investment recommendation" in general. Consequently, the DOL's Rule seems to be narrower and to fall under the SEC's standard. This argument might not be strong but could be used by those who refuse to comply with the Fiduciary Rule, if implemented in its current version. Instead of figuring out whether they are fiduciaries for purposes of the ERISA or under the SEC, advisers will likely stick to the easier choice.

And finally, because the Fiduciary Rule is not currently workable in its proposed version yet still has great potential, it should be amended. Perhaps the DOL should lessen the proposed fiduciary standard. The Department could require investment professionals to recommend best investment options, rather than "suitable" options under the current standard, to their clients, and hold them responsible for proposing options that are not in the best interest of the clients. More important, to eliminate the possibility that advisers might choose to work only with big clients, the DOL should require advisers to work with a particular number of low- and moderate-income accounts per year. Thus, advisers will be able to have as many wealthy clients as they want, and retirement savers will be assured that they will receive financial advice regardless of how much money they have. After all, the current suitability standard is ineffective and the proposed fiduciary standard seems to be too strict; therefore, a combination of the two standards is the best option.

And to eliminate the second flaw—an excessive compliance burden for investment advisers and broker-dealers under other federal laws—the DOL could expressly include in the Rule a provision that investment professionals who make recommendations solely relating to retirement are exempt from fulfilling the SEC's standard. Thus, advisers, broker-dealers, insurance agents, and other financial professionals working with retirement plans and IRAs will know that they will be unable to escape their ERISA fiduciary duty by claiming reliance on the SEC standard. Perhaps this suggestion will be hard to implement, but it might have great results in the long run.

Another alternative to improving the proposed Rule is to have a uniform fiduciary standard for all individuals who provide financial advice. While the DOL and the SEC are two separate agencies with two separate statutory mandates, they govern the same individuals—financial professionals. And although such professionals have different titles and provide diverse types of financial advice, they make financial recommendations on which average, hard-working people rely. But while financial advisers are governed by the Investment Advisers Act and can be controlled by the SEC, both of which hold advisers to a fiduciary standard, broker-dealers are regulated by the Financial Industry Regulatory Authority ("FINRA") under standards that require them to make suitable recommendations to their clients. The DOL now proposes to bind all financial professionals, including both advisers and broker-dealers, to one fiduciary standard, which is a good idea, yet the standard must be uniform so nobody can avoid complying with fiduciary duties under the law. Rather than having several sets of rules to abide by, one uniform standard that applies to all financial professionals who provide personalized investment advice, and shield clients from paying excessive fees and commissions or receiving substandard performance, will benefit not only advisers but also investors.

Conclusion

The DOL's Fiduciary Rule was proposed with good intentions to make sure that financial advisers help their clients with retirement planning and assets, act in the clients' best interest, avoid conflicts of interest when possible, and be transparent with clients about their compensation and fees. Unfortunately, the proposed version of the Rule is unlikely to fulfill such goals because instead of protecting retirement savers, the Rule creates regulatory confusion and threatens financial professionals' ability to adequately serve hardworking Americans who plan their retirement. To eliminate these flaws, the Rule should be amended by either lessening the proposed fiduciary standard or by creating a uniform fiduciary standard for all professionals who give financial advice. Ultimately, for millions of Americans, retirement savings decisions are among the most important financial choices they make, yet they cannot make such choices without relying on investment advice for guidance on how to manage their savings. These investors deserve to receive advice that is in their best interest and will lead to successful outcomes, and therefore amending the proposed Rule will hopefully do all that.

Endnotes

1. *DOL Fiduciary Rule Explained as of April 18, 2017*, Investopedia, http://www.investopedia.com/updates/dol-fiduciary-rule/ (last visited Apr. 21, 2017).
2. *Presidential Memorandum on Fiduciary Duty Rule.* Whitehouse, https://www.whitehouse.gov/the-press-office/2017/02/03/presidential-memorandum-fiduciary-duty-rule (last visited Apr. 25, 2017).
3. According to the Presidential Memorandum, the Department of Labor must consider the following:

   > (i) Whether the anticipated applicability of the Fiduciary Duty Rule has harmed or is likely to harm investors due to a reduction of Americans' access to certain retirement savings offerings, retirement product structures, retirement savings information, or related financial advice;
   >
   > (ii) Whether the anticipated applicability of the Fiduciary Duty Rule has resulted in dislocations or disruptions within the retirement services industry that may adversely affect investors or retirees; and
   >
   > (iii) Whether the Fiduciary Duty Rule is likely to cause an increase in litigation, and an increase in the prices that investors and retirees must pay to gain access to retirement services.

   Presidential Memorandum on Fiduciary Duty Rule, Whitehouse, https://www.whitehouse.gov/the-press-office/2017/02/03/presidential-memorandum-fiduciary-duty-rule (last visited Apr. 25, 2017).
4. Joy M. Napier-Joyce, *President Trump Orders Review of Labor Department Fiduciary Rule and Addresses Financial Industry in Latest Actions,* Jacksonlewis. https://www.jacksonlewis.com/publication/president-trump-orders-review-labor-department-fiduciary-rule-and-addresses-financial-industry-latest-actions (last visited Apr. 25, 2017).
5. *DOL Fiduciary Rule Explained as of April 18, 2017*, Investopedia, http://www.investopedia.com/updates/dol-fiduciary-rule/ (last visited Apr. 21, 2017).
6. *Id.*
7. Richard Veres, *Understanding the New Fiduciary Rule and Its Impact to Retirement Plan Sponsors,* Highlandusa, https://www.highlandusa.net/blog/the-fiduciary-rule-impact-to-retirement-plan-sponsors-and-important-questions-to-ask-your-consultant (last visited Apr. 20, 2017).
8. *Id.*
9. *Department of Labor Final Rule on Fiduciary Investment Advice,* Americanbar, http://www.americanbar.org/content/newsletter/groups/labor_law/ebc_newsletter/2016/ebc_sum2016/page03.html (last visited Apr. 17, 2017).
10. The five-point test required a person to (1) make recommendations on securities or other property, (2) on a regular basis, (3) pursuant to a mutual understanding that the advice, (4) will serve as a primary basis for investment decisions, and (5) will be individualized to the particular needs of the plan. *DOL Fiduciary Rule: Impact and Next Steps,* Nuveen, https://www.nuveen.com/WealthManagement/Documents/Default.aspx?fileId=67427 (last visited Apr. 27, 2017).

11. *Department of Labor Final Rule on Fiduciary Investment Advice,* Americanbar, http://www.americanbar.org/content/newsletter/groups/labor_law/ebc_newsletter/2016/ebc_sum2016/page03.html (last visited Apr. 17, 2017).

12. *Id.*

13. *Id.*

14. *DOL Fiduciary Rule Explained as of April 18, 2017*, Investopedia, http://www.investopedia.com/updates/dol-fiduciary-rule/ (last visited Apr. 21, 2017).

15. Ian S. Kopelman, *Department of Labor Proposes to Expand the Definition of Fiduciary: Top Points,* Dlapiper, https://www.dlapiper.com/en/us/insights/publications/2015/05/department-of-labor-proposes-to-expand/ (last visited Apr. 28, 2017).

16. Since the enactment of the Investment Advisers Act, the Supreme Court has repeatedly held that investment advisers, as defined by section 202(a)(11) of the Advisers Act, are fiduciaries. *A Federal Fiduciary Standard Under the Investment Advisers Act of 1940: A Refinement for the Protection of Private Funds*, Hblr, http://www.hblr.org/2016/12/a-federal-fiduciary-standard-under-the-investment-advisers-act-of-1940-a-refinement-for-the-protection-of-private-funds/ (last visited Apr. 28, 2017). *See also Breach of Fiduciary Duty*, Justia, https://www.justia.com/banking-finance/securities/breach-of-fiduciary-duty/ (last visited Apr. 20, 2017). ("An investment adviser's fiduciary duty includes the standard duties of care, loyalty, good faith, and disclosure. This means that an investment adviser must use reasonable care when acting on behalf of or advising clients; avoid misleading clients; seek the best price and terms for each transaction; place the client's interest above his or her own; avoid conflicts of interest and fully disclose potential conflicts; never use clients' assets for his or her own benefit; and fully disclose any material facts about a transaction.").

17. Matthew Frankel, *The Fiduciary Rule: Pros and Cons*, Mcoblaw, http://www.mcoblaw.com/documents/The-Fiduciary-Rule_-Pros-and-Cons.pdf (last visited Apr. 228, 2017).

18. Ian S. Kopelman, *Department of Labor Proposes to Expand the Definition of Fiduciary: Top Points,* Dlapiper, https://www.dlapiper.com/en/us/insights/publications/2015/05/department-of-labor-proposes-to-expand/ (last visited Apr. 28, 2017).

19. *Emphasis added*. *DOL Fiduciary Rule: Impact and Next Steps,* Nuveen, https://www.nuveen.com/WealthManagement/Documents/Default.aspx?fileId=67427 (last visited Apr. 27, 2017).

20. Patrick C. DiCarlo, *Fiduciary Defined: DOL's Proposed New Rule Creates More Questions Than Answers*, Alson, http://www.alston.com/Files/Publication/abc409f6-e521-4faa-aea4-c8356b2edced/Presentation/PublicationAttachment/0897545b-8bb7-42b1-a2d3-cde5e8956889/BLJ_Autumn15_DiCarlo.pdf (last visited Apr. 28, 2017).

21. Clark Packard, *Trump Must Delay, Alter or Withdraw Obama's Fiduciary Rule*, Washingtonexaminer, http://www.washingtonexaminer.com/trump-must-delay-alter-or-withdraw-obamas-fiduciary-rule/article/2617885 (last visited Apr. 27, 2017).

22. *Id.*

23. Yet registered investment advisers—another class of financial professionals—are always required to put clients' interests first, even though these advisers provide exactly the same services as brokers. *Id.*

24. Rollover IRAs have become hot spots for high-fee, poor-performing investments, such as variable annuities and nontraded real estate investment trusts. The rule does not bar advisers from recommending any of those products, but it does limit them to charging "reasonable" fees, and it requires firms that charge commissions to jump through some cumbersome hoops. As a result, such products may disappear from IRAs altogether. Elizabeth Leary, *Eight Things You Must Know About the New Broker Rule*, Kiplinger, http://www.kiplinger.com/article/investing/T047-C000-S002-8-things-you-must-know-about-the-new-broker-rule.html (last visited Apr. 27, 2017).

25. *Advisor's Guide To DOL Fiduciary And The New Best Interests Contract (BIC) Requirement*, Kitces, https://www.kitces.com/blog/best-interests-contract-exemption-bice-and-dol-fiduciary-bic-requirements/ (last visited Apr. 28, 2017).

26. Advice provided before April 10, 2017 is not covered by the new rule, and your adviser or broker can continue to receive compensation after that date for recommendations made before that date. However, any advice given after that date regarding your old investments would be held to the new rule's standards. Elizabeth Leary, *Eight Things You Must Know About the New Broker Rule*, Kiplinger, http://www.kiplinger.com/article/investing/T047-C000-S002-8-things-you-must-know-about-the-new-broker-rule.html (last visited Apr. 27, 2017).

27. The Best Interest Contract Exemption is intended to exempt the receipt of commissions, 12b-1 fees and other forms of third-party compensation received in connection with rollover recommendations and other forms of investment advice to plan participants and IRA holders. *Complying with the Best Interest Contract Exemption*, Pershing, https://www.pershing.com/_global-assets/pdf/dol-complying-with-the-best-interest-contract-exemption.pdf (last visited Apr. 28, 2017).

28. *Best Interest Contract Exemption,* Amazonaws, https://s3.amazonaws.com/public-inspection.federalregister.gov/2016-07925.pdf (last visited Apr. 27, 2017).

29. Ian S. Kopelman, *Department of Labor Proposes to Expand the Definition of Fiduciary: Top Points,* Dlapiper, https://www.dlapiper.com/en/us/insights/publications/2015/05/department-of-labor-proposes-to-expand/ (last visited Apr. 28, 2017).

30. *Id.*

31. *Id.*

32. *Id.*

33. *Id.*

34. *Id.*

35. *DOL Fiduciary Rule Explained as of April 18, 2017*, Investopedia, http://www.investopedia.com/updates/dol-fiduciary-rule/ (last visited Apr. 21, 2017).

36. *Id.*

37. Mitch Tuchman, *Opinion: Trump's Last-second Swipe at a Obama Retirement Rule,* Marketwatch, http://www.marketwatch.com/story/ignorance-is-expensive-when-it-comes-to-retirement-investing-2017-03-16 (last visited Apr. 28, 2017).

38. *Updating Financial Advisor Standards*, Ally, https://www.ally.com/do-it-right/money/updating-financial-advisor-standards/ (last visited Apr. 28, 2017).

39. *Six Ways the DOL Fiduciary Rule Improves Protections for Retirement Savers*, Consumerfed, http://consumerfed.org/wp-content/uploads/2016/04/6-Ways-the-DOL-Fiduciary-Rule-Protects-Retirement-Savers.pdf (last visited Apr. 27, 2017).

40. Zeke J. Miller & Haley Sweetland Edwards, *White House Stalls Obama Administration Rule on Retirement Advisers,* Time, http://time.com/4659152/donald-trump-fiduciary-rule-retirement-financial-advisers/ (last visited Apr. 27, 2017).

41. Karen Riccio, *How the New DOL Fiduciary Rule Is Disrupting the U.S. Advisory Landscape*, Kurtosys, https://blog.kurtosys.com/how-the-new-dol-fiduciary-rule-is-disrupting-the-u-s-advisory-landscape/ (last visited Apr. 27, 2017).

42. Apparently, the stricter fiduciary standards could cost the financial services industry an estimated $2.4 billion per year by eliminating

conflicts of interest, like front-end load commissions and mutual fund 12b-1 fees paid to wealth management and advisory firms. *DOL Fiduciary Rule Explained as of April 18, 2017*, Investopedia, http://www.investopedia.com/updates/dol-fiduciary-rule/ (last visited Apr. 21, 2017).

43. *Id.*

44. *Id.*

45. Meghan Milloy, *The Consequences of the Fiduciary Rule for Consumer,* Americanactionforum, https://www.americanactionforum.org/research/consequences-fiduciary-rule-consumers/ (last visited Apr. 20, 2017).

46. Thaya Brook Knight, *If You've Got $650 Million, the Fiduciary Duty Rule Is Not Your Problem,* Cato, https://www.cato.org/blog/youve-got-650-million-fiduciary-duty-rule-not-problem (last visited Apr. 28, 2017).

47. Mark P. Cussen, *Lawsuits That Aim to Stop the New Fiduciary Rule*, Investopedia, http://www.investopedia.com/articles/financial-advisor/080116/lawsuits-aim-overturn-dols-fiduciary-rule.asp (last visited Apr. 28, 2017).

48. *Id.*

49. *Id.*

50. *U.S. Court Upholds Obama-era Retirement Advice Rule,* Cnbc, http://www.cnbc.com/2017/02/09/us-court-upholds-obama-era-retirement-advice-rule.html (last visited Apr. 28, 2017).

51. Mark P. Cussen, *Lawsuits That Aim to Stop the New Fiduciary Rule*, Investopedia, http://www.investopedia.com/articles/financial-advisor/080116/lawsuits-aim-overturn-dols-fiduciary-rule.asp (last visited Apr. 28, 2017).

52. *Investment Adviser*, CornellUniversity, https://www.law.cornell.edu/uscode/text/15/80b-2 (last visited Apr. 28, 2017).

53. *Id.*

54. *Information for Newly-Registered Investment Advisers,* Sec, https://www.sec.gov/divisions/investment/advoverview.htm (last visited Apr. 27, 2017).

55. The new proposed definition provides that a person is a fiduciary with respect to a plan or IRA if the person gives advice (1) pursuant to an agreement, arrangement or understanding, (2) the advice is individualized or specifically directed for use in making investment decisions for a plan or IRA concerning securities or other property, (3) the advice is provided for a fee or other compensation, and (4) the advice falls into one of four categories: (a) recommendations on acquiring, holding, disposing or exchanging securities or other property (including distributions from a plan or IRA), (b) recommendations on managing securities or other property (including distributions from a plan or IRA), (c) appraisals, opinions or other statements on the value of securities or other property in connection with a specific transaction involving those securities or other property, or (4) recommendations of a person to give the plan or IRA advice described in (a), (b) or (c) for a fee or other compensation.

    Christopher K. Buch & Gary Howell, *DOL Proposes to Revise Definition of Fiduciary Under ERISA*, Jdsupra, http://www.jdsupra.com/post/contentViewerEmbed.aspx?fid=1708500a-bd0e-4dae-866a-80b7f430d0a4 (last visited Apr. 27, 2017).

Cybersecurity and Its Impact on the Financial Services Industry

By Niyati Sangani

Cybersecurity is known as "the state of being protected against the criminal or unauthorized use of electronic data, or the measures taken to achieve this." While the Internet has encouraged the growth of technological developments in areas of business and central intelligence, it has also boosted the need for pro-active defense due to the increased risk of cybercrimes.

I. INTRODUCTION

"United we stand, [but] divided we fall."[1] The United States government is committed to protecting its citizens from threats, including cyber attacks on financial service institutions. As the chair of the U.S. Securities and Exchange Commission noted, cybersecurity poses one of the biggest threats to the American financial system.[2] It has been reported that attacks against financial services institutions are four times higher than against companies in other industries.[3] These attacks not only have a crippling effect on the global economy, but they also pose a high-risk threat on entities that hold private data on consumers.[4]

A cyber attack is deliberate misuse of an organization's computer systems, technology-dependent enterprises, and networks by third-party hackers or an organization's own employees.[5] Cyber attacks often utilize malicious codes to rework computer codes, logic, or data, which result in compromised data and cybercrimes such as information and identity theft.[6] Cyber attacks on financial service institutions have become more frequent, sophisticated, and widespread because cyber criminals can attack through a variety of methods. For example, in 2011, Nasdaq and Citigroup were hacked. Nasdaq stated that its computer systems—but not its core trading platform—were infiltrated by external hackers.[7] Four months later, Citigroup's online credit card website was hacked, and 360,000 of its customers' accounts were compromised externally.[8] From 2012–2013, there were a string of external distributed denial-of-service attacks ("DDos attacks") against several U.S. banks, such as Bank of America, BB&T, Capital One, Citibank, Fifth Third Bancorp, JPMorgan Chase, PNC, UnionBank, and U.S. Bank.[9] In 2014, Chinese hackers attacked the computer networks of the Office of Personnel Management, which manages data for federal employees, including sensitive financial information; from June 2014–August 2014, hackers stole customer records of more than 83 million customers, which contained identifying financial information, from JP Morgan Chase & Co, Scottrade, and Dow Jones.[10] In 2015 there was an internal cyber attack on Morgan Stanley and Wells Fargo, where employees stole customers' financial information. Later in 2015, Carbanak, a criminal gang, led an attack on e-payment institutions and other financial institutions that led to a $1 billion loss.[11] In February 2016, Bangladesh Bank was externally hacked, and 35 SWIFT payment instructions were purportedly sent to the Federal Reserve Bank of New York.[12]

In recent years, both cyber attacks on the financial services industry, and the monetary repercussions resulting from these attacks, have increased.[13] The Ponemon Institute's 2015 Cost of Cyber Crime Study in the United States found that the average annualized cost of cybercrime for financial service companies was the highest of any industry sector, totaling $28.33 million.[14] That amount surpassed the six-year average within the financial services industry by $9 million, and was $15 million over the general average.[15] This upward trajectory continued in 2016.[16] The Ponemon Institute's 2016 Cost of Data Breach Study stated that the financial service industry has one of the most costly data breaches because "fines [are] higher than [the] average rate of lost business and customers," and this industry also has the third highest per capita cost at $221 per person.[17]

The rise of cybercrimes against U.S. financial service institutions and the costs to mitigate these attacks have alarmed the government and caused it to call for tougher legislation.[18] U.S. Federal Law imposes affirmative prohibitions and restrictions on this industry.[19] These regulations include the following: Gramm-Leach-Bliley Act (GLB Act), the Bank Secrecy Act of 1970 (BSA), Federal Deposit Insurance Corporation Improvement Act of 1991, the Sarbanes-Oxley Act of 2002 (SOX) and Regulation S-P. These regulations require financial service institutions to address cybersecurity issues.[20] However, because the language in these texts are broad, such as what qualifies as "appropriate" safeguards, "proper" procedures, and "material" risks,[21] multiple guidance reports have been published to help enable financial service institutions to deal with cybersecurity assessment.[22] Some examples include the National Institute of Standards and Technology (NIST) Cybersecurity Framework, FINRA's Report on Cybersecurity Practices Guidance on Complying with the Safeguards Rule, and the SEC Cybersecurity Guidance. Despite federal regulation that imposes cybersecurity requirements on financial service institutions, and guidance reports informing businesses about best cybersecurity

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practices that comply with federal regulations, cyber attacks are *still* increasing.[23]

This article contends that in light of existing regulation, in addition to incentives to share cyber threat information with the federal government and the imposition of best practice methods, financial service institutions should be able to detect where these attacks are coming from and apply active defense methods, such as a "hack back," by utilizing cyber letters of marque and reprisal. A letter of marque and reprisal is found in Article 1, Section 8 of the U.S. Constitution and has allowed private citizens in the past to take action against various threats.[24] Letters of marque and reprisal were effective because they were an efficient way to combat threats without breaching international peace.[25] In today's digital age, it would be called a cyber letter of marque and reprisal, which is a form of a hack back. Hacking back is a digital counterstrike against one's cyber attackers. A cyber letter of marque and reprisal would be effective for financial services institutions to utilize because it would allow them to track and even disrupt cyber attacks on certain occasions so as to protect their systems.[26] By allowing financial service institutions the option to use this method, marque and reprisal creates more effective barriers to entry, and control over systems is regained.[27]

This article proposes effectuating cyber letters of marque and reprisal as a solution to the problem of cyber attacks on financial services institutions. Following this Introduction, Part II surveys the history of notable internal and external cyber attacks on financial services institutions from 2011–2016. These attacks show the vulnerabilities of the financial services sector and suggest that given these attacks, new methods for dealing with cyber attacks are needed. Part III evaluates currently enacted federal regulations concerning cybersecurity in the financial services sector and government guidance report requirements on best practice methods. Part III will also address the newly enacted cybersecurity regulation by the New York State Department of Financial Services and a proposed rule promulgated by the OCC, FDIC, and the Federal Reserve Board on financial services institutions. Lastly, Part III will address what is done when a cyber attack occurs. Part IV addresses which method is more effective, a pure regulatory scheme or the best practices approach. Part V proposes a solution to empower financial services institutions to more effectively tackle cyber attacks by utilizing "active defense" methods of hacking back, such as cyber letters of marque and reprisal. Part VI concludes.

II. THE HISTORY OF CYBER ATTACKS ON FINANCIAL SERVICES INSTITUTIONS

The financial services industry is one of the top five industries at risk of a cyber attack.[28] Financial services institutions hold an enormous amount of personal and financial data on their consumers.[29] When these institutions are attacked, millions, if not billions, of dollars could be lost.[30] Not only have cyber attacks increased, but they also have become more complex and refined.[31] Cyber attacks are not only external attacks from third parties; internal attacks are just as damaging because employees leaking sensitive consumer data not only sabotage an entity's system, but they also degrade the public's trust in that entity. Cyber attacks on financial service institutions started to gain momentum in 2011 when Citibank and Nasdaq were attacked.[32]

A. Nasdaq and Citigroup Breach in 2011

Nasdaq is one of the United States' largest stock exchanges, which many companies utilize to list their shares.[33] In February 2011, Nasdaq noticed "suspicious files" implanted on U.S. servers, which contained many Fortune 500 companies' confidential financial information.[34] A five-month investigation was conducted by the National Cybersecurity and Communications Integration Center (NCCIC).[35] After the investigation, the National Security Agency (NSA) acknowledged that the malware within Nasdaq's system was built by Russia's main spy agency and had the ability to disrupt and even eliminate Nasdaq altogether.[36] This hack, though unsuccessful, revealed the vulnerabilities of the financial services industry.[37]

Shortly thereafter, on June 16, 2011, Citigroup announced that 200,000 customers were affected due to a cyber attack,[38] which comprised approximately one percent of the bank's 21 million North American customers.[39] Citigroup discovered the security breach when it noticed that an external hacker accessed hundreds of thousands of accounts containing personal information.[40] Customer information, including names, account numbers, and contact information such as emails, were viewed.[41] However, information such as social security numbers, birth dates, card expiration dates, and security codes were not viewed by the hacker.[42] Citigroup notified its customers on June 3, but waited until June 9 to fully disclose the breach to the public.[43] It was later revealed that 360,000 user accounts were actually compromised.[44] This cyber attack on Citigroup led to a $2.7 million loss for the company.[45]

B. QCF DDoS Attacks on Financial Institutions 2012–2013

In September 2012, al Qassam Cyber Fighters (QCF), targeted nine banks and launched DDos attacks against them in retaliation for a video that was posted on YouTube that offended many Muslims.[46] QCF first attacked and disrupted service to Bank of America's website.[47] Then QCF launched DDoS attacks on Wells Fargo and JPMorgan Chase and released advance warnings of attacks against PNC Financial Services and U.S. Bancorp.[48] The group continued to carry out these attacks.[49] After attacking HSBC in mid-October,[50] QCF attacked JPMorgan Chase, US Bancorp, and Wells Fargo, on December 10, 2012, along with PNC Financial Services Group in the following days.[51] On February 25, 2013, QCF continued carrying out its DDoS attacks by disrupting websites of Bank of America, PNC, Capital One, Zions Bank, 5/3, Unionbank, Comerica, Citizens Bank, Peoples, UFCU, and Patelco.[52] While these banks spent millions of dollars on countermeasures for defense,[53] this raised a concern for defending trading applications, trading networks, and funds transfer networks because they are critical assets to the U.S. financial system.[54]

C. Office of Personnel Management, JP Morgan Chase, E*Trade Financial Corp., Scottrade Financial Services Inc. and Dow Jones & Co. Data Breach in 2014

In March 2014, the United States Office of Personnel Management (OPM) was hacked.[55] It was presumed that the motive behind the attack was for Chinese hackers to infiltrate the OPM's computer systems to collect information on federal employees who applied for top security clearances.[56] This breach was notable because federal employees who applied for security clearances had to enter not only their personal information, but also financial information.[57] Initially, there was no announcement of the attack because no personal information was compromised.[58] However, in April 2015, OPM detected another breach in which as many as 4 million current and former federal employees potentially had their personally identifiable information compromised.[59] Public notice of the breach and notice to the employees who were directly implicated were not given until June 4, 2015.[60] The OPM hack alerted businesses and legislators to concerns that stronger defense mechanisms needed to be implemented in order to stop future cyber attacks.[61]

Another notable cyber attack in 2014 was the attack on JP Morgan Chase, which compromised the customer information of 76 million households and 7 million small businesses.[62] The information stolen consisted of names, addresses, phone numbers, and email addresses.[63] This data breach was a part of a series of data thefts hitting financial firms earlier that year.[64] It was later realized in 2015 that JP Morgan's hack in 2014 was tied to the largest cyber breach ever seen, which involved E*Trade Financial Corp., Scottrade Financial Services Inc., and Dow Jones & Co. as well.[65] The U.S. Attorney for the Southern District of New York, Preet Bharara, charged three people connected to these hacks.[66] From 2012 to mid-2015, the suspects and their co-conspirators were successfully able to manipulate dozens of publicly traded stocks, steal email addresses from clients of banks and brokerages and send them misleading pitches, and profited by using fake trading accounts set up under false names.[67] The loss of information not only took a financial toll on these companies, but led to hundreds of millions of dollars in illicit proceeds for the hackers.[68]

D. Carbanak Data Breach in 2015 and the Bangladesh Bank Heist of 2016

On February 16, 2015, it was announced that Carbanak, a criminal gang, had stolen over $1 billion from 100 financial institutions over the previous two years. Carbanak stole money directly from banks, e-payment institutions, and other financial institutions.[69] In February 2016, instructions were issued to transfer $951 million out of Bangladesh Bank's account at the New York Federal Reserve to other accounts;[70] $81 million was transferred to a fraudulent bank account in the Philippines using the SWIFT system.[71] SWIFT—the Society for Worldwide Interbank Financial Telecommunication—is a secure global banking system that banks utilize to authorize payments from one account to another.[72] A representative of SWIFT acknowledged that its system was used to conduct similar attacks on other banks.[73] This attack and SWIFT's admission raised concerns about whether money is being moved in a secure manner around the world.[74]

E. Cyber Attacks on Morgan Stanley, Wells Fargo

Internal cyber attacks also have a disparate impact on financial service institutions, especially when institutions' own employees lead them. On January 5, Morgan Stanley reported that an employee stole and posted for sale approximately 350,000 of its 3.5 million customers' account names, numbers, and transaction details.[75] That following Monday, Morgan Stanley's company stock declined by more than three percent.[76] In April and May of 2015, Wells Fargo disclosed that its employees stole customers' information to open fraudulent accounts.[77]

Overall, financial services institutions, no matter how advanced, depend on information technology and telecommunications to deliver services to consumers and businesses on a day to day basis.[78] These institutions conduct operations ranging from executing billions of dollars of transactions to managing consumer information and audit reports.[79] When attacked, not only are millions, if not billions, of dollars lost, but consumer confidence in the nation's financial services sector is undermined.[80]

III. FINANCIAL CYBERSECURITY REGULATIONS

The U.S. financial services industry is an essential part of the global financial system and one of its strongest players.[81] Ensuring the global financial system's integrity, security, and resilience is critical to protecting firms and their customers, and to maintaining stability.[82] While federal regulations—such as the Bank Secrecy Act, Federal Deposit Insurance Corporation Improvement Act, Gramm-Leach-Bliley Act, the Sarbanes-Oxley Act, and Regulation S-P—impose various cybersecurity requirements on financial service institutions, these rules contain broad or generic language—such as what qualifies as "appropriate" safeguards, "proper" procedures, and "material" risks.[83] As a result, multiple guidance reports have been published to help financial service institutions with cybersecurity assessment.[84] These reports, however, do not provide the incentive to have an institution "hack back"—allowing for a digital counterstrike against one's cyberattackers—and instead only discuss best practices and how to comply with the regulations.[85]

A. Legal and Regulatory Requirements

The existing federal laws and regulations impose cybersecurity requirements through rules governing anti-money laundering and operational assurance, personal data protection, identity theft prevention, audit and corporate disclosure accuracy, and systemic risk mitigation.[86] The early requirements for cybersecurity in the financial services sector started with the Bank Secrecy Act of 1970 (BSA) and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).[87] These acts focused on operational assurance and transaction monitoring, and required companies to retain information security systems that monitored transactions, customer accounts, and suspicious activity.[88] While the BSA does not mention cybersecurity directly, efficient compliance with the Act mandated firms to implement anti-money laundering IT management systems, log and analyze customer information, and account for transaction activity to detect suspicious behavior.[89] Under the Act, financial institutions are also required to notify the Financial Crimes Enforcement Network (FinCEN) and fill out a Suspicious Activity Report ("SAR") if they become aware of any suspected suspicious activity.[90] The FDICIA required that depository institutions governed by the FDIC "have internal controls and information systems that are appropriate to the size of the institution and the nature, scope, and risk of its activities."[91] The governing depository institutions are given flexibility in enforcing these rules because of the text's broad language.

1. Gramm-Leach-Bliley Act of 1999

The Gramm-Leach-Bliley Act of 1999 (GLBA) imposes personal data security requirements on financial institutions.[92] The "Safeguards Rule" under GLBA requires financial services firms to institute a written information security plan that shields and precludes a consumer's personal data from unauthorized disclosure.[93] It does so by "designating a program coordinator, assessing risk, implementing information safeguards, ensuring security of service providers, and updating the plan to ensure ongoing data protection."[94]

While the Federal Trade Commission (FTC) and the Federal Financial Institutions Examination Council (FFIEC) provide guidance on how companies can comply with the Safeguards Rule, the guidance report was written in general language in order to accommodate a range of business models that financial service institutions use.[95] Some of the measures laid out in the report include the "use [of] multiple layers of access controls to computer systems, monitor[ing] network and host activity to identify policy violations and anomalous behavior, analyz[ing] the results of monitoring to respond appropriately, and implement[ing] appropriate controls to prevent and detect malicious code."[96] Because the law itself does not provide a prevailing set of protocols that banks are required to follow, the interpretation and application of practices are as varied as the number of banks regulated.[97]

2. Sarbanes-Oxley Act of 2002

After the Enron and WorldCom scandals, Congress passed the Sarbanes-Oxley Act of 2002 (SOX), which required efficient auditing and regulatory reporting systems.[98] SOX indirectly imposes cybersecurity requirements through Section 302, Corporate Responsibility for Financial Reports, and Section 404, Management Assessments of Internal Controls.[99]

Within these sections, cybersecurity is not explicitly mentioned in the text itself.[100] Instead, Section 302 outlines a broad expectation that a company's CEO and CFO will certify that its financial reports are accurate, complete, and that internal controls for financial reporting are satisfactory and efficient.[101] Meanwhile, Section 404 requires an assessment of effective internal controls, which must be reviewed by a third party auditing firm.[102] Guidance is broad because no specific controls are proposed.[103] As a form of implicit cybersecurity requirement, annual assessments of a company's security system were required since "an insecure system would not be considered a source of reliable financial information because of the possibility of unauthorized transactions or manipulation of numbers."[104]

In order to determine that computer-based financial reporting and internal controls comply with Sections 302 and 404, the following frameworks were generated for companies to ensure that compliance: the Public Company Accounting Oversight Board (PCAOB), the Committee of Sponsoring Organizations (COSO), and the Control Objectives for Information and Related Technologies (COBIT).[105] PCAOB oversees auditors evaluating SOX compliance by stating that: "controls should be tested, [which] include[s] controls over all relevant assertions related to all significant accounts and disclosures in the financial statements." Generally, such controls include ". . . information technology general controls, on which other controls are dependent."[106] The COSO framework was published by the Committee of Sponsoring Organizations, an organization that provides guidance to companies on how to comply with internal control and financial reporting requirements.[107] The framework "provides thought leadership through the development of frameworks and guidance on enterprise risk management, internal control and fraud deterrence."[108] The COBIT Framework was published by the Information Systems Audit and Control Association (ISACA) and provides detailed guidance on IT controls.[109]

While SOX aims to protect investors through robust financial reporting and controls during the reporting process via IT controls requirements, these controls are quite narrow in their focus.[110] Most organizations establish additional controls in order to protect other confidential data and intellectual property.[111] Therefore, because SOX does not fully cover either of these types of data, compliance should not be assumed to be sufficient in protecting all valuable company data or intellectual property from a cyber attack.[112]

3. Regulation S-P

Investment advisers and brokerage firms are regulated by the SEC, and in order to protect non-public personal information, Regulation S-P was promulgated. Regulation S-P in part states

> Every broker, dealer, and investment company, and every investment adviser registered with the Commission must adopt policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information. These policies and procedures must be reasonably designed to: (a) Insure the security and confidentiality of customer records and information; (b) Protect against any anticipated threats or hazards to the security or integrity of customer records and information; and (c) Protect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to any customer.[113]

While this protects non-public personal information, the SEC does not issue technically detailed procedures regarding cybersecurity.[114] It instead repeats the GLBA's provision related to the protection of non-public personal information.[115] These procedures allow the SEC to punish firms after a breach has occurred if it concludes that the firm has not adopted suitable policies and procedures.[116]

4. New York State Department of Financial Services Cybersecurity Regulation

On March 1, 2017, the New York State Department of Financial Services (DFS) cybersecurity regulation was enacted.[117] This regulation requires banks, insurance companies, and other financial services institutions regulated by DFS in New York "to establish and maintain a cybersecurity program designed to protect consumers' private data and ensure the safety and soundness of New York's financial services industry."[118] The regulation mandates banks, insurance companies, and other financial services institutions to include minimum regulatory standards that provide protection and avoidance of cyber breaches.[119] The regulation includes the following requirements: a cybersecurity program that is adequately funded and staffed, overseen by qualified management, and periodically reported to the organization's most senior governing body; minimum risk-based standards for technology systems that include access controls, data protection such as encryption and penetration testing; required minimum standards addressing cyber breaches that include an incident response plan, data preservation to respond to such breaches in the future, and notice to DFS of material events, and accountability by requiring identification and documentation of material deficiencies, remediation plans and annual certifications of regulatory compliance to DFS.[120]

5. Proposed Cybersecurity Regulation by the OCC, FDIC, and the Federal Reserve Board

The OCC, FDIC, and the Federal Reserve Board joined together to submit a proposed cyber regulation that affected large entities and their service providers subject to their jurisdictional supervision.[121] The rule addressed five categories of cyber standards: (i) cyber risk governance; (ii) cyber risk management; (iii) internal dependency management; (iv) external dependency management; and (v) incident response, cyber resilience, and situational awareness.[122] According to the proposed rule, the categories were organized in this order because the agencies wanted to emphasize the core cyber risk governance and management standards that agencies would expect a covered entity to develop, to establish a foundation of informed risk-based decisions that would support its business objectives.[123] Standards in the internal dependency management, external dependency management, and incident response, cyber resilience, and situational awareness categories were designed to work together and to be jointly reinforcing.[124]

For cyber risk governance, covered entities would have to maintain a formal cyber risk management strategy and a supporting framework of policies and procedures that implement the strategy into the entities' overall strategic plans and risk governance structures.[125] This includes holding the covered entity's board of directors, or an appropriate board committee, responsible for approving the entity's cyber risk management strategy and holding senior management accountable for establishing and implementing appropriate policies consistent with the strategy.[126]

For cyber risk management, the covered entities would be responsible for incorporating cyber risk management into the responsibilities of at least three independent functions—such as business units, independent risk management, and audit—with appropriate checks and balances.[127] This could allow covered entities to more accurately and effectively identify, monitor, measure, manage, and report on cyber risk.[128] The internal dependency management category ensures that covered entities have effective capabilities in place that identify and manage cyber risks associated with their business assets such as their workforce, data, technology, and facilities.[129] This can arise from a wide range of sources, including insider threats, data transmission errors, or the use of legacy systems acquired through a merger.[130]

The external dependency management category refers to the covered entity's relationships with outside vendors, suppliers, customers, utilities, and external organizations and service providers that the entity does business with to thrive in the marketplace.[131] The proposed rule would require covered entities to integrate an external dependency management strategy into their overall strategic risk management plan to address and reduce cyber risks associated with external dependencies and interconnection risks.[132] This would ensure that roles, responsibilities, policies, standards, and procedures for external dependency management are well defined and regularly updated and that appropriate compliance mechanisms are in place.[133]

Last but not least, standards within the incident response, cyber resilience, and situational awareness category would require covered entities to operate critical business functions when faced with cyber-attacks and continuously enhance their cyber resilience by establishing processes designed to reliably predict, analyze, and respond to changes.[134] Since these standards would apply to the largest institutions subject to their jurisdiction, the Board proposed applying these standards to all U.S. bank holding companies with total consolidated assets of $50 billion or more, the U.S. operations of foreign banking organizations with total U.S. assets of $50 billion or more, and U.S. savings and loan holding companies with total consolidated assets of $50 billion or more. The Board would also apply these standards to nonbank financial companies supervised by the Board pursuant to § 165 of Dodd-Frank and to financial market utilities designated by FSOC for which the Board is the Supervisory Agency pursuant to §§ 805 and 810 of the Dodd-Frank Act.[135] As for the OCC, these standards would apply to any national bank, federal savings association and any subsidiaries thereof, or federal branch of a foreign bank that is a subsidiary of a bank holding company or savings and loan holding company with total consolidated assets of $50 billion or more, or any national bank, federal savings association, or Federal branch of a foreign bank that has total consolidated assets of $50 billion or more that does not have a parent holding company.[136] Lastly, the FDIC would apply the standards to any state nonmember bank or state savings association and any entity that is a subsidiary thereof, that is a subsidiary of a bank holding company or savings and loan holding company with total consolidated assets of $50 billion or more.[137] Further, the FDIC would apply the standards to any state nonmember bank or state savings association that has total consolidated assets of $50 billion or more that does not have a parent holding company.[138]

B. Legal Frameworks

While the federal regulations provide oversight and guidelines for cybersecurity requirements, they are broad, ambiguous, and therefore ineffective without guidance.[139] As a result, financial firms and their regulators have used security standards and frameworks to serve as templates against which firms and their auditors can measure cybersecurity assessments.[140] Posted guidance by the Office of the Comptroller (OCC), the Securities and Exchange Commission (SEC), NIST Framework for Improving Critical Infrastructure Cybersecurity, the Financial Industry Regulatory Authority (FINRA), the Basel Committee on Banking Supervision, and the Federal Reserve discusses best practice methods that institutions can utilize to make themselves stronger.[141]

1. FINRA Report on Cybersecurity Practices

FINRA proposed best practices techniques that are more aggressive and recognize that third-party relationships create significant risk for cyber attacks. The FINRA guidelines propose (1) development of a defense-in-depth strategy that layers multiple independent security controls throughout an IT system; (2) controls that limit users' and employees' access to the firm's systems and data; (3) data encryption to protect data confidentiality and information integrity; (4) third-party penetration testing to assess a firm's cybersecurity weaknesses; and (5) increasing third-party vendor management to heighten a firm's security standards.[142] While these best practices are helpful, FINRA's guidelines are completely voluntary for firms to implement and improve their cybersecurity procedures.[143]

2. SEC Cybersecurity Best Practices

The SEC's best practices include creating a strategy that is designed to prevent, detect and respond to cybersecurity threats by:

> (1) controlling access to various systems and data via management of user credentials, authentication and authorization methods, firewalls and/or perimeter defenses, tiered access to sensitive information and network resources, network segregation, and system hardening; (2) data encryption; (3) protecting against the loss or exfiltration of sensitive data by restricting the use of removable storage media and deploying software that monitors technology systems for unauthorized intrusions, the loss or exfiltration of sensitive data, or other unusual events; (4) data backup and retrieval; and (5) the development of an incident response plan.[144]

The SEC further suggests that firms that are subjected to periodic reporting obligations disclose potential cyber risks they face; disclose any cyber incidents that have occurred; disclose whether they outsource material cyber-functions; and disclose any relevant insurance coverage.[145] While this disclosure alerts the public about cyber risks, there is a question of whether cyber risks should be disclosed at the outset.[146] Disclosing too little information creates liability risks, but disclosing too much information damages capital raising efforts.[147]

3. OCC Cybersecurity Guidance

The OCC has released multiple bulletin boards about cybersecurity best practices and expectations. Examples include the following: (1) notifying banks of FFIEC guidance and encouraging multifactor authentication; (2) executing appropriate risk assessment strategies and mitigation practices for web applications; (3) informing banks about NSA guidance on responding to the RSA security hack that altered SecurID authentication, and guiding banks to employ NSA and United States Computer Emergency Readiness Team (US-CERT) resources to enhance information security programs; and (4) directing banks to report DDoS attacks to law enforcement officials by filing a SAR.[148] While some of these reports are expectations, most are common best practices firms can use, but they do not contain any mandatory language.[149]

4. NIST Framework for Improving Critical Infrastructure Cybersecurity

The NIST Framework for Improving Critical Infrastructure Cybersecurity outlines five important functions which form the foundation of cybersecurity policies, and twenty-two security procedure categories to complete those functions.[150] The NIST Framework is broad and voluntary because it includes best practices that reduce cyber risks in critical infrastructure sectors. While the executive order directed federal regulators to evaluate the adequacy of existing cybersecurity requirements and propose new regulations using existing legal authorities if current requirements are insufficient, it does not explicitly create new requirements for the financial industry.

5. Basel Committee on Banking Supervision: Sound Practices for the Management and Supervision of Operational Risk

The Basel Committee on Banking Supervision published a guidance report, *Sound Practices for the Management and Supervision of Operational Risk* ("Basel I"), which named cyber hacks as an operational risk and established parameters that banks could follow to alleviate their risks.[151] This was codified into the *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* ("Basel II"), which required banks to hold more capital against operational risks in addition to financial risks, thereby reducing the amount they can lend.[152] While Basel I and II attempt to regulate capital adequacy amongst international banks, they are not binding on any specific country.[153]

6. The Federal Reserve: Federal Reserve Banks Operating Circular No. 5: *Electronic Access*

The Federal Reserve also outlined specific cybersecurity requirements for firms that use their payment systems.[154] The Federal Reserve Banks Operating Circular No. 5: *Electronic Access* instructed institutions connected to a Reserve Bank's payment systems to implement cybersecurity controls on their internal networks.[155] The controls needed to be "commercially reasonable security measures . . . to prevent disruption to the operations of any Reserve Bank's, and other Institutions' computers, networks, systems and software."[156] In July 2012, the Federal Reserve distributed Operating Circular 6, *Funds Transfers through the FedWire Funds Service*.[157] This required banks that issued or received payment orders online to implement physical security, logical security, and management controls, so that systems connected to FedWire would be protected from illegal access and use.[158]

The beginning note in the circular states,

> Auditors should use these procedures to measure the adequacy of the credit union's IT risk management process, including management awareness and participation, risk assessment, policies and procedures, reporting, ongoing monitoring, and follow-up. This review is intended to assist auditors in determining the effectiveness of a credit union's IT management process. However, auditors may choose to use only particular components of the work program based on the size, complexity, and nature of the credit union's business.[159]

The circulars thus allow for flexibility to fit particular ranges and models of business plans.

C. The Aftermath of a Cyber Attack

Despite the regulations and best practice methods set in place, financial service institutions still face the risks of cyber attacks. Once a financial service institution has been attacked, it is required under the GLB Act to immediately notify its oversight regulatory agency of the incident.[160] The agency then conducts a reasonable investigation to determine whether the information accessed has been or has the potential to be misused.[161] Based on the investigation and the severity of the attack, the institution then determines whether to disclose the attack to the customers involved.[162] If the institution and agency's investigation into the attack involves law enforcement agencies such as the Department of Homeland Security or the Department of Justice, affected customers are notified.[163] If the investigation reveals that the information accessed does not have the potential to be misused or that the severity of the attack was not significant, financial service institutions are not required by federal law to disclose the attack.[164] However, these institutions may still be bound by state law to disclose the attack to affected consumers by reporting their findings to state specific regulatory agencies.[165]

IV. THE EFFECT OF THESE REGULATIONS ON CURRENT DAY FINANCIAL SERVICE INSTITUTIONS

While the need for more effective legislation to regulate cybersecurity has been the push for the past six years, there has been a constant discussion on whether the best approach is pure regulation, regulation with a side of best practice methods, or some other viable strategy.[166] There have been proponents of a pure federal cybersecurity regulatory regime for financial service institutions because such a regime would create "enhanced standards for the largest and most interconnected entities…as well as for services that these entities receive from third parties."[167]

However, there has also been criticism of stringent federal regulatory cybersecurity requirements such as the one proposed by the OCC, FDIC, and the Federal Reserve Board.[168] These stringent requirements join a host of other already-existing mandatory federal cybersecurity regulations addressed above, and they would impose an additional regulatory burden on financial service institutions.[169] Furthermore, because states have the power to mandate even more stringent cybersecurity requirements—such as those proposed by the New York State Department of Financial Service—financial service institutions already face the burden of complying with state-specific laws.[170] With other states potentially following in the wake of New York's stringent cybersecurity requirements and creating their own separate requirements, financial service institutions now have to further assess the compliance costs of all their branch offices and ensure that they comply with state requirements.

The argument has been made that, given the already extensive existing federal cybersecurity regulations and mandated state-specific requirements, increased federal regulation is not necessary and that, instead, a best practice model would be more effective.[171] The frameworks for best practice methods for financial service institutions, as addressed above, allow flexible and risk-based guidelines in order to properly mitigate and evaluate particular cybersecurity risks according to their business plans.[172] Proponents argue that this method is more effective because financial service institutions already face costs in complying with federal and state requirements, so the best practice method allows them to prioritize their risks and address them accordingly, in a voluntary manner, without facing the burden of additional compliance costs.[173] Furthermore, best practice methods avoid the risk of new regulations being duplicative of existing counterparts and becoming outdated as new technological developments evolve.[174]

V. AN EFFECTIVE SOLUTION: HACKING BACK THROUGH CYBER LETTERS OF MARQUE AND REPRISAL

While some have argued that following these best practice frameworks and regulations is effective in putting financial service institutions in a stronger position to combat cyber attacks through efficiency and risk management, financial service institutions should be able to take proactive measures to defend themselves.[175] Active defense is seen as a proactive measure companies can take to defend themselves from a cyber attack.[176] However, this approach is seen as controversial because it includes the idea that companies can "hack back" at intruders.[177] Back hacking is the "process of reverse engineering of hacking efforts, which attempts to stop cyber crimes by identifying attacks on a system and their origin; some definitions also include aggressive active defense actions, such as stealing back what was stolen."[178]

Since the definition of hacking back is unclear and ambiguous, it has been a trending topic for the past two years.[179] For the government to legalize active defense, there needs to be express authorization in order to avoid liability.[180] While the private sector has greater demand for a secure cyber environment, the Computer Fraud and Abuse Act (CFAA) and the Electronic Communications Privacy Act (ECPA) are not comprehensive regulatory and criminal frameworks that should be given deference.[181] Neither the CFAA nor the ECPA makes reference to the internet, so courts can and should fill the gap regarding growing cybersecurity practices due to the absence of definitive legislation.[182] However, this also results in an uncertain legal environment that includes a multitude of state and federal legislative proposals, as well as case law.[183]

The CFAA states that it is illegal for anyone who

> (a) accesses a computer without authorization or exceeds authorized access, and thereby obtains information from any protected computer; (b) Knowingly causes the transmission of a program, information, code, or command, and as a result of such conduct, intentionally causes damage without authorization, to a protected computer; (c) Intentionally accesses a protected computer without authorization, and as a result of such conduct, recklessly causes damage; or (d) Intentionally accesses a protected computer without authorization, and as a result of such conduct, cause[s] damage and loss.[184]

Because this statute has been interpreted broadly, there is uncertainty as to what "authorization," "without authorization," or "exceeds authorized access" means.[185] This thereby assumes that active defense measures that involve accessing an attacker's computer or network to obtain stolen data would likely fall within the CFAA violations.

The ECPA states it is illegal for anyone to

> a) intentionally or purposefully intercept (or endeavor to intercept), disclose or use the contents of any wire, oral, or electronic communication; b) intentionally or purposefully use (or endeavor to use) a device to intercept oral communication.

In addition, the ECPA provides the following definition:

> c) a "device" is any device or apparatus which can be used to intercept a wire, oral, or electronic communication other than a telephone or telegraphy equipment given to the user by a provider of wire or electronic communication and used in the ordinary course of business, or a hearing aid or similar device.[186]

This also assumes that active defense measures that involve accessing an attacker's computer or network to obtain stolen data would likely fall within the ECPA violations. With the limitations in U.S. law, it is clear that there is no express right for active defense measures by private companies against cyber threat actors.[187]

In order for active defense to be a viable option for companies in the financial services sector, the government should be willing to allocate adequate resources to develop a clear regulatory and criminal framework for cybersecurity. As will be discussed in detail below, while some commentators have opposed the use of active defense measures, such as hacking back, there have also been supporters.[188] In 2013, James Lyne conducted a TED talk on everyday cybercrime and what people can do about it.[189] Mr. Lyne showed how active defense techniques could be used to trace hackers by accessing cloud services used by hackers, pinpointing their phone numbers, and using GPS information to locate their office building.[190] Some of the most aggressive active defense tactics have been beaconing, threat counter-intelligence gathering, sinkholing, honeypots, and retaliatory hacking.[191] These tactics are controversial and sometimes violate U.S. law.[192] The Department of Justice states that "based on a simple, plain-text reading of the Computer Fraud and Abuse Act, such conduct is generally unlawful."[193] However, another tactic can be used by companies to defend themselves from cyber attacks, namely cyber letters of marque and reprisal.

Letters of marque and reprisal derive from the Constitution. Article 1, Section 8 allows Congress the power to "provide for calling forth the militia to execute the laws of the Union, suppress insurrections and repel invasions…"[194] This section empowers Congress "to declare War, grant Letters of Marque and Reprisal, and make Rules concerning Capture on Land and Water."[195] Applying this provision to the financial services sector, cyber letters of marque and reprisal would allow U.S. private sector actors to track and even disrupt cyber attacks in certain instances to defend their systems.[196] Cyber letters of marque also restrict the time, place, and manner of the authorized "reprisal."[197]

Most recently, the United States Federal Communications Commission (FCC) utilized a waiver that was analogous to a cyber letter of marque and reprisal. The FCC allowed Jewish community centers to trace threatening phone calls that were sent from a private number.[198] These types of emergency waivers are rare because normally FCC rules allow for calling parties to protect their privacy by blocking their numbers.[199] However, the FCC justified its decision by stating that the threatening calls "pose a new, grave, and immediate danger to the 'safety of life and property' of the call recipients." A cyber letter of marque would similarly allow a private institution to trace an attack and defend its system to ensure public safety, as in the Jewish Community Center situation, where the actual solution adopted was effective because there was a "need to ensure public safety in accordance with the commission's statutory mission."[200] Public safety took "precedence over a caller's interest in maintaining the privacy of his or her telephone number . . . [because that] number [was] associated with the origination of . . . clear threats of unlawful action."[201] Furthermore, this action could potentially bring the perpetrators to justice by expanding tracking ability to help catch and deter any future attacks.[202]

As in the situation of the FCC and the community centers working together, financial service institutions can defend their systems by disrupting cyber attacks if they collaborate with Congress to compile the resources necessary to detect the attacks, and to set express rules that draw a line on procedure and liability.[203] The FCC and the community centers came together to balance out the privacy interests of the calling party with the public safety interests of the centers themselves.[204] Similarly, a letter of marque scheme in the cyber world of financial services would help institutions defend themselves, but there would have to be a balance between civil liberties and privacy.[205] If disrupting cyber attacks means tracking down where the attack is coming from, some civil liberty and privacy concerns might include the following: (1) unintentional disclosure of personal information; (2) hacking an innocent bystander; and (3) liability for the company if the disclosure occurs outside of the United States.[206] Another concern is that financial service institutions may respond "excessively or disproportionately" to external or internal attacks.[207] Some commentators are opposed to the idea of any private company having powers of active defense simply because it wants to protect third parties from suffering significant incidental damages.[208] Another possible concern associated with the use of cyber letters of marque and reprisal is the extent to which companies using this method may detrimentally impact American foreign relations, hinder ongoing U.S. law enforcement investigations, and interfere with security research.[209] There is also the notion that foreign laws may also be violated, raising concerns over the possibility of foreign penalties and extradition requests.[210]

Despite these concerns, financial services institutions in particular should have the option to engage in this type of active defense method. This method would be faster because it would cut down on delays and lags in government investigations and could "significantly drive up the costs that hackers incur, deterring future conduct."[211] Additionally, the "disruption caused by the hack back can raise the cost of hacking in the first place," if there is a possibility of accurately tracing the source of the hack.[212] This can make hackers less effective by giving financial service institutions the opportunity to understand who is conducting the hack, thereby allowing institutions to create effective barriers to entry and regain control of their data.[213] Such a solution was utilized by the FCC in the Jewish Community Center case for a "good cause" to protect the public from an unlawful attack, and the government should provide financial service institutions with the same ability to engage in this method, with some legislative guidance, to protect the public from unlawful cyber attacks.

VI. CONCLUSION

Cybersecurity hacks are among the biggest risks and threats posed to American financial systems, and cyber attacks on financial service institutions have become more frequent, sophisticated, and widespread over time. Consumers have lost confidence in the marketplace as a result. While existing regulations and frameworks allow financial service institutions to be in a stronger position to combat cyber attacks and to follow cybersecurity best practices, these companies still need to defend themselves.[214] Applying a cyber letter of marque scheme would not only provide financial service institutions with the authority to defend themselves from cyber threats, but it would also allow proactive measures to neutralize the threat before that threat escalates to a dangerous point.[215] In addition, a cyber letter of marque regime would regulate prospective cyber threats and ensure responsibility to comply with the letter of marque's terms and with rules of international law.[216] All in all, issuing cyber letters of marque and reprisal is a constitutionally authorized method that Congress and the financial services sector can utilize to fight future cyber attacks.

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Robo-Advisors: Regulation and Design Features for Risk Mitigation

By Melvin Tjon Akon

Introduction

In the wake of the financial crisis of 2008, a new type of investment adviser emerged: the automated investment adviser or "robo-advisor." Robo-advisors provide investment advisory services at a lower price point than traditional investment advisers and are gaining market share. With hundreds of firms offering robo-advisory services and more and more assets under management, robo-advisory is a steadily growing branch of novel financial services collectively known as "Fintech."

As business activities in the financial services industry are subject to regulation, those rules play an important role in the development of technological innovations such as robo-advisory. The purpose of this article is to analyze whether robo-advisors could be designed to comply with existing financial services regulation and the fiduciary duties imposed by such regulation.

Robo-Advisors

Robo-advisors (and the companies offering them) vary widely in the type of investment algorithms they use, the business models under which they operate, the degree of human interaction involved, the methods used to collect information from clients, as well as the quality and quantity of information collected.[1]

All robo-advisors have in common that they are software applications, offered by firms (or natural persons) and designed to automate investment advisory and/or investment management decisions. To make those decisions, robo-advisors generally use asset allocation algorithms based on economic theories to invest the funds of investors, who have varying profiles and preferences. Those theories, which stem from the financial economics academic literature, often include Markowitz's modern portfolio theory,[2] asset pricing models[3] and some use insights from behavioral finance.[4] Robo-advisors are designed to maximize the expected return on a portfolio of investments by choosing from a set of possible investment options, which is limited by both the company offering the robo-advisor's choices and restrictions imposed by the investor's profile and preferences.

How does this work in practice? The client uses an interactive, digital platform (a website, mobile application or other graphical user interface ("GUI")) and provides personal information and other data, such as his or her financial background, age and risk preferences, generally by responding to a questionnaire.[5] Using decision-making control structures for flow control,[6] the software then processes that information and presents the customer with a recommended investment portfolio or trade. The firm offering the robo-advisor has pre-selected the set of financial instruments that can be recommended to the client, which tend to be liquid assets, such as shares, bonds, exchange–traded funds or index trackers (the investment universe).[7] The customer also sets up the investment account, either by granting the software permission to access an account held with a financial institution or by wiring the funds to a designated account. Once this information is provided and all necessary choices are made, the software configures the algorithm that will manage the client's account. Therefore, robo-advisors can be considered automated, because no human assistance or intervention from the firm offering the robo-advisor is required to configure the algorithms and ancillary software to manage the individual customer´s account and portfolio.

Firms use widely varying software architectures and data inputs to build their robo-advisors. Consequently, the GUI, the use of collected client data to generate model portfolios (including the degree of personalization), the algorithm (e.g., whether it uses machine learning to predict market data or uses hardcoded economic assumptions) and the security of the advisory system differ from robo-advisor to robo-advisor. For this reason, it is difficult to make general statements regarding robo-advisors. Instead, the hypothesis under exploration is whether a robo-advisor could be designed such that the regulatory requirements, as set out below, are met.

Business Models

Generally, we can distinguish two types of automated advisors that recommend portfolios, which differ with respect to the degree of automation. Excluded from the analysis are robo-advisors that combine a robo-advisor with a human financial adviser ("hybrid" robo-advisors).[8] The first type is the automated investment or portfolio manager. In this business model, the software recommends a portfolio, automatically makes the necessary trades to allocate the funds to the investments to create the portfolio, rebalances from time to time (as configured) to make sure that the portfolio remains consistent with the investor preferences, and wires any generated funds (returns) to the investor's account. Given that all investment actions are automated, it is considered a *fully automated* model.[9] A recent study suggests that human al-

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location decisions are still preferred over fully automated models.[10]

The second type is the automated investment adviser. This business model primarily differs from the former in that the software chooses and manages a *hypothetical* portfolio. It recommends to the investor how to construct and manage his or her portfolio, without doing so. Therefore, this is a *partly automated* model.[11] Both the automated investment manager and the automated investment adviser will be called robo-advisors, unless otherwise stated.

Product Delivery Models

It is useful to consider the variety in robo-advisory delivery models. Currently, three different delivery models are prevalent. We specifically exclude B2B delivery models from our analysis.

First, a firm can choose to develop and manage the software (in-house development) and offer it directly to its customers, who hold accounts with the firm or have appointed the firm to manage accounts elsewhere for them ("integrated model").[12]

Second, firms can choose to use robo-advisory software under a license granted by a third-party software developer, who normally also manages and updates the software (white label solution). Instead of licensing, firms can also choose to subcontract the development, deployment and management of the software to a third party. In both cases, the end user of the robo-advisor holds an account with the firm, not the third party ("third party contracting model").[13]

In the third model, the firm enters contractual arrangements with an entity which sponsors individual retirement accounts (IRAs) or 401(k) accounts (a plan sponsor). Pursuant to those arrangements, the firm makes the robo-adviser available to the account holders, who can subsequently opt-in and use the robo-advisor ("plan sponsor model").

As the analysis of the regulatory framework set out below shows, the latter two product delivery models involve additional obligations, next to the rules applicable to all product delivery models.

Client-Adviser Relationship Models

A third vector of differentiation between the *business practices* of robo-advisors is the range of offered services and associated representations as set out in the investment agreement with the client. Without considering the enforceability of these provisions, some robo-advisors are said to use agreements waiving fiduciary duties, limiting fiduciary responsibilities and narrowly qualifying the investment advisor's role in the client-adviser relationship.[14] Other robo-advisors clearly declare to be an investment adviser.[15]

It is important to separate the technical aspects of, and the agreements entered by, robo-advisors. The hypothesis under exploration, whether robo-advisors can be designed in a way that ensures compliance with existing regulations, is ultimately a technical matter pertaining to design features.[16]

Regulatory Law; Investment Adviser

Robo-advisors are engaged in the business of providing advice regarding securities and are therefore "advisers" in the sense of the Investment Advisers Act of 1940.[17] Therefore, they must meet the substantive and fiduciary obligations of the 1940 Act.[18] In addition, robo-advisors must comply with the rules of the Securities and Exchange Commission (SEC) issued under the 1940 Act and can benefit from new guidance published by the SEC in February for the purpose thereof.[19]

Pursuant to the 1940 Act, investment advisers have fiduciary duties,[20] which require them to disclose information to their clients. They must, *inter alia*, fully disclose all facts material to the engagement of the adviser, disclose material facts regarding any conflicts of interest and employ reasonable care to avoid misleading clients.[21] The information must also be sufficiently specific so that the client can understand the adviser's business practices and conflicts of interest, presented in a manner likely to be read and understood,[22] and not "buried."[23] Clients are advised to consider this information.[24]

As a fiduciary, the investment advisor also has the duty to only provide investment advice that is suitable for the client based on the client's financial situation and investment objectives.[25] Moreover, the SEC takes the view that if a robo-advisor allows a client to select a portfolio other than that recommended by the robo-advisor, the obligation to act in the client's best interests implies that the robo-advisor should provide commentary if the selected portfolio is unsuitable.[26] In that cases, design features could be "useful to alert the client."

Pursuant to the SEC rules under the 1940 Act, investment advisers are obliged to have a compliance program in place and to appoint a chief compliance officer.[27] Any compliance program promulgated under Rule 206(4)-7 of the 1940 Act must include written policies and procedures that are reviewed annually and reasonably designed to prevent violations of the 1940 Act.

Any compliance program must also take into consideration the nature of the firm's operations and the risk exposures created by such operations.[28] Based on this obligation, robo-advisors may have to consider policies and procedures addressing the development, testing and post-implementation monitoring of the algorithmic code, disclosures of any changes to the algorithmic code that may have an impact on a client's portfolio, as well as appropriate oversight of any third party developer and the protection of key advisory systems.[29] The latter obligation is particularly relevant for firms using the third party contracting model to offer the robo-adviser.

Robo-advisors generally register with the SEC. If robo-advisors provide investment advice exclusively through an interactive website, they fall within the exemption from prohibition on SEC registration in section 203A of the 1940 Act regarding Internet investment advisers, pursuant to SEC Rule 203A-2(e).[30] If the robo-advisor combines automated advice with human advice, which does not exclusively take place over the internet, and the robo-advisor is not registered with the SEC as a large investment adviser or a multi-state adviser, registration and compliance with the New York Investment Advisory Act[31] is required.

Broker-Dealers[32]

A robo-advisor (acting as an automated investment manager), or a company that manages portfolios for clients recommended by robo-advisors, is engaged in the business of effecting transactions in securities for the account of others and can be considered a broker-dealer in the sense of the 1934 Exchange Act[33] (the "1934 Act"). Therefore, it must meet the substantial obligations of the 1934 Act.[34]

Brokers must respect the duty of fair dealing derived from the antifraud provisions of the act, pursuant to which they must deal fairly with customers.[35] Derived from this duty are, *inter alia,* the duties to disclose certain material information, charge prices reasonably related to the prevailing market, and fully disclose any conflicts of interest.[36] Brokers also have the obligation to recommend only specific investments that are suitable for their customers. The concept of suitability involves both reasonable basis suitability and customer-specific suitability.[37]

FINRA has also begun to investigate internal controls implemented by robo-advisors, including how robo-advisors assess customers' risk tolerance.[38] The agency is believed to also be focusing on how robo-advisors record data, the suitability of the advice, and how and when customers can access and alter their investment profiles.

A third relevant duty is the duty of best execution. This duty, which partly stems from the common-law agency duty of loyalty, requires a broker-dealer to obtain the most favorable terms available under the circumstances for its customer orders.[39]

Plan Fiduciary

Under the Employee Retirement Income Security Act of 1974[40] (ERISA), a robo-advisor may be considered a "fiduciary" with respect to a plan, to the extent (i) he or she exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he or she renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he or she has any discretionary authority or discretionary responsibility in the administration of such plan.[41] A company can be a fiduciary either by exercising managerial authority or by possessing administrative authority.[42] This rule particularly affects robo-advisors offered under a plan-sponsor model.

The fees charged in connection with robo-advice are contentious.[43] In *Rosen v. Prudential Retirement Insurance and Annuity Co. et al.*, U.S. District Judge Bolden decided that Prudential (which operated the automated investment adviser program *GoalMaker*) could not be considered a fiduciary based on the initial selection of available investment options (it was up to the plan sponsor to enter into the service agreement), but that Prudential could still be considered a fiduciary if the agreement allowed some discretionary authority to modify the menu of available investment options. The judge also considered that a service provider to an ERISA plan may have fiduciary status if it retains contractual authority to adjust its own compensation and the compensation is not concretely defined in the terms of the plan, which was not the case. The judge concluded that the relevant details of the GoalMaker program were disclosed and that the investment selection was ultimately made by the plan sponsor, dismissing the complaint of the plaintiffs that the GoalMaker program steered assets into proprietary funds and higher-cost investment options without full disclosure. Therefore, Prudential was not considered a fiduciary under ERISA. Note that if considered a plan fiduciary, the robo-advisor must satisfy the fiduciary obligations as set-out in ERISA § 1104 and the rules of the U.S. Department of Labor (DOL).

In April 2016, the DOL introduced the Fiduciary Rule.[44] Under that rule, digital advisers are explicitly recognized as fiduciaries and held responsible for providing investment advice to retirement plans and retirement plan participants consistent with the obligations of a "fiduciary" under the Employee Retirement Income Security Act of 1974.[45] The rule makes clear that a recommendation is fiduciary investment advice when the adviser receives direct or indirect compensation for the advice.[46] A party that provides fiduciary investment advice to plan participants is not permitted to receive payments creating conflicts of interest, such as a commission, unless it falls under a prohibited transaction exemption.[47] This newly introduced Best Interest Contract Exemption contains certain conditions to the advice and applies to fiduciaries receiving level fees.[48] While contested and under review, the Fiduciary Rule is still set to apply as of June 2017.[49]

Comparative Perspective on the U.S. Regulatory Approach

The U.S. regulatory approach taken by the SEC and the DOL, namely to apply existing regulation to robo-advisors, is similar to the approach of European regulators. It is noteworthy that in addition to applying existing regulation, the European regulators also place special emphasis on the policy objectives to stimulate innovation and make robo-advisors available to more consumer segments and not just the most affluent.[50]

Regulatory Risk Mitigation

Given the regulatory directives set out above, what are some design features which robo-advisors could implement to mitigate the associated regulatory risks?

Disclosing Information

Information required to be disclosed must be presented in a manner likely to be read and understood. Given the amount of facts robo-advisers are required to disclose, the design features must be properly tailored to highlight certain facts, for example, if they are new (such as a change in contractual terms) or of relatively greater importance to the customer (a conflict of interest or specific fees). For example, rather than displaying the information in plain text, the GUI can display different icons and colors for different categories of information, with links to more extensive information within those categories, use a conversational interface to interact with the user, or feature a pop–up, as suggested by the SEC in its guidance.[51]

Analyzing Customer Data for Portfolio and Algorithm Configuration

To assess the suitability of a portfolio or to allow the client to adjust a recommended portfolio, sufficient customer data must be collected and analyzed. A robo-advisor could adopt a conversational interface, for example, a "chatbot," to assure that sufficient information is collected. The benefit of conversational interfaces over questionnaires is that they can "learn" from interacting with the client, which enables that interface to capture more and richer information from the client by tailoring successive questions to the client's background, communication habits and prior answers.

Subsequently, the firm can extract relevant information from the collected data using natural language processing algorithms and automate decisions based on that information. This can be achieved, for example, by means of decision trees and control structures that automatically verify if the portfolio parameters satisfy the necessary conditions, and display the information via the GUI. These design features could be applied to the suitability assessment, the selection of the right client accounts (ERISA or non-ERISA covered) and any other regulatory risk management decision involving the assessment of individual customer data.

Monitoring Performance

Many factors, such as the increased use of algorithmic trading, may make it hard to predict market prices of certain liquid securities and amplify systemic risk.[52] At the same time, reliance on assumptions and the absence of continuous monitoring by human analysts may increase the risk of losses due to automated investment management in case of certain events (e.g., "flash crashes").[53] Robo-advisors, both those merely advising customers and those placing orders, should incorporate mechanisms in their algorithms (or supervisory algorithms) to detect and timely respond to such events as well as to minimize the negative impact of those events on clients' accounts (e.g., financial and regulatory risk controls).[54] These design features allow robo-advisers to comply with the duty of reasonable care.

Conclusion

Unlike what some commentators have previously concluded, there is a view that robo-advisors could be designed to comply with the duties imposed by existing regulatory regimes governing human investment advisers. The key to effective compliance is the use of design features that enable the robo-advisor to process the necessary information and perform the necessary actions to meet the regulatory standards. To the extent that the implementation of the necessary design features is not attainable, the robo-advisory software must be designed in a way that enables effective intervention and controls by the firm's compliance personnel.

Endnotes

1. *See, e.g.*, Melanie L. Fein, *Robo-advisors: A Closer Look* (Jun. 30, 2015), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2658701.
2. H. Markowitz, *Portfolio Selection*, The Journal of Finance, Vol. 7, No. 1, March 1952, 77-91.
3. *See, e.g.*, E. Fama and K. French, *Common risk factors in the returns on stocks and bonds*, Journal of Financial Economics, 1993, 33, 3–56.
4. *See e.g.*, R. Shiller, *From Efficient Markets Theory to Behavioral Finance*, Journal of Economic Perspectives, Vol.17, No. 1, 2003, 83-104.
5. This process description is based on the author's personal experience with a number of major robo-advisors.
6. *See, e.g.,* Microsoft's Visual Basic Concepts, accessed via https://msdn.microsoft.com/en-us/ on 7 June 2017.
7. *See Report on Digital Investment Advice*, FINRA 1, 7 (March 2016). Some robo-advisors consider financial instruments (ultimately) issued by a great number of issuers, while other robo-advisors consider a set of proprietary products from a more limited set of issuers.
8. *See, e.g.*, Vanguard Personal Advisor Services, https://investor.vanguard.com, accessed on 7 June 2017.
9. *See, e.g.,* the services offered by Betterment LLC, https://www.betterment.com, accessed on 7 June 2017.
10. *See Bank Customers Don't Want Robo-Advisers Making Financial Decisions for Them,* Fortune (May 30, 2017), available at http://www.fortune.com/2017/05/30/bank-customers-robo-advisers/.
11. *See, e.g.,* capitalize recommends investment strategies, which investors can subsequently run. See http://capitali.se, accessed on 7 June 2017.
12. *See, e.g.,* Betterment LLC, *supra* note 9.

13. *See, e.g.*, KeyPrivate, a robo–advisor offered by KeyTrade Bank which uses algorithms designed by Gambit Financial Solutions, https://www.keytradebank.be, accessed on 7 June 2017.

14. *See generally*, Fein, *supra* note 1.

15. *See e.g.*, SigFig Terms of Service, available via sigfig.com, accessed on 7 June 2017.

16. *See also* SEC Guidance No. 2017-02, *infra* note 19.

17. 15 U.S.C. § 80b-1 *et seq.* These rules apply to each product delivery model.

18. Section 202 (a) (11) 1940 Act. SEC Guidance No. 2017-02.

19. SEC Guidance No. 2017-02, February 2017, Robo-advisers, p. 7-15. This Guidance comes a month after the SEC Office of Compliance Inspections and Examinations released a "priorities letter" listing the robo-advisory industry as a primary focus of the SEC's current examination program. *See* https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2017.pdf.

20. The fiduciary duties are embodied in the 1940 Act. *See also SEC v. Capital Gains Research Bureau, Inc., et al.*, 375 U.S. 180, 186, 194 (1963). SEC Guidance No. 2017-02.

21. *SEC v. Capital Gains Research Bureau, Inc., et al.*, 375 U.S. 180, 186, 194 (1963). *See also In re T. Rowe Price and Associates, Inc., Advisers Act* (Release No. 658 (Jan. 16, 1979).

22. *Amendments to Form ADV*, Advisers Act Release No. 3060 (July 28, 2010); *see also,* SEC Guidance No. 2017-02, *supra* note 19.

23. *Commission Guidance on the Use of Company Web Sites*, Investment Company Act Release No. 28351 (Aug. 1 2008) at 68, in SEC Guidance No. 2017-02.

24. *See e.g.*, *Investor Alert: Automated Investment Tools*, Sec. Exchange Comm, (May 8, 2015); *see also Investor Bulletin: Robo-Advisers*, Sec. Exchange Comm. (Feb. 23, 2017).

25. *See Suitability of Investment Advice Provided by Investment Advisers,* Investment Advisers Act Release No. 1406 (Mar. 16, 1994); *See also* SEC Guidance No. 2017-02, *supra* note 19, at 6. This duty is enforceable under the antifraud provisions of the 1940 Act.

26. *See SEC v. Capital Gains Research Bureau*; *see also*, SEC Guidance No. 2017-02, *supra* note 19.

27. 17 CFR 275.206(4)-7.

28. *See* SEC Guidance No. 2017-02, *supra* note 19, at 7-15.

29. *Id*.

30. 17 CFR 275.203A-2(e).

31. Chapter 961 of the Laws of 1960.

32. *See* 1940 Act and 1934 Act.

33. 15 U.S.C. §§ 78a *et seq*.

34. *See* Section 3(a)(4)(A) of the 1934 Exchange Act; *see also* Section 15(a)(1) 1934 Act.

35. *See* §§ 9(a), 10(b), 15(c)(1) and 15(c)(2) of the 1934 Act.

36. *See Guide to Broker-Dealer Registration*, Sec. Exchange Comm., (Oct. 6, 2009); *see also*, *Report on Digital Investment Advice*, FINRA (Mar. 2016) 1, 7 (stressing that broker-dealers should disclose if the digital advice tool favors certain securities and, if so, explain the reason for the selectivity).

37. *See id.*

38. *See Offering Robo Advice? Prepare for FINRA Scrutiny, On Wall Street*, NASDAQ.com (Jan. 27, 2016), available at: http://www.nasdaq.com/article/offering-robo-advice-prepare-for-finra-scrutiny-cm570897.

39. *See* Securities Exchange Act Release No. 34902 (October 27, 1994), 59 FR 55006, 55007 at n.15 (Nov. 2, 1994); *see also, Newton v. Merrill, Lynch, Pierce, Fenner & Smith*, 135 F.3d 266, 270 (3d Cir. 1998); *and see Best Execution Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets*, Regulatory Notice 15-46 FINRA (Nov. 2015).

40. 29 U.S.C. ch. 18 §§ 1001 *et seq*.

41. 29 U.S.C. §1002(21) (A); *see also U.S. District Court of Connecticut, Rosen v. Prudential Retirement Insurance and Annuity Company, et al.*, Case 3:15-cv-01839-VAB (D.C.T. 2016).

42. 29 U.S.C. §1002(21) (A)(i) and 29 U.S.C. §1002(21) (A)(iii).

43. *See Robo-Advisers Steer 401(k) Plan Litigation Trend*, Bloomberg.com, available at https://www.bna.com/roboadvisers-steer-401k-n57982083440/. A number of other lawsuits have been filed targeting plan fees.

44. 29 CFR 2510.31-2.

45. *See* Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice, 81 Fed. Reg. 20,946 (Apr. 8, 2016). *See also* Morgan Lewis & Bockius—Evolution of Advice—Digital Investment Advisers as Fiduciaries, https://www.morganlewis.com.

46. *See* DOL FAQs January 2017.

47. *See* DOL FAQs October 2016.

48. A level fee is a fee or compensation that is provided based on a fixed percentage of the value of the assets or a set fee that does not vary with the investment recommended. See DOL FAQs October 2016.

49. Two courts have upheld the rule, *U.S District Court of Kansas, Market Synergy Group, Inc. v. U.S. Department of Labor, et al.*, Case No. 16-CV-4083-DDC-KGS (S.D.K.A. 2016). *U.S. District Court of Dallas, Chamber of Commerce of the United States of America, et al. v Hugler and U.S. Department of Labor*, Case 3:16-cv-01476-M (N.D.T.X. 2017). Furthermore, pursuant to a Presidential Memorandum dated February 3, 2017, the DOL is reviewing the rule.

50. European Supervisory Authorities, *Report on automation in financial advice*, p. 11, accessed via https://esas-joint-committee.europa.eu/; European Commission, *Fintech: a more competitive and innovative European financial sector*, consultation document, 23 March 2017, accessed via https://ec.europa.eu/info/finance-consultations-2017-fintech_en. *See also* the Financial Services Action Plan, http://europa.eu/rapid/press-release_IP-17-609_en.htm; European Parliament, Resolution of 17 May 2017 on Fintech: the influence of technology on the future of the financial sector (2016/2243(INI)), P8_TA-PROV(2017)0211, accessed via http://www.europarl.europa.eu/.

51. SEC Guidance No. 2017-02, 7-15. Currently, chatbots are introduced as software applications which combine computer logic, artificial intelligence and natural language processing to mimic human conversation, enabling users to provide or receive information, or use the services of the adviser. *See* S. Brewster, *Do Your Banking with a Chatbot*, MIT Technology Review (May 2016) available at https://www.technologyreview.com/.

52. *See Algorithmic Trading Briefing Note,* Senior Supervisors Group, (Apr. 2015), available at https://www.newyorkfed.org/.

53. *See, e.g.*, *Understanding the Flash Crash: What Happened, Why ETFs Were Affected, and How to Reduce the Risk of Another*, Blackrock Viewpoint (Nov. 2010), available at https://www.blackrock.com/corporate/en-br/literature/whitepaper/understanding-the-flash-crash-nov-2010.pdf; *see also, Findings Regarding the Market Events of May 6, 2010*, Sec. Exchange Comm., (Sept. 30, 2010), available at https://www.sec.gov/news/studies/2010/marketevents-report.pdf.

54. *See, e.g.,* SEC Market Access Rule 15c3–5, codified at 17 CFR 240.15c3-5, which only applies to brokers and dealers with market access. *See also Equity Trading Initiatives: Supervision and Control Practices for Algorithmic Trading Strategies*, FINRA Regulatory Notice 15–09.

Committee Reports

Report of the Incoming Section Chair

The Business Law Section held its Spring Meeting on May 12 at the Harvard Club in New York City. At the Section Meeting luncheon, David Glass, editor of the *NY Business Law Journal*, presented the Section's Law Student Writing Competition awards to Caitlin Dance (New York Law School), first prize, and Lawrence Crane-Moscowitz (Vanderbilt University Law School), second prize. Incoming Section Chair Kathleen Scott made a presentation to outgoing Section Chair Sarah Gold with deep appreciation for her hard work during her tenure. Section liaison Stephanie Bugos' outstanding work for the Section also was acknowledged in a special presentation by outgoing Section Chair Gold. Diversity Committee Chair Anthony Fletcher discussed the committee's mentorship program and solicited attendees to participate.

Kathleen Scott, Section Chair

Report of the Outgoing Section Chair

This year has gone by in a blink of an eye. It seemed like just yesterday we were awarding the service plaque to outgoing Chair David Oppenheim, and now I'm handing over the reins to Kathy Scott. And the Section is in good hands. We have been actively implementing our strategic plan for the Section, and have come along further than we realized. With new committee chairs at the helm, we are having more programs than we have had in prior years, and Section members are getting involved in new ways. We cannot have a successful Section without the involvement and commitment of the members, and our Executive Committee has been focused on maintaining the positive momentum. Our Spring meeting in May featured timely and well-attended programs in Bankruptcy, Banking, and Franchise, keeping our members well-informed and on point on the ever-changing legal landscape.

Our Fall Meeting planning is well under way for a program in New York City and will be timely and prescient in a business environment that is anything but these days. Stay tuned for updates and a forthcoming "save the date" notice.

We also have a new and exciting program in the works, geared to attracting new attorneys to the fold—and those who would like to learn a bit about those sectors of business law that they may not practice. Business Law: Bridging the Gaps will be a full-day program, webcast out of New York City, and will bring together our collective committees to educate and elucidate on topics ranging from banking to non-profits, bankruptcy to securities. Designed to help you as a practitioner understand those topics that you may not ever have taken in law school, this program aims to boost your confidence for those situations when a client comes to you, and you really want to help, but you don't know how to get started.

The state of the Section is strong and we look to keep it that way. But ultimately, we can't do it without you. We are always ready to welcome like-minded practitioners looking to become more involved in the programs and legislative initiatives that the Section has to offer. Involvement is key to keeping our Section active and productive.

If anyone has any questions about the Section or its Committees and programs, please contact me by email at sg@goldlawny.com. I may no longer be chair, but I'm still here to help.

Sarah Gold, Outgoing Section Chair

Banking Law Committee

A Banking Law Committee meeting was held at the Harvard Club on May 12, 2017, in conjunction with the Section's Spring Meeting. We had a strong turnout of Committee Members. The format of the meeting was set up as an interactive panel discussion on various "hot button" regulatory and legal issues. Following the presentations, the Chair moderated a lively and open conversation among the members and the presenters. Materials were distributed to attendees in advance. The topics for discussion were as follows: President Trump's immigration-related Executive Orders and their effect on the provision of banking services; the New York State Department of Financial Services' Final Rule imposing cybersecurity requirements on all entities it licenses or oversees; and the US Court of Appeals ruling (which has been stayed pending rehearing *en banc*) holding the structure of the Consumer Financial Protection Bureau unconstitutional, and its potential implications for the Bureau's actions to date. There was a spirited discussion on all topics, but in particular the Immigration Order issue. Additionally, there was ancillary discussion about the potential for regulatory reform under the Trump Administration. The Committee will meet again during the Section's Fall Meeting.

Tanweer Ansari, Chair

Bankruptcy Law Committee

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

Matt Spero, Chair

Corporations Law Committee

No report submitted.

Derivatives and Structured Products Law Committee

The Derivatives and Structured Products Committee has held four meetings so far this year. The meetings were hosted by Cleary Gottlieb Steen Hamilton (Cleary), Sidley Austin (Sidley), Willkie Farr & Gallagher (Willkie) and Blake, Cassels & Graydon LLP (Blake). As with all our recent meetings, members who could not attend in person were welcomed to participate for CLE credit via teleconference. To date, the topics that have been covered are: (i) Derivative Transactions: Guarantees and Other Forms of Third Party Credit Support (Cleary), (ii) Financial Developments under the Trump Administration (Sidley), (iii) a fireside chat with Eileen Flaherty, Director of the CFTC's Division of Swap Dealer and Intermediary Oversight, which was hosted by Willkie, and (iv) the current regulatory framework for cross-border trading of derivatives with Canadian entities, the status of G20 regulatory reforms in Canada (including uncleared margin rules) and the recent proposal by Canadian regulators to introduce new external business conduct standards for derivatives dealers and advisers (Blake). CLE credit was provided for the Sidley, Cleary and Blake seminars. The meetings continue to be well attended with very active participation by our members, and our topic selections have been largely based on current issues and market practices.

Rhona Ramsay, Chair
Ruth Arnould, Vice Chair

Franchise, Distribution and Licensing Law Committee

On May 12, 2017, the Franchise, Distribution and Licensing Law Committee held a meeting in conjunction with the Business Law Section Spring Meeting at the Harvard Club. At the meeting, Joe Buble and Paul Dailey, tax experts and CPAs with Citrin Cooperman, led a packed room in a discussion entitled: "How the Trump Tax 'Plan' Will Affect Franchise, License and Distribution Businesses." The program included a detailed overview of the Trump Administration's proposed changes to the tax code. An active discussion among all the attendees and Committee members helped to capture the effect those changes might have on franchise, distribution and license businesses. The response to the meeting was extremely positive and the topic well received. One conclusion that all in attendance could agree on is that there will definitely be a need for significant additional discussion once the formal plan is rolled out.

In addition, at the outset of the meeting, the Chair asked the members to provide feedback on the Committee as a whole and requested that members share ideas about future meeting topics and speakers. So far, there have been some excellent suggestions that are presently being explored and are sure to make solid programs. We look forward to additional suggestions and commentary on how we can make the Committee a stronger resource for its members.

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

Justin M. Klein, Chair

Insurance Law Committee

No report submitted.

Legislative Affairs Committee

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

Mike de Freitas, Chair

Not-for-Profit Corporations Law Committee

The Not-for-Profit Corporations Law Committee's years-long efforts to address some of the most problematic provisions and unintended consequences of the Nonprofit Revitalization Act of 2013 culminated in the amendments to the Not-for-Profit Corporation Law signed by Governor Cuomo in late 2016 that became effective on May 27, 2017. To bring these changes to fruition, our Committee, under the leadership of Fred Attea, our prior chair, worked in close collaboration and partnership with Lawyers Alliance for New York, the Nonprofit Coordinating Committee of New York, the New York State Law Revision Commission and the New York City Bar Association. This coalition, in turn, worked with the leadership of the Attorney General's Charities Bureau and with the legislature, with the indispensable assistance of Ron Kennedy, the NYSBA's Director of Governmental Relations, to achieve consensus and passage of the ultimate package of statutory changes.

At the Committee's winter 2017 meeting, we presented a CLE that focused on the aforementioned amendments to the Not-for-Profit Corporation Law and analyzed the impact of these changes. Presenters included Sean Delany, Executive Director of Lawyers Alliance for New York, one of our principal partners in the coalition that proposed and shepherded through these important statutory changes. Committee members Fred Attea, Mike de Freitas, Josh Gewolb and David Goldstein also presented.

A Committee meeting is being planned for the early fall that will include a substantive presentation on an area of interest to practitioners. In addition, the Committee (together with the Trusts and Estates Law Section) is organizing and will be co-sponsoring a full-day CLE program on not-for-profit corporation law and practice to be held in Albany on Thursday, November 30, 2017. The program will also be available live via webcast and will be recorded and archived for on demand viewing.

David Goldstein, Chair

Public Utility Law Committee

No report submitted.

Securities Regulation Committee

At the Spring Meeting of the Section, the Committee and its Private Investment Funds Subcommittee co-hosted a program related to FCPA enforcement matters and gift and entertainment restrictions and other related current topics. Speakers included Alison Conn, Attorney-Adviser in the New York Regional Office of the Securities & Exchange Commission; Scott Black, General Counsel and Chief Compliance Officer at Hudson Bay Capital Management LP; Tram Nguyen, Partner in the Investment Management Practice of Paul Hastings LLP; and John Nowak, Partner in the Investigations and White Collar Defense practice at Paul Hastings LLP.

Other recent topics covered at Securities Regulation Committee Meetings this year included: in January, Skadden litigation partners Susan Saltzstein and Joseph Sacca and Skadden litigation counsel Jeffrey Geier and William O'Brien presented on 2016's most significant securities litigation decisions; in February, Willkie Farr & Gallagher LLP partner James R. Burns discussed the SEC's National Market System Plan Governing the Consolidated Audit Trail, and David R. Lallouz and Michael J. Riela, both partners at Tannenbaum Helpern Syracuse & Hirschtritt LLP, discussed the NY State Department of Financial Services Cybersecurity Regulation; in March, Columbia Law Professor Jeffrey Gordon, and Frederick Alexander, head of Legal Policy at B Lab and counsel at Morris Nichols Arsht & Tunnell, discussed dual class stock issues, while Lee Schneider and Lilya Tessler of Debevoise & Plimpton addressed recent business and regulatory developments in the FinTech industry; in April, Wachtell, Lipton, Rosen & Katz partner David Katz discussed board diversity and corporate governance issues, Goodwin Procter LLP partner Peter LaVigne discussed the FINRA Regulatory Notice 17-06 proposal to amend Rule 2210 (Communications Rules), and Jenner & Block partner Stephen Ascher discussed the resolution of the *Salman v. U.S.* case.

At the time this issue went to press, Morrison and Foerster partners Anna Pinedo and Lloyd Harmetz were scheduled to discuss "All things FINRA" (including proposed updates to the Corporate Financing Rules, Desk Commentary Safe Harbor, Capital Formation Related Rules, Family Office Interpretation of FINRA 5131 and Social Media) on June 20; and Sheelah Kolhatkar, the author of "Black Edge", was scheduled to present to the Committee in July.

Anastasia Rockas, Chair
Kelley Basham, Deputy Chair

Securities Regulation Committee—Private Investment Funds Subcommittee

Apart from the very active schedule of the Securities Regulation Committee itself, detailed above, the Committee's Private Investment Funds Subcommittee has been busy and productive. The Subcommittee holds quarterly meetings focusing on issues affecting private funds, including hedge funds, private equity funds and venture capital funds, as well as sponsors and investors. Last September Igor Rozenblit, co-head of the SEC's Private Funds Unit in the Office of Compliance Inspections and Examinations, led a roundtable discussion of the SEC's areas of focus and recent developments in the examinations process. Then on November 30, May Beth Grover, Ed Rowley and Taylor Ingraham of ASC Advisors, a leading investment management communications firm, presented on the social media landscape. Michael Saarinen, a partner of Alston & Bird in Investment Management, Trading & Markets, and associates Malachi Alston and Allison Muth, led a panel discussion regarding co-investment programs and areas of focus for both sponsors and investors.

The Subcommittee's schedule continued unabated in 2017. In February, Norm Champ, a partner of Kirkland & Ellis and the former Director of the SEC's Division of Investment Management, and Luke Varley, an Investment Funds associate at the firm, presented a seminar on the recent enforcement priorities of the SEC. As this issue went to press, the Subcommittee was scheduled to hold a meeting on June 28 at which the featured guests were to be Jack Rader and Raj Bakhru of ACA Compliance Consultants, a leading compliance firm. They were to present on the most recent examination requests, focus areas and operational risks, including the latest trends on cybersecurity. The Subcommittee is also organizing meetings to discuss the effect of new European regulations on U.S. investment managers.

Kristine Koren, Subcommittee Chair

Technology and Venture Law Committee

The Technology and Venture Law Committee held a meeting in May, in conjunction with the Business Law Section Spring Meeting at the Harvard Club in New York City. The main topic was a presentation by Jocelyn Jacobson, a partner at Reitler Kailas & Rosenblatt LLC in New York City, entitled "Recent Developments in Non-Compete Law as They Affect Venture-Backed Companies." A spirited discussion among the attendees ensued on the ever-changing world of non-competition provision enforceability.

Peter Rothberg, Chair

NEW YORK STATE BAR ASSOCIATION

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Business Law Section Committees

Please designate from the list below those committees in which you wish to participate.

___ Banking Law (BUS 1100)

___ Bankruptcy Law (BUS 1200)

___ Continuing Legal Education (BUS 1020)

___ Corporations Law (BUS 1600)

___ Derivatives and Structured Products Law (BUS 1300)

___ Franchise, Distribution and Licensing Law (BUS 1800)

___ Insurance Law (BUS 1900)

___ Legislative Affairs (BUS 2000)

___ Membership (BUS 2100)

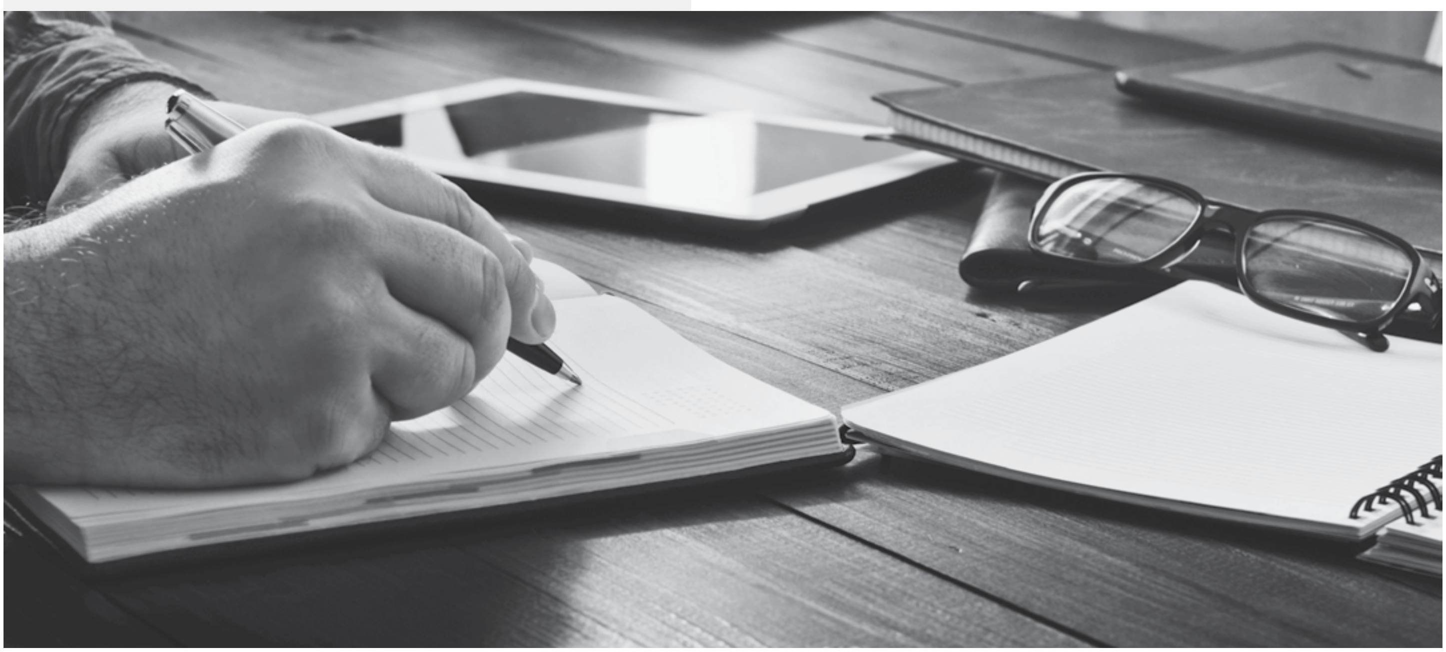
___ Not-for-Profit Corporations Law (BUS 2300)

___ Public Utility Law (BUS 2200)

___ Securities Regulation (BUS 1700)

___ Private Investment Funds Subcommittee (BUS 1703)

___ Technology and Venture Law (BUS 1400)



Publication Policy and Manuscript Guidelines for Authors

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

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

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

Manuscripts are to be submitted to:

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NY Business Law Journal
Macquarie Group Ltd.
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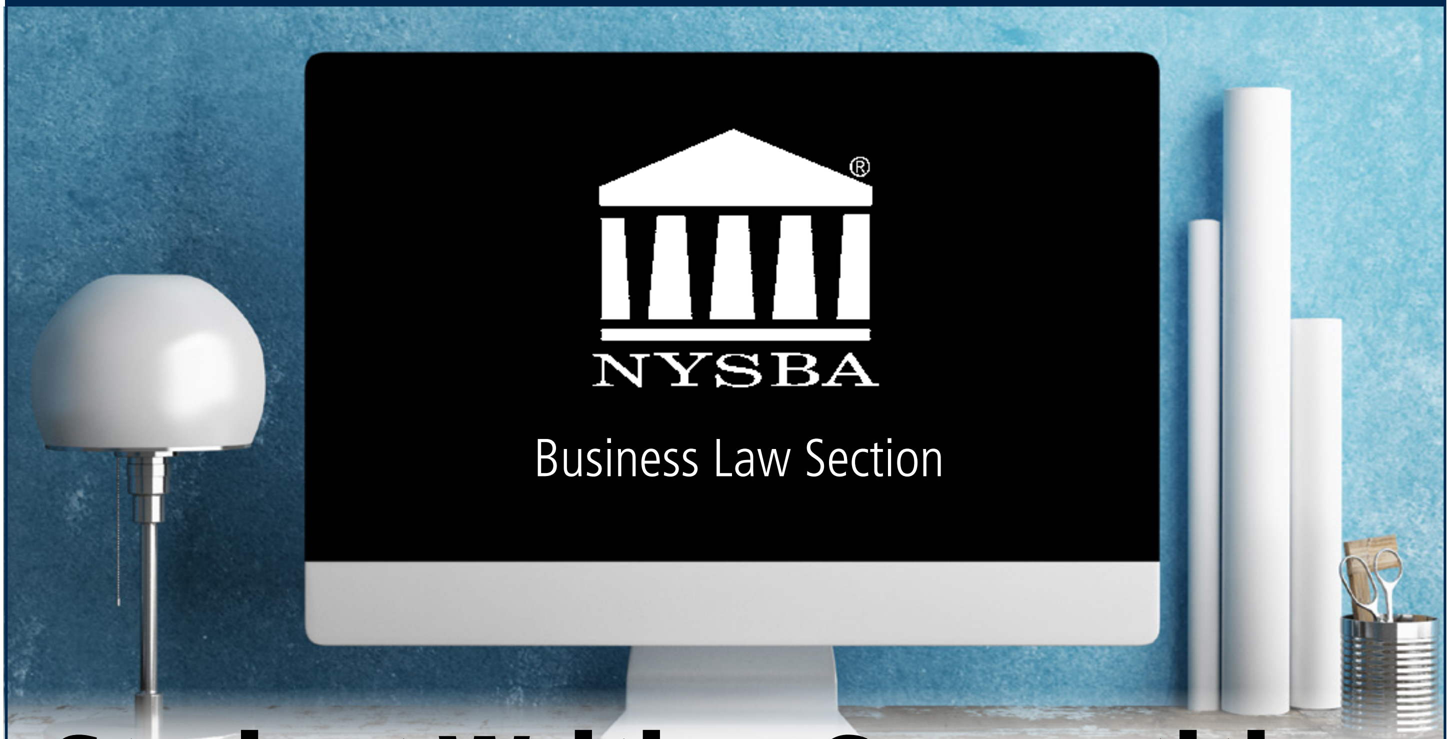

Student Writing Competition

The Business Law Section sponsors an annual Student Writing Competition, open to all students who are candidates for the J.D. or LL.M. degree at an accredited law school during the year in which the article is submitted.

Articles submitted in a given year that are judged first, second and third best, provided they are of publishable quality and otherwise meet the criteria of the Competition, will receive cash prizes of $2,000, $1,500 and $1,000, respectively.

At the discretion of the editors, they also will be published in the *NY Business Law Journal*, which is sponsored by the Section in cooperation with Albany Law School.

Additional cash prizes may be awarded in the discretion of the Section. Entries that do not qualify for cash prizes may also be considered for publication in the *Journal*.

The Editors congratulate the winners of the 2016 Competition:

Caitlin Dance
New York Law School

Lawrence Crane-Moscowitz
Vanderbilt School of Law

Articles submitted will be judged on the following criteria:

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

The manuscript should follow *Bluebook* cite format (using endnotes rather than footnotes) and be a minimum of 3,000 words (there is no maximum). All submissions become the property of the NYSBA and the *NY Business Law Journal*. By submitting an article, the student is deemed to consent to its publication, whether or not a cash prize is awarded. To enter, the student should submit an original, unpublished manuscript in Word format to David L. Glass, Editor-in-Chief, NYSBA *NY Business Law Journal* (david.glass@macquarie.com). The student should include a brief biography, including law school attended, degree for which the student is a candidate, and expected year of graduation.

Visit the Business Law Section at www.nysba.org/BUS.

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