LEGAL ALERT

April 10, 2012

Summary of Selected Programs from SIFMA Compliance & Legal Society's 2012 Annual Seminar

On March 18 - 20, 2012, the Securities Industry and Financial Markets Association (SIFMA) Compliance & Legal Society hosted its annual seminar. Drawing some 1,300 securities industry participants and observers, the seminar constitutes one of the leading educational seminars of its kind.

To share information from this meeting, we are sending a summary of certain selected seminars and workshops to our clients and others. The topics discussed are listed below:

We hope you will find our summary informative. As always, if you have any questions, please contact any of the attorneys listed at the end of this summary.

Feel free to pass this Legal Alert along to your colleagues who may have an interest in the SIFMA conference discussions; click here to sign up for Legal Alerts on this and other topics of interest.

I. Regulatory and Compliance Issues

Keynote Address by Preet Bharara

Preet Bharara, the U.S. Attorney for the Southern District of New York, started the SIFMA conference this year by discussing the role of firms in establishing a culture of integrity. Mr. Bharara emphasized the need for broker-dealers and investment advisery firms to internalize compliance and ethics because, in his view, it is impossible to legislate a culture of integrity. He suggested that firms can facilitate the development of a culture of integrity through their hiring processes. In addition, Mr. Bharara stressed the role of corporate counsel as gatekeepers; he encouraged them to make ethics part of the daily fabric of the company. On a somewhat related note, Mr. Bharara briefly touched on the role and plight of employees who are whistleblowers. He cautioned the audience that it was imperative that firms create a culture where employees can speak up and be heard. The full text of his speech can be found here.

General Session with Mary L. Schapiro

During the general session on March 20, Mary L. Schapiro, Chairman of the U.S. Securities and Exchange Commission (SEC), discussed the successes of the SEC since she rejoined the agency in 2009. She also explained the SEC's ongoing efforts to modernize its infrastructure, processes and procedures in order to effectively fulfill its role in the 21st century by implementing a "comprehensive, forward-looking strategy designed to restructure, re-orient, and refocus the SEC in ways that make[s] [the agency] a much more effective regulator." The full text of her speech can be found here.

Chairman Schapiro described a "re-energized" SEC since her return and enumerated some of the rules recently enacted, including rules "to make money market funds more resilient," rules to strengthen "custody controls that investment advisers must have in place to protect investor assets" and rules to end "'pay-to-play' practices by advisers to public pension plans." Chairman Schapiro noted that, while implementing its investor protection agenda, the SEC was at the same time supporting Congress with respect to the formulation of regulations pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Moreover, to date, the SEC has proposed or adopted more than three-fourths of the more than 100 rules the agency has been directed to write under Dodd-Frank. Chairman Schapiro further noted that, in 2011, the SEC brought more cases than ever before, won orders for more than $2.8 billion in judgments and returned $2.2 billion to "wronged investors."

In addition to the SEC's recent rulemaking and enforcement activities, Chairman Schapiro described the SEC's efforts to modernize its technology to enhance investigations, streamline examinations and facilitate interaction with registrants and investors. The new technology will enable SEC personnel to better perform their jobs by providing them with quicker access to information and modern search technology, making it more likely that SEC staff will find the crucial "needle in the haystack" during investigations. The new technology will also help staff prepare for examinations, thereby making better use of both the examiner's and registrant's time. Chairman Schapiro noted that registrants will also benefit from updated filing technology when EDGAR, the agency's corporate filing system based on technology from the late 1990s, receives a much-needed update.

Regulators' Panel

Head of Enforcement for both the SEC and the Commodity Futures Trading Commission (CFTC) addressed key developments in their agencies as well as expected future changes likely to impact the industry. Staff of both the SEC and CFTC discussed supervisory liability issues. The SEC staff said that its Division of Enforcement already uses its discretion in charging supervisors. Therefore, although rules articulating the standards for charging individuals with supervisor liability would be helpful, such rules likely would not change the substantive standards. The CFTC staff noted that the CFTC has enacted final rules for chief compliance officers of swap dealers.

<u>Staff Review of CFTC Developments:</u> CFTC staff presented a summary of new CFTC rules and enforcement priorities. The staff stressed that the CFTC was interested in bringing actions in which entities or people failed in their gatekeeping obligations.[1] According to CFTC staff, a failure to follow up on red flags can be actionable.

CFTC staff also discussed its Wells process, which departs from the SEC's process in several material ways. Notice by the CFTC can be oral; it will not necessarily be written. The CFTC imposes a page limit on responses and will seek a single response from subjects in a Wells notice rather than separate responses from various subjects.

Settlement of administrative proceedings with the CFTC will involve very little negotiation, according to CFTC staff. If a respondent can establish that one of the "facts" alleged by the CFTC is wrong, then the CFTC will correct it, but otherwise it will not engage in negotiations regarding the factual recitations in any settlement agreement. The staff added that civil monetary penalties are likewise not subject to much negotiation. The staff figures out what it thinks the amount of penalty should be and then communicates this amount to the respondent. The CFTC's offer, therefore, does not presume room for negotiation;

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[1] Click here for "The CFTC Flexes its Enforcement Muscles: Some Tips for Handling CFTC Administrative Proceedings."

unless a respondent can convince the CFTC that its proposed penalty is based on a faulty factual or legal predicate, a respondent should not expect the CFTC to agree to lower the penalty.

CFTC staff briefly mentioned that the CFTC created two new investigative "squads." One of these squads will investigate cases involving market manipulation and destructive trading. The other squad will focus its investigation on swaps.

Staff Review of SEC Developments: SEC staff discussed a recent Second Circuit ruling that stayed proceedings in the Southern District of New York pending appeal of District Court Judge Rakoff's order, which had rejected a proposed settlement between the SEC and Citigroup Global Markets, Inc. (Citigroup). *S.E.C v. Citigroup Global Markets, Inc.*, 2012 WL 851807 (2nd Cir. Mar. 15, 2012). Judge Rakoff's order not only rejected the SEC's settlement with Citigroup, but it also called into question the SEC's practice of allowing parties to settle allegations against them without admitting or denying the allegations. Judge Rakoff stated that "[a]s a matter of law, an allegation that is neither admitted nor denied is simply that, an allegation. It has no evidentiary value and no collateral estoppel effect." *S.E.C v. Citigroup Global Markets*, *Inc.*, 2011 WL 5903733, at *4 (S.D.N.Y. Nov. 28, 2011). The Second Circuit stayed proceedings in the district court after concluding that "the S.E.C. and Citigroup have a strong likelihood of success in their joint effort to overturn the district court's ruling." *S.E.C v. Citigroup Global Markets, Inc.*, 2012 WL 851807, at *6 (2nd Cir. Mar. 15, 2012). The court based this conclusion on a number of factors, including the fact that the district court:

- Presumed that the SEC could prove its case at trial (*Id*. at *3);
- Failed to give "deference to the S.E.C.'s judgment on wholly discretionary matters of policy" (*Id*. at *4);
- Incorrectly "view[ed] that the public interest is disserved by an agency settlement that does not require the defendant's admission of liability" (*Id*. at *5);
- Improperly viewed as its "legitimate concern to protect a private, sophisticated, counseled litigant from a settlement to which it freely consents" (*Id*.); and
- Incorrectly determined that it could "reject a settlement on the basis that liability has not been conclusively determined." (*Id*. at *6.)

SEC staff discussed the reasons why the agency's ability to settle is crucial to its enforcement efforts. The staff stated, for example, that it considers it a positive result for the SEC if it can obtain a settlement for a substantial portion of what it could get at trial without the investment of the time and resources that would be required for a trial. The fact that investors can receive a recovery more quickly was an additional important advantage of settlements for the SEC.

SEC staff discussed some of the benefits of injunctions. The staff said that injunctions serve as notice to the industry and others. According to the staff, injunctions also provide a basis for follow-on administrative proceedings. The staff noted that injunctions are difficult to use as a predicate for a contempt action because a civil contempt action requires that the conduct be ongoing.

The SEC staff reviewed a number of the new tools that the SEC's Division of Enforcement has under Dodd-Frank, including:

- The ability to share privileged information with other government agencies without waiver;
- Setting recklessness as the standard for aiding and abetting liability;
- Expanding aiding and abetting liability to violations under both the 1933 and 1940 Acts;
- Expanded authority for collateral bars; and
- Allowing certain penalties in cease and desist proceedings.

SEC staff reviewed the current status of its whistleblower program.[2] Since the whistleblower rules became effective in August, the SEC's Office of the Whistleblower has received 2,000 telephone calls. About 230 cases are "award eligible." According to the SEC staff, the vast majority of whistleblowers report internally to their employers either prior to contacting the SEC or simultaneously with reporting to the SEC.

Equity Market Structure

A panel consisting of an Associate Director in the SEC's Division of Trading and Markets, legal and compliance representatives from Fidelity Capital Markets and JPMorgan Chase & Co. and outside counsel discussed the characteristics of the equity markets in the 21st century and the challenges facing regulators with respect to making sure regulations keep up with the changing face of equity market structure.

Algorithmic and High Frequency Trading: Market Trends, Oversight Challenges: The panel discussed the increase in "high frequency trading," which the panel defined as "automated trading through frequent orders driven by complex algorithms." The panel noted that the "speed of information flows and order flows is critical to high frequency trading firms."

The panel noted that, given the increase in high frequency trading and resulting perceived issues of fairness, the SEC has taken heightened interest in this type of trading. Regulators appear to be concerned that market participants receive equal access to tools provided by trading centers and utilized to facilitate high frequency trading. For example, with respect to co-location (the practice of a trading center allowing market participants to place their servers within close physical proximity to a trading center's matching engine in order to maximize transaction speed), the panel noted that regulators are concerned that all market participants have an equal opportunity for access to the co-location facility.

The SEC continues to study whether high frequency trading is beneficial or detrimental to the market. In January 2010, the agency issued a Concept Release seeking public comment about both the beneficial and detrimental effects of such trading on the market. *See* Exchange Act Release 61358 (January 13, 2010). The SEC is weighing alternatives for further regulation of high frequency trading, including charging fees for such activity. The panel noted that the question is whether these fees should be structured to discourage this type of activity or simply to recover costs. Two exchanges (NASDAQ and Direct Edge) have recently filed proposals for charging fees for high frequency trading.

Seeking Liquidity: The Changing Role of the Exchanges and Dark Pools: The panel discussed how dark pools (alternative trading systems that do not display bids and offers in the public quotation stream) and other off-exchange trading have diluted the primary role of the exchanges. The panel noted that, despite regulators' concerns about the lack of transparency in "dark" transactions, dark pools have increased liquidity for customer orders and provided additional opportunity for retail price improvement. Dark pools also provide for anonymity, which may be a necessity for some clients. The panel opined that market fragmentation is becoming less of an issue as technology evolves to reduce fragmentation by finding liquidity and reaggregating it.

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[2] For a detailed discussion of the SEC's whistleblower policies as well as suggested steps for firms to take in response to these policies, click here for the Sutherland Legal Alert "Blowing Your Own Whistle: Trumpeting Your Whistleblower Policies in Response to the SEC's New Whistleblower Program."

The panel discussed the NYSE's proposed Retail Liquidity Program, which would create a dark pool under the NYSE available to retail member organizations, thereby allowing member organizations to submit retail orders to the exchange with a new class of market makers. The panel noted that this program raises issues such as fair access (Rule 610 of Regulation NMS) as well as the application of the quote rule (Rule 612 of Regulation NMS) and subpenny quoting. The SEC has not yet ruled on the NYSE's proposal. SIFMA's comments on the proposal can be found here.

The Volcker Rule and Proprietary Trading: The panel discussed the challenges relating to the application of the so-called "Volcker Rule," which restricts banks from proprietary trading and investing in private equity or hedge funds. The version of the proposed rule that was released in October 2011 has been criticized as being too difficult to understand. The panel noted that, as currently written, exemptions to the restrictions on proprietary trading by banks, such as market making and hedging, are unclear. For example, the definition of what constitutes a market maker involves multiple factors, many of which are unclear. The panel noted that, with respect to the hedging exemption, the determination of whether a profit results from hedging activity will be difficult. The proposed rule does not define bid/ask spreads, and it is not known whether such spreads are supposed to move over time for this purpose.

The SEC has received a large number of comment letters on the proposed rule Given that the rule is still in the drafting stage, it is possible that the Federal Reserve will extend some deadlines for implementation. [Editors' Note: Certain senators are expected to introduce legislation in coming weeks to push back the Volcker Rule start date to one year after regulators finalize the rule.]

Circuit Breakers and Limit Up-Limit Down: Addressing Volatility: The panel discussed steps regulators have taken since the May 6, 2010 "flash crash" to curb market volatility: specifically, the Circuit Breaker pilot program and the exchanges' proposed Limit Up-Limit Down plan.

The Circuit Breaker pilot program, initially implemented by FINRA in June 2010 and covering only S&P 500 stocks, has been expanded both in time and scope through successive rulemaking. The program now covers all National Market System (NMS) stocks and runs through July 31, 2012. The circuit breaker rule (FINRA Rule 6121.01) provides for the pause of trading of a covered stock if that stock's price has risen or dropped a certain percentage in five minutes.[3] The pause is intended to provide time for orders to be entered during a time of rapid price fluctuations in order to stabilize the market.

FINRA and the exchanges have also proposed that the SEC implement a "Limit Up-Limit Down" mechanism that would prevent trading in covered equities outside of specific price bands and trigger a five-minute pause in trading if trading were unable to occur within the bands for more than 15 seconds. The SEC has not yet approved the "Limit Up-Limit Down" rule proposal.

The panel noted the CFTC has also taken steps to address market volatility and that coordination between the SEC and CFTC could be a challenge.

Comparing U.S. and Key Foreign Market Structures: The panel discussed foreign market structures and differences with market structure in the U.S. The European Union now has 90 regulated markets and more than 130 alternative trading systems (ATS). Standardization throughout these markets and ATSs is

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[3] The percentage threshold for triggering the pause in trading is 10% for most stocks, but, for the final group of securities included in the pilot program (referred to by the Commission as Phase III securities), the threshold triggering the pause is 30% for those securities priced at $1 or higher and 50% for such securities priced less than $1. This increased threshold for Phase III stocks, which is not included in the various stock indices, recognizes that these types of stocks are by nature more volatile.

an issue. For example, there is no standardization for consolidated tapes and no limit on tick size. The EU is currently engaged in formulating additional legislation that may address some of these issues.

State Regulatory Update

This panel consisted of representatives from the Alabama Securities Commission and the New York State Attorney General's Office, representatives of Edward Jones and Morgan Stanley, as well as outside counsel.

The panel first discussed the impact of Dodd-Frank on state regulation, focusing on the switch of investment adviser oversight from federal to state regulators, as is now required by Dodd-Frank for advisers with assets under management of between $25 million and $100 million. Until now, advisers could register with the SEC with as little as $25 million under management; this change will go into effect this year. The panel discussed resources available to investment advisers making the switch, including the North American Securities Administrators Association (NASAA) IA Switch Resource Center, available here. Staff for the New York State Attorney General's Office stated that there would not be a new state exam program; investment advisers will continue to be examined by the SEC.

Second, the panel discussed the standard of care for industry professionals when rendering investment advice. Panel members noted that NASAA's position is that there should be a uniform standard for brokers and investment advisers. Also, arbitration panels almost uniformly apply the same standard, and the public has no appreciation of the difference between investment advisers and brokers.

Finally, the panel reviewed the current landscape of enforcement actions and examination priorities at the state level. Its list of examination and enforcement priorities consisted of:

- Private placements;
- Structured products;
- Hybrid securities;
- Distressed real estate pools;
- Pension fraud;
- Affinity fraud;
- Elderly investors; and
- Ponzi schemes.

Private Client Sales Practice Issues

This panel included FINRA staff and representatives of Raymond James & Co., RBC Wealth Management, Fidelity Investments and Morgan Stanley Smith Barney, as well as private sector counsel.

Sale of Complex Products: The panel first addressed issues relating to the sale of new and complex products. The panel discussed two FINRA Notices to Members related to this issue: NTM 05-59, *NASD Provides Guidance Concerning the Sale of Structured Products*; and NTM 05-26, *NASD Recommends Best Practices for Reviewing New Products*. The panel discussed how training should be conducted on new products. Speakers stressed that wholesalers should not conduct training and that brokers should be instructed on marketing issues for a product only after the firm has first established a sufficient foundation of knowledge of the product through training of the broker. The panel also mentioned the need to re-evaluate new products within the first six months to one year in order to ensure that the product operates as expected and that the brokers are selling as intended. Finally, the panel addressed the need to document all training, including the materials used, the individuals presenting and the attendees.

Due Diligence for New Products: The panel discussed some of the necessary elements of due diligence reviews of new products, including:

- An initial high-level review of the product;
- An analysis of operational issues relating to the product (for example, how will the new product be categorized on statements?);
- A focus on fees (both their reasonableness and transparency); and
- Documentation of the due diligence process (including through committee minutes).[4]

The panel suggested that firms create forms for their clients, boiling down the key terms of the prospectus and have their clients sign these forms in connection with any purchase. It was also suggested that firms include a specific disclosure on each monthly statement.

FINRA Staff Discussion: FINRA staff focused on: (1) product training; (2) suitability issues; and (3) senior investors. The staff emphasized the need for firms to ensure that their representatives understand the products they sell. Additionally, FINRA stated that firms should currently train representatives on the new FINRA suitability rule, although FINRA Rule 2111 does not go into effect until July 9, 2012.[5] FINRA staff discussed senior investors and noted that the fastest growing segment of society was individuals over 85. FINRA discussed its 2011 survey of the use of senior designations by broker-dealers and the special issues for senior investors (including limited time horizon for investments and potential need for greater liquidity).

Private Client Firms: Key Legal and Regulatory Issues

The panel began with a discussion of FINRA's new suitability and know-your-customer rules, Rule 2090 and Rule 2111, which will take effect July 9, 2012.[6] Regulatory Notices 11-02 and 11-25 provide guidance on these rules. Rule 2090, modeled after NYSE Rule 405(1), requires firms to use "reasonable diligence" to learn the "essential facts" concerning every customer who opens or maintains an account, regardless of whether the broker has made a recommendation.

One of the factors mentioned in the regulatory notice about the know-your-customer obligation is third-party authority. Thus, firms should take a closer look than they did in the past at the scope of the authority of third parties over customer accounts.

FINRA Rule 2111, modeled after NASD Rule 2310, requires firms or associated persons to have "a reasonable basis to believe that a recommended transaction of investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile." The suitability rule applies not only to recommended purchases or sales of a security, but also to any recommended "strategy." The word "strategy" applies to explicit holder claims. The panel remarked on the novel concept that inactivity might be viewed as an "investment strategy."

[4] For a discussion of best practices when drafting corporate minutes, click here for "Preparing Corporate Minutes: Time Well Spent."

[5] For an analysis of this and other suitability rule changes, click here for the Sutherland Legal Alert, "Significant Changes to FINRA's Know Your Customer and Suitability Rules to Take Effect in 2011."

[6] As stated above, an analysis of this and other suitability rule changes can be found here, in "Significant Changes to FINRA's Know Your Customer and Suitability Rules to Take Effect in 2011."

The suitability rule requires firms to collect data points in the customer profile, including age, investment experience, time horizon, liquidity needs, risk tolerance, other holdings, financial situation and needs, tax status and investment objectives. This rule applies to existing accounts as well as to new accounts. Broker-dealers do not have to collect information about all factors from every customer, but if a firm or its broker chooses not to collect information about any of the factors, it is required to document why it believes that factor is not relevant to the particular customer.

The suitability rule imposes three separate suitability obligations: (1) reasonable basis suitability, which requires that the firm have a reasonable basis to believe the security is suitable for at least some customers; (2) customer-specific suitability, similar to the current suitability analysis under NASD Rule 2310; and (3) quantitative suitability, which focuses on the number of recommended transactions in a customer's account within a time period—in other words, churning.

The new reasonable basis suitability assessment focuses on the firm's due diligence and broker training obligations. Reasonable basis suitability requires broker-dealers to act as "gatekeepers," particularly with respect to approval of complex products, before the products are offered to customers and to ensure that their representatives are trained in these products before they can sell them.

The panel noted that firms may wish to have a dedicated committee to determine whether a complex or structured product passes reasonable basis suitability. The panel mentioned several considerations that may be relevant to the reasonable basis suitability analysis, including the following: (1) Are there less complex or less costly alternatives? (2) Is there a detailed explanation of the product? (3) How do you adequately disclose the details of a complex product to a retail customer? (4) Do you need to prequalify customers before they purchase a structured product, similar to options?

Institutional investors are exempt from the customer-specific provisions of the suitability rule where the broker has a reasonable basis to believe that the customer is capable of evaluating investment risks independently and where the institutional customer "affirmatively acknowledges" that it is exercising independent judgment. To qualify for the institutional investor exemption, an institutional investor must have $50 million in assets. Firms should obtain written representation of the client's assets, so an institutional customer that refuses to sign a representation letter might not qualify. In anticipation of the institutional investor exemption, SIFMA and member firms have developed a standardized certificate that numerous broker-dealers intend to use to satisfy the obligation that institutional investors "affirmatively acknowledge" their independent judgment.

The panel generally discussed the likely overall implications of the new suitability rule for firms, including increased record keeping requirements and a greater need for training and supervision of potential suitability issues.

The panel also discussed FINRA's guidance regarding the use of social media and broker-dealer compliance review of social media use. Regulatory Notice 11-39, released in August 2011, addresses social media websites and the use of personal devices. This regulatory notice incorporates Notice to Members 10-06, which addresses correspondence review. A firm's review of social media communications must comply with the same rules that apply to the firm's correspondence review. FINRA has stated that social media and electronic communications and, in particular, recordkeeping and supervision related to social media and electronic communications, are among its exam priorities in 2012.

A preliminary question for compliance review is whether a social media post qualifies as a "communication" triggering review. For example, a review on LinkedIn is not a "communication," but a list of products offered by the firm might be. Because discussion of products via social media will trigger compliance obligations, firms should not allow their financial advisers to make product "testimonials" online. Third-party posts and websites are not subject to compliance review, unless they have become entangled with the broker-dealer or otherwise adopted by the broker-dealer. For example, if the broker-dealer's logo appears on the third-party's website, this would raise the question of whether the website has become "entangled" with the firm so as to trigger compliance review.

The panel also discussed the implications of electronic communications and social media for compliance with rules related to outside business activities. Rule 3270 requires "prior written notice" of outside business activities. It is suggested that, as a best practice, firms should adopt a requirement that financial advisers seek approval from their firms in advance of beginning an outside business activity so as to allow the approval process to work. Email surveillance remains the best way to detect unapproved outside business activities. In addition, firm compliance departments may wish to conduct Google searches of the names of financial advisers, along with LinkedIn and Facebook searches, to improve detection of unauthorized outside business activities by their representatives.

Finally, because communications on personal devices are subject to review, firms that allow financial advisers to use personal devices to communicate may want to consider an application that separates out personal communications from communications made in the adviser's advisory capacity.

Other topics addressed in the panel included the SEC's anticipated progress in implementing provisions of Dodd-Frank in 2012; social media guidance for investment advisers; issues presented by complex and non-traditional products, addressed in Regulatory Notice 12-03; and developments regarding fees and services, including proposed FINRA rules addressing fees.

The General Counsel Roundtable

This panel included representatives of various broker-dealers in addition to private sector counsel. The panel addressed a number of issues that in-house counsel face regularly. Panelists explained that the problems in-house counsel deal with are often not purely legal, but also have implications for business, investors, and the government. Some of those issues include the following:

<u>Dealing with the Press:</u> Because press coverage affects the public's perception of events, the panel discussed the importance of keeping the corporate communications group involved with issues so that they can quickly respond. The panel also advised that it sometimes makes sense for outside counsel to reach out to the press to correct misstated facts.

<u>Whether to disclose a Wells notification:</u> While there are no bright line tests, most of the panel said that Wells notifications on significant issues should be disclosed. Investors often look to see whether such events have been disclosed. Additionally, plaintiffs' counsel often highlight a lack of disclosure in subsequent litigation.

<u>Supervisor and CCO liability:</u> In light of the industry attention on the *Urban* case (*In the matter of Theodore W. Urban*, Adm. Proc. File No. 3-13655, Initial Decision (Sept. 8, 2010)) and the subsequent developments in this case, there was, not surprisingly, a discussion of supervisor liability.[7] The panel agreed that the following are important issues to focus on: clear reporting lines; the role of the lawyer

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[7] For a detailed discussion of the SEC's *Theodore W. Urban* decision, click here for the article "*Whither Supervision? In the Matter of Theodore W. Urban*;" click here for "*While You Were Complying: SEC and FINRA Disciplinary Actions Taken Against Chief Compliance Officers (Again)*;" click here for "*The Girl with the SEC/FINRA Tattoo: Disciplinary Actions Taken Against Chief Compliance Officers (November 2010—June 2011)*" and click here for "*Sutherland's Cliff Kirsch on Legal/Compliance Officer Liability*."

when he or she gets involved in a situation; and, at times, hiring outside counsel to provide in-house counsel with support as well as to substantiate that the in-house counsel is acting as a lawyer and not as a business person.

Compliance for Large Private Client Firms

In addition to private sector counsel, this panel included representatives of UBS Wealth Management Americas, Fidelity Investments, Morgan Stanley Smith Barney and Wells Fargo Advisors, LLC as well as FINRA staff.

This session focused on how large firms are dealing with the recent wave of legal and regulatory changes, from Dodd-Frank to FINRA's rulebook consolidation. The panelists discussed methods to keep up with all of the pending proposals and rulemakings. Among the suggestions were signing up for legal alerts from law firms and regulators. The panelists also discussed creating committees to work on proposals and rule implementation within the firm. These committees should be multi-disciplinary and include legal, compliance, business, technology and subject matter experts. It was emphasized that the technology department needs to be brought into the process early to plan and budget for implementation. Panel members also suggested that firms should perform risk assessments for new rules, in a manner similar to how firms perform risk assessment for new products.

The panel also addressed complex products and the regulatory notices regarding these products. The panel acknowledged that firms would like more guidance from regulators. The panel also discussed the merits of financial adviser certifications as well as client certifications. Many agreed that it is difficult to prove customer understanding years after a transaction took place. Client certifications, therefore, can be valuable to establish customer understanding.

Managing Legal Issues for Small and Regional Firms

In addition to outside counsel, this panel included representatives of D.A. Davidson & Co., Piper Jaffray & Co., Robert W. Baird & Co. Inc., and Stifel, Nicolaus & Company, Inc.

The panel discussed the *Urban* case and the importance of policies and procedures both specifying supervisory roles and being clear about the legal function.[8] Panelists also discussed that retaining outside counsel may further protect the legal function by demonstrating that in-house counsel was not functioning as management.

The panel also discussed risk management, focusing on the business line's tone at the top and the importance of including key support functions in risk assessments. Regarding FINRA's risk assessment survey, the panel questioned whether it was truly "voluntary" and noted that the survey was an example of how FINRA was using risk assessment more and changing the way that it investigates firms.

The panel noted that it was difficult for small firms to handle foreign accounts because of various legal and logistical issues. Finally, the panel discussed the importance of not only adequate policies and procedures but also effective implementation and training regarding those procedures.

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[8] For a detailed discussion of the *Urban* case as well as supplementary materials regarding this decision specifically and supervisory issues in general, *see* The General Counsel Roundtable *supra*.

Internal Investigation

A panel with members from Citigroup, Bank of New York Mellon and outside counsel discussed a hypothetical involving a whistleblower and reviewed the impact of Dodd-Frank on the handling of alleged internal wrongdoing. The panel discussed some of the ways the whistleblower protection provisions under Section 922 of Dodd-Frank may impact the role traditionally played by in-house counsel and compliance personnel in the investigation and remedy of alleged internal wrongdoing.[9] The panel noted that in-house counsel generally do not qualify as "whistleblowers" unless the subject entity fails to disclose the misconduct to the SEC within a reasonable time or proceeds in bad faith. The Dodd-Frank whistleblower provisions apply to all companies, including non-public companies, and, thus, are substantially broader than the Sarbanes-Oxley whistleblower provisions, which are limited to public companies and their contractors and agents.

The panel offered the following advice for firms dealing with whistleblowers:

- It may make sense to try to identify the whistleblower to learn more facts (although the firm must not fire or intimidate that person);
- It may be appropriate for in-house counsel to investigate if they are separate from the relevant business function;
- Firms need to be careful about who knows about the allegations and the investigation to prevent leaks to the press or other whistleblowers, to prevent tampering with the evidence, and to keep the attorney-client privilege from being waived;
- It may make sense to hire an outside law firm that has no ties to the firm if senior management's conduct is at issue;
- Timing is important because the whistleblower has 120 days to report to the SEC after internal reporting and still have the SEC report be deemed as contemporaneous with the internal report;[10]
- Firms need to consider when to report to the regulators because there is a tension between reporting early with not enough facts and reporting too late;
- Outside communications firms can play an important role but firms need to be careful about whether communications with such firms are protected by the privilege;
- For Rule 4530 reporting, firms may need internal processes and documentation of the firm's conduct;
- Firms should be careful about trying to protect the privilege but may want to waive it at some point;
- Selective waiver may be problematic because some courts have ruled that it would waive all privileges;
- Firms may be able to disclose underlying facts without disclosing confidential communications;
- Outside counsel may be able to provide oral reports, rather than written, without waiving the privilege; and
- When dealing with auditors, it may be appropriate to provide them with facts, but firms should know that all information provided to auditors will end up in the work papers, which could ultimately be produced to regulators or litigants.

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[9] For a detailed discussion of the SEC's whistleblower policies as well as suggested steps for firms to take to respond to these policies, click here for the Sutherland Legal Alert, "Blowing Your Own Whistle: Trumpeting Your Whistleblower Policies in Response to the SEC's New Whistleblower Program."

[10] This is important because a whistleblower is only entitled to compensation if he/she provides original information, but the information that he/she provides is deemed original if it was internally reported by the whistleblower prior to other discovery by the SEC as long as the whistleblower reports to the SEC within this 120-day period. *See* Rule 21F-4(b)(7).

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Emerging Technologies and New Ways of Communicating

The panel discussed regulatory issues arising from the increasing use of social media websites, such as LinkedIn and Facebook, in the securities industry. The panel emphasized that regulators have repeatedly stated that the use of social media by firm employees during the course of business is subject to FINRA and SEC rules relating to books and records retention, public appearances and advertising. The applicable rule will depend on the content communicated via social media. Firms have a duty to monitor content posted by their employees on social media sites during the course of business in order to ensure compliance with regulations. Firms also have a duty to retain social media content posted for business purposes for the same amount of time they must retain other documentation. Therefore, it is imperative that—before allowing its employees to utilize a social media site for business purposes—a firm has the technological capability to monitor and retain content from that site in accordance with the applicable rules.

The panel noted that FINRA recently issued regulatory notices where it has drawn a distinction between static posts and interactive posts on social media sites with respect to the point in time when the post must receive firm approval. Static posts—that is, posts that do not involve interaction with third parties—are considered to be advertisement and thus, require firm approval before being posted pursuant to FINRA Rule 2210. Interactive posts—that is, posts that involve interaction with third parties—are considered to be public appearances and, thus, require approval after the post has been made.

The panel noted that the rules for investment advisers with respect to social media differ somewhat from the rules for broker-dealers and flatly ban testimonial ads, including testimonials via social networking sites. This raises the question of whether a third party "liking" an investment adviser on Facebook is considered a testimonial ad that violates investment adviser rules. The panel noted that Massachusetts has provided that a simple "like" on Facebook, without additional comment, is not a testimonial. However, the SEC has not specifically addressed at what point a third-party comment becomes a testimonial.

The panel noted that Twitter can be problematic because its 140-character limit makes it difficult for investment professionals to provide fair and accurate information.

The panel drew the distinction between use of social media by firm employees to conduct business with the personal use of social media by firm employees. The panel noted that a firm does not have a duty to monitor its employees' personal use of social media. However, the firm should have a policy in place to monitor an employee's personal use of social media if that employee has in the past disregarded firm policies with respect to the separation of personal and professional communication, such as by sending business-related emails from a personal email account.

According to the panel, the bottom line is that a firm's social media usage policy must be well thought out and carefully planned. The firm should decide which social media is permissible, based in part on the firm's ability to monitor and retain data from that site. The firm should also determine the type of activity permissible on the social media site, i.e., will the firm allow static communication, interactive communication, or both? The firm should also determine who at the firm will be permitted to use social media to conduct business and what third parties will be able to view the social media, i.e., will it be available to the general public or restricted to clients? The panel suggested various best practices for ensuring that the firm's use of social media does not run afoul of regulations. These best practices include the use of written supervisory procedures that explicitly set forth what is and what is not permissible when using social media during the course of business as well as the use of a committee to review potential social media outlets to establish guidelines for the use of this media.

II. Regulatory Issues with Particular Products

Swaps and OTC Derivatives Panel

In addition to private sector counsel, this panel included representatives of Nomura Securities International, Barclays Capital, Bank of America Merrill Lynch, and Goldman Sachs, as well as SEC staff. The panel noted that the CFTC is significantly further along than the SEC in promulgating rules relating to swaps and OTC derivatives.[11] The SEC is considering issuing two releases as well as its cross-border rule under Title VII of Dodd-Frank simultaneously so that there is consistency across rules. The SEC will probably issue these releases and the cross-border rule in the second half of this year.

The panel noted that among the provisions that await agency action are a number of definitional provisions. Finalizing the definitions is important since it will have downstream implications for many statutes and implementation by firms. Further, the territorial application of certain definitions is still unclear, so firms may need to comply with regulations while their scope remains unclear.

According to SEC staff, the agency understands that there will be implementation challenges for firms adjusting to the new rules for swaps and OTC derivatives. Consequently, the SEC will likely institute a phase-in period rather than adopt a "big bang" approach. There will, therefore, be time for firms to come into compliance with the new rules and build out their systems in order to ensure ongoing compliance. The interdependency of the rules will also likely lead to the phasing-in of some rules. SEC staff noted that the order in which new rules are adopted will not necessarily be the same as the order in which the rules will come online.

The panel discussed the similar idea that several different regulatory schemes with similar provisions might be phased in over time, leading to successive iterations of compliance initiatives. As an example, speakers discussed the possibility of various overlapping suitability requirements coming into effect over time from FINRA, the CFTC and the SEC.

The panel discussed a number of issues that are still unresolved. For example, one of the big unknowns is how the agencies will deal with legacy portfolios. Also, the consideration of guarantees as a form of swap has significant consequences that have not been addressed. Other issues include whether a holding company which is a guarantor would be considered an entity subject to registration; for inter-affiliate transactions, whether risk can reside in an entity different from the one conducting the transaction; and which rules should apply to securities-based swaps (which are securities) and how to articulate the ones that do apply.

The panel reviewed some of the unresolved issues relating to margin requirements. If the margin requirements require models with a statistical confidence interval of 99% and a ten-day horizon, this would imply that a significantly greater amount of margin is required than what is currently used for futures and cleared swaps (maybe 40% to 100% more). There is a concern that not enough very high quality collateral is being discussed under the proposals, which could, therefore, have liquidity implications.

[11] For a discussion of some of the major CFTC rule adoptions relating to swaps, click here for the Sutherland Legal Alert, "CFTC Holds First Open Meeting of 2012 and Finalizes Key Rulemakings Under the Dodd-Frank Act."

Fixed Income Derivatives and Securitized Investments

In addition to private sector counsel, this panel included representatives of Barclays Capital, Bank of America Merrill Lynch, Citigroup Global Markets, Inc., Credit Suisse, and RBS Global Banking & Markets Americas. The panel discussed the sea change in how firms will do business in the fixed income area as a result of Dodd-Frank in general and the Volcker Rule (Section 619 of Dodd-Frank) specifically.[12] The panel noted that there is a perception that fixed income markets should look more like the equity markets, and the rules enacted pursuant to Dodd-Frank will result in some convergence of the features between the markets. There are, however, structural reasons for treating the markets differently. The panel also noted that the new rules would leave out the Treasury markets, despite the fact that Treasuries are most similar to equities.

The panel discussed the immediate challenge of how to prepare for compliance changes based on the Volcker Rule since the actual language of the rule is still significantly in flux. Several aspects of the Volcker Rule, however, are already clear: it will apply to the operations of US banks worldwide and the US operations of foreign banks; it will also apply to certain instruments in a trading account (with various exceptions). The proposed regulations leave many questions, however, about the scope of these exceptions and create uncertainty about whether the exceptions can be relied upon. For example, a hedge is not supposed to create significant new risks, but it may increase different types of risk, like counterparty risk. It is unclear how the Volcker Rule will address this issue.

If a covered institution wants to prepare for the new fixed income rules, the panel recommended that it conduct detailed impact assessments, with a particular focus on current firm technologies. Because so many parts of the regulation are yet unknown, it is difficult to be too detailed, but firms can do a “deep look” at their metrics to see what their businesses look like. Because the rules are designed to require firms to show that what they are doing is permitted, rather than show that they did not violate a standard, it may be necessary to know the nitty-gritty of operations. One question firms should ask is whether the information that will be needed under the new regulations can be captured with existing technology or whether the firm’s technology will need to be updated. Under the new regulations, it is likely that businesses and products will need to be better documented and the sources of profit and loss better understood. These documentation requirements will pose huge challenges.

The panel discussed the effect of Dodd-Frank on attorneys practicing in the derivatives field. Until Dodd-Frank’s rules are clearer, derivatives lawyers will need to become more comfortable with ambiguity. Additionally, lawyers will need to become more conversant with the technical aspects of the operations of their client firms, e.g., how trades are processed and how systems work, so that they can advise operations employees on the best methods to assure compliance.

Commodities, Futures and Energy Issues

The panel—consisting of a branch chief for the Federal Energy Regulatory Commission (FERC), in-house counsel for the Newedge Group and outside counsel—discussed issues relating to the regulation of commodity transactions, including the effect of Title VII of Dodd-Frank on these transactions.

[12] The Volcker Rule prohibits banking entities from entering into certain relationships with hedge funds and private equity funds as well as engaging in certain proprietary trading. For a detailed discussion of the Volcker Rule (with a focus on its effect on insurance companies) click here for the Sutherland Legal Alert “The Financial Stability Oversight Council Holds Inaugural Meeting; Proposed Rulemakings on Nonbank Financial Companies and the Volcker Rule Will Impact Insurers.”

The panel discussed potential factors that regulators might take into consideration when evaluating whether a transaction or group of transactions is manipulative. The panelists noted that the bottom line is that a manipulation inquiry is fact-intensive. The intent of a transaction is key, because scienter is an important factor of market manipulation. If the intent is to earn a profit in the cash and swaps market, the transaction or transactions may not constitute market manipulation. The panel noted that inter-day activity, which may show a trader's intent, is sometimes overlooked by compliance personnel.

The panel discussed Constellation Energy's settlement with FERC. It noted that the monitoring requirements imposed by the settlement, which requires Constellation to monitor trading profit and loss, appear to require Constellation to monitor activity differently from what is considered industry standard. Traders tend to look at portfolio profit and loss rather than trading profit and loss. The panel also noted that the Constellation order named individuals, which indicates an increased willingness by regulators to go after individuals potentially engaging in manipulative activity.

The panel discussed the CFTC's new rule regarding Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, which goes into effect on April 17, 2012. The panel noted that the rule, which prescribes external business conduct standards for swap dealers and major swap participants, potentially makes those firms quasi-broker-dealers. Under the new rules, firms will have to make certain disclosures, modify their documentation and monitor representations made by their sales forces. Firms may need to start thinking about counterparties differently and may need to proceduralize fairness into their compliance metrics. This may require the involvement of their IT personnel, the front office and the sales force. Additionally, swap dealer interactions with special entities may give rise to fiduciary duties subject to enforcement by the CFTC, as well as private rights of action. The panel noted that the rule may require a change in firm culture, and the counterparty mindset may have to be jettisoned.

The panel also discussed extraterritorial limits of the Business Conduct Standards. The panel noted that, until now, it has been relatively easy to conduct transactions in the United States from elsewhere. However, under the new rule, there are different paths for conducting international transactions. The CFTC announced it will be issuing guidance in the near future regarding certain international issues. It remains to be seen whether international regulators will be able to harmonize their approaches. If regulations make swaps more costly and less efficient, there may be a movement toward physical alternatives.

Regarding the effect of Dodd-Frank on commodity transactions, the panel noted that Title VII of Dodd-Frank modifies the Commodities Futures & Exchange Act to include swaps in its anti-manipulation provisions. The panel also noted that Dodd-Frank has amended the Act by adding section 6(c)(1), which enables the CFTC to pursue fraud-based manipulation. The resulting rule is modeled after the SEC's Rule 10b-5. Although similar to FERC and Federal Trade Commission (FTC) anti-manipulation rules, the CFTC rule expressly refers to "attempted manipulation." The panel noted that, although traditionally there has not been an insider trading concept under the rules, this is changing. The "know your counterparty" requirement of the new Business Conduct Standards creates a category of confidential customer information.

III. Arbitrations

Arbitration: Dodd-Frank, Public Panels, and Structured Product Cases

George Friedman, Executive Vice President and Director of Dispute Resolution at FINRA, discussed arbitration filing trends. In 2011, parties filed 4,729 cases, a 17% decrease compared to the 5,680 cases filed in 2010. Customer claims decreased by 19% in 2011 compared to 2010. More than one-third of the cases served in 2010 and 2011 involved only industry parties. FINRA mediation cases also decreased. In 2011, parties filed 659 mediations—a 20% decrease compared to the 823 mediations filed in 2010.

In 2011, 44% of customers who brought claims were awarded damages, a slight decrease from 47% in 2010 and 45% in 2009. Forty-six percent of cases that actually went to hearing (as opposed to being decided on the papers) resulted in awards. Approximately 74% of all customer claimant cases resulted in some monetary or non-monetary recovery for the investor, through either settlements or awards. In 2011, 21% of cases were closed by award, down from 25% in 2009 and 23% in 2010. Cases involving mutual funds and individual securities remain the two most commonly filed claims.

The panel discussed the implications of Dodd-Frank on the future of mandatory pre-dispute arbitration. Arbitration agreements between broker-dealers and their customers have been enforced since the decision of *Shearson/American Express v. McMahon*, 482 U.S. 220, in which the U.S. Supreme Court found that Exchange Act claims were arbitrable because the Exchange Act did not require judicial resolution of its provisions. However, under Dodd-Frank § 921, the SEC may, by rule, prohibit pre-dispute arbitration agreements. It remains an open question of whether the SEC would move in this direction. The panel also noted that states could try to enact arbitration fairness statutes, but that the Exchange Act and the Federal Arbitration Act might preempt such statutes. Even if pre-dispute arbitration provisions were disallowed in the future, FINRA Rule 12200 gives the customer the right to compel arbitration. Mr. Friedman noted that FINRA would not support a repeal of Rule 12200 because a repeal would not advance the protection of investors.

The panel noted that FINRA's new All-Public Panel option may have weakened any arguments against abolishing mandatory pre-dispute arbitration. Effective February 1, 2011, FINRA amended the Customer Code to allow customers the option to choose an arbitration panel that has two public arbitrators and one non-public arbitrator, as was previously the cases, or to have their cases heard by an All-Public Panel. Under either selection method, parties receive lists of ten arbitrators for each category (Chairperson, Public Arbitrator and Industry). If the All-Public Panel option is selected, any party may strike all of the arbitrators on the non-public list. If the parties collectively strike all non-public arbitrators, then FINRA will not appoint a non-public arbitrator, but will select the next-highest-ranked public arbitrator.

FINRA's pilot program for the All-Public Panel option, which ran from October 2008 to January 2011, suggested that case outcomes will not differ significantly under the new rule. The panel noted that customers might choose a non-public arbitrator in a case where broker misconduct was at issue but might be less likely to do so in a product failure case. The panel also commented that the definition of "industry arbitrator" was broad enough to include people who may not have strong connections to the industry. The panel noted that industry respondents should continue to rank non-public arbitrators, even if the customers opt for the All-Public Panel option. Further, results of the pilot program suggest that parties are no more likely to use expert witnesses with an all-public panel than with a majority public panel. FINRA is continuing to analyze the results of the pilot program.

The panel also discussed electronic discovery in arbitration. There are no current FINRA rules on electronic discovery in arbitration. However, FINRA has created a Discovery Task Force, currently in progress, and new electronic discovery rules are likely to be proposed this year. The panel discussed e-discovery issues including the scope of a party's duty to preserve digital evidence during the course of litigation or even when it first acknowledges that a chance of litigation exists, the lawyer's duty to monitor compliance with litigation holds, data sampling, cost-shifting and possible sanctions, using the case of *Zubulake v. UBS Warburg*, 229 F.R.D. 422 (S.D.N.Y. 2004) as a reference.

The panel noted the likelihood that future electronic discovery standards would follow the model of the Sedona Conference on electronic discovery. The panel also discussed certain practice pointers for e-discovery, including issuing a litigation hold as soon as possible; identifying key witnesses and custodians early on; coordinating e-discovery with opposing counsel soon after the arbitration commences and obtaining claimant email addresses as early as possible; considering the proportionality of e-discovery; documenting all preservation and production efforts; and considering cost-shifting. The panel noted that any new e-discovery rules will require additional training of arbitration chairpersons.

The panel also addressed developments and trends in claims arising from non-traditional structured products. In 2011, a large customer arbitration award in the *Hosier v. Citigroup* case, which involved a leveraged municipal arbitrage fund, attracted attention in the arbitration community.

Firms face challenges in defining, identifying and monitoring complex products in customer accounts. Currently, there is no set definition of "structured finance" and thus no guidelines that define all structured-type products. Regulatory Notice 12-03, released in January 2012, addresses "heightened supervision of complex products," but does not define these products. The Regulatory Notice mentions "structured notes, inverse or leveraged exchange-traded funds, hedge funds and securitized products, such as asset-backed securities" and thus provides guidance for supervising these products. The Regulatory Notice mentions "heightened compliance and supervisory procedures" and "heightened supervision"; however, according to the panel, FINRA did not intend to graft the "heightened supervision" scheme sometimes imposed on registered representatives. Rather, the "heightened supervision" described in the Regulatory Notice is a more detailed description of the "reasonable basis suitability" analysis required for complex products. The Regulatory Notice also mentions "post approval follow through." Firms may wish to consider periodic reviews of these products post-approval. With respect to structured finance products generally, the panelists observed that FINRA appears be moving toward a standard where these products, particularly those with embedded options, may be sold only to clients who are qualified to purchase options. Firms will continue to face challenges with respect to the approval, review, and suitability considerations related to these products.

The final topic addressed by the panel was management of ethical and strategic conflicts with former brokers. The panel emphasized the necessity of *Upjohn* warnings when speaking with both current and former brokers when representing a firm. Model Rules of Professional Conduct Rules 1.7 and 1.9 provide guidance in this respect. The panel also discussed the potential for conflicts to arise with brokers given the new customer complaint reporting requirements and the "subject of the complaint" standard, which requires reporting of customer complaints when a broker was involved in the conduct that was the subject of the complaint even if the broker was not personally named. The panel also discussed strategies for dealing with "turncoat" brokers, again referencing *Upjohn* and the Model Rules. The panel noted that filing cross-claims against a "turncoat" former broker is not always an effective strategy for dealing with this potential problem.

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