

K&L GATES

Global Government Solutions® 2016:
Mid-Year Outlook

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 governmentsolutions@klgates.com

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To learn more about the K&L Gates Global Government Solutions® initiative or any of the information presented in this report, please contact one of our editors:

Michael D. Ricciuti
Boston
+1.617.951.9094
michael.ricciuti@klgates.com

Stephen G. Topetzes
Washington, D.C.
+1.202.778.9328
stephen.topetzes@klgates.com

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2016 MID-YEAR OUTLOOK



As we issue this 2016 Mid-Year Outlook, the global community has begun to wrestle in earnest with the momentous political, economic, and doing-business implications of the Brexit vote on 23 June. This comes on top of continued anemic economic growth in Europe, uncertainty surrounding the diverse economies in Asia, turbulence in the Middle East, an election in Australia to determine all members of parliament, and in November, a hotly contested presidential election in the United States.

To meet these challenges and succeed in these turbulent times, businesses must understand and navigate the relationship between the private sector and government. The K&L Gates Global Government Solutions® initiative brings together our firm's diverse government-related practices from around the world. With a global platform comprising over 30 policy and regulatory disciplines and more than 500 alumni of government agencies on five continents, K&L Gates is strategically positioned to assist clients in dealing effectively with virtually any issue related to government enforcement, regulations, and policy.

This 2016 Mid-Year Outlook includes a diverse collection of articles from practitioners across our global platform that we hope will be a useful resource for your business. The articles address important industry and regulatory trends and their correlation with governmental and political developments. This edition covers varied topics including Brexit issues; a review of the U.S. government's aggressive approaches to securities regulation and white collar criminal cases; an examination of the UK government's increasing appetite for regulatory and criminal investigations and prosecutions; a look at the new U.S.-EU Privacy Shield Agreement; and analyses of developments in the financial services, trade, transportation, energy, environmental, and technology sectors.

If you have questions about any of the articles, or wish to obtain further information, you may contact the authors directly or send an email to governmentsolutions@klgates.com.

Best wishes for continued success in 2016 and beyond!

Peter J. Kalis

Chairman and Global Managing Partner



“K&L Gates is strategically positioned to assist clients in dealing effectively with virtually any issue related to government enforcement, regulations, and policy.”

After the BREXIT

OVERVIEW

Calling for a referendum

Ever since the United Kingdom's (UK) entry into the European Economic Community in 1973, Britons have been concerned about the gradual erosion of sovereignty and the widening powers of the European Commission. The demand for a new referendum on the UK's membership gained momentum in the 1990s following the painful negotiation of the Maastricht Treaty, which created the EU in its current guise.

The Conservative government promised a referendum on the UK's membership of the EU right before the 2015 general election, and a vote took place on 23 June 2016. With a turnout of 72 percent, this historical referendum resulted in the electorate voting by 52 percent to 48 percent to leave the EU.

On 10 November 2015, Prime Minister Cameron had sent a formal letter to Donald Tusk, the president of the European Council, which gathers the heads of state or governments of the EU member states, including four key demands. The UK prime minister stated in his letter that if he could reach agreement with his counterparts on each of these four areas, he would campaign to keep Britain inside a reformed EU. His requests related to:

- **Economic governance:** including acceptance of demands that the EU can have more than one currency and that non-Eurozone taxpayers should never be financially liable to support the Eurozone as a currency.
- **Competitiveness:** harmonizing of many aspects of the single market; making the free flow of capital, goods, and services across the market easier; and cutting regulation (a common Tory theme), all designed to boost competitiveness and productivity of the EU and to drive growth and jobs.

- **Sovereignty:** including ending Britain's obligation to work towards a closer union and to enhance the role of national parliaments.
- **Immigration:** removal of the immediate entitlement to in-work benefits and social housing for migrant workers from the EU and some restrictions on the free movement of workers for future new EU members.

After weeks of discussions and preparations behind the scenes, the European Council met on 18 and 19 February 2016 and gave a formal reply to the demands of the British prime minister in the form of a formal "Decision Concerning a New Settlement for the United Kingdom within the EU" (the Decision), which was annexed to the European Council's other formal conclusions. It was agreed that the Decision would only take effect if the pro-EU option won the referendum and after the UK government had formally confirmed its decision to remain part of the EU.

As the vote result was to leave the EU, a solemn joint statement by "the four presidents" (of the European Council, of the European Parliament, of the rotating Presidency of the Council of the EU, and of the European Commission) declared that all these commitments would "not take effect" and "ceased to exist." Adding, in case there was any doubt, that there would be no negotiation.

THE CONSEQUENCES OF THE "LEAVE" VOTE

Immediate consequences and timing

A vote to exit did not result in the UK immediately ceasing to be a member of the EU. The results of the referendum were taken as a political mandate for the government without immediate effect on the actual UK membership of the EU. The EU is based on international treaties,

which have created a rather complex relationship between the UK and the EU as a whole and—through the EU—between the UK and its other members. This includes legal as well as financial obligations that cannot be terminated via the unilateral decision of any EU member.

Thus, the implementation of the referendum result needed a formal communication to the EU requesting for a termination of membership. Only then would a period of transition start for the UK to negotiate with its EU partners the actual terms of its exit from the EU.

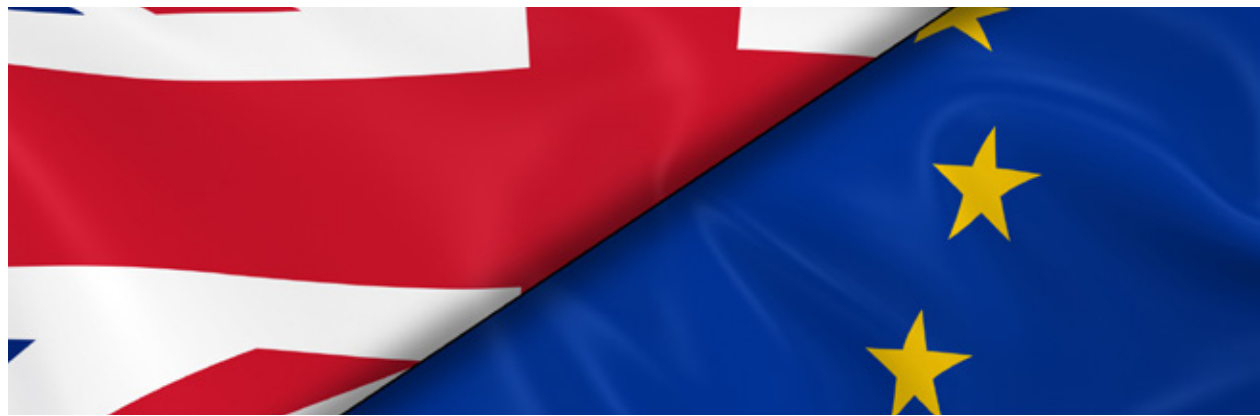
The Lisbon Treaty introduced for the first time a basic procedure for "withdrawal from the Union." It fixes the requirement for the "withdrawing member state" to officially notify its intention to the European Council. After that, a negotiation starts, somehow similar to an accession membership negotiation but in "inverted terms," to clarify chapter by chapter and matter by matter the real effect of such decision and creating a tailor-made situation that can be acceptable for all parties. There is no comparable precedent for such an agreement, but if we compare it with accession agreements or with the negotiation of association agreements with third countries, it is difficult to imagine that it would take less than a year. This "Withdrawal Agreement" shall set out "the arrangements for [the state's] withdrawal, taking account of the framework for its future relationship with the Union." Thus, this will be a complex treaty with details on very different topics such as security and defense, social matters, fisheries, patents, financial services, trade, or indeed access to the internal market.

From the moment of the notification to the Council, the UK is not allowed to participate nor vote in any European Council or Council discussions which may affect it. The situation and voting rights of the UK elected MEPs required a specific and unprecedented

decision by the Parliament's Bureau and its Conference of Presidents (the Parliament's governing bodies).

Unless expressly otherwise agreed among member states, the treaties will cease to apply to the UK from the date of entry into force of the Withdrawal Agreement, or two years after the withdrawal notification if there is no agreement (for example, if the negotiations become protracted due to disagreement on the terms, or if there is no internal agreement within the Council (qualified majority), or at the European Parliament (simple majority)).

In other words, as the treaties stand today, there is no way back. The formal request to leave the EU set a complex procedure with only one possible outcome, which is even automatic if no agreement has been reached—the exit of that member from the EU.



The United Kingdom's initial commitment to the EU was effected essentially by Parliament through the European Communities Act 1972 (the EC Act), after a period of negotiation about the legal and economic details resulting from joining the club. After that, successive modifications to the Treaties (the last one being the Treaty of Lisbon) have been subject to parliamentary ratification. Since 1972, Parliament has also approved a long series of legislation implementing EU law, in compliance with the obligation to do so imposed by European Directives. Therefore, at the end of this process, the withdrawal agreement will have to be ratified and implemented by an act, or acts, of Parliament. The EC Act might need to be repealed (or possibly amended), and other primary legislation implementing

EU law would be similarly affected. It is not difficult to envisage a drawn-out process of creating and/or repealing relevant legislation originally derived from the EU membership, each piece of which would be subject presumably to normal parliamentary approval/voting processes.

WHAT ARE THE SPECIFIC IMPLICATIONS FOR BUSINESSES?

It is impossible to list here all of the repercussions of the BREXIT on the legal, social, and economic reality of both the

Market. The withdrawal agreement will need to include the terms according to which the UK would eventually keep all or most of the trade benefits it currently enjoys as part of the EU Single Market.

The UK will have the choice to join the European Economic Area (EEA) at the same time it leaves the EU and, in practical terms, remaining a part of the EU Single Market (as is the case with Norway). The disadvantage of this option is that the UK would be subject to EU law and regulation without being able to influence its drafting. For instance, the

UK and its European counterparts. But here's a list of potential impacts in some areas of high importance to business.

Trade

The departure of the UK from the EU will impact its trading of goods and services, both with the EU and with the rest of the world. Such impact will vary substantially depending on the level of integration that the UK will be able to maintain with the EU.

An important distinction is to be made between trade with the EU and trade with other countries.

In regard to the trade relations with the EU, BREXIT will impact the free movement under which goods circulate without any barriers within the EU Single

need of the UK to secure access to the EU market for its cars or food will make it necessary for the UK to still comply with the European regulation in those sectors, but the UK will not be part of any related negotiations on such regulation.

Alternatively, the UK could include in the Withdrawal Agreement a bilateral arrangement with the EU similar to the one the EU has with Switzerland, which is not a member of the EU or EEA but enjoys tariff-free access to the EU Single Market. However, the Swiss model is not easy to replicate—the EU and Switzerland have signed over 120 bilateral agreements, including a free trade agreement in 1972 and two major series of sectoral bilateral agreements that aligned a large portion of Swiss law with that of the EU

at the time of signing. For many, these agreements have created a complex and sometimes incoherent network of obligations which are not easy to sustain.

In addition, any preferential access to the EU Single Market could also trigger the intervention of other world trade partners of the EU, which could challenge this preferential treatment under the most-favored-nation principle of World Trade Organization (WTO) law.

Should the UK not be able to secure preferential access to the EU Single Market, its commercial relations with the EU will be governed by the WTO rules, which are not as wide in scope as the four freedoms of the EU Single Market.

In regards to trade with non-EU countries, BREXIT will impact several free trade agreements from which the UK has benefited, including the ones with Korea, Chile, Mexico, and South Africa. The ability of the UK to maintain the trade benefits negotiated for such a large trade zone—and in particular, the reduction of trade barriers—would largely depend on the not-easy legal interpretation of its rights as a remaining party to those agreements independently and in its own right, after having left the EU. Perhaps more significantly, the UK will be excluded from the benefits derived from any future agreements to be entered into by the EU, including the Transatlantic Trade and Investment Partnership (TTIP), and further agreements with the Association of Southeast Asian Nations (ASEAN), India, or Singapore.

So, although the UK will enjoy more freedom in negotiating its own new bilateral trade treaties, it will compromise its bargaining power, as the EU as a whole currently represents one

of the biggest and most powerful trading blocs in the world.

It is important to note, though, that the UK does not have the right to negotiate any trade agreement as long as it remains a member of the EU, that is, before the entry into force of the Withdrawal Agreement. After Article 50 is activated, the UK is bound by EU treaty law for two years (or more if agreed, as previously explained). That includes “all the rights and obligations” of being a full member, which forbid an independent trade policy. Therefore, as long as the withdrawal has not become legally effective, the UK is a member state with all rights and obligations, including the obligation to respect the European Commission competences in the area of international trade.

Financial Services

Much of the regulation of financial services in the UK is governed by EU law. This includes the regulation of banks, broker-dealers, insurers, insurance intermediaries, fund managers, and payment services providers. Therefore, the BREXIT will mean that financial institutions with operations crossing UK and EU borders will become subject to a new regulatory regime. The precise implications of the BREXIT will depend on a variety of factors, including the arrangements that the UK implements to govern cross-border business between the UK and the remaining countries of the EU and the extent to which the UK government chooses to retain legislation that is based upon EU law.

An important element of the EU financial services regime is “passporting.” Passporting is the exercise of the right by firms authorized under an applicable

EU financial services directive to carry on activities in another EEA member state on the basis of their home state authorization. Their activities can be conducted through a branch in the host member state or on a cross-border services basis.

Many firms have adopted a business model based upon passporting to conduct their EU-wide operations. Should the BREXIT result in the passporting regimes ceasing to apply in relation to business conducted into and out of the UK, firms in the UK and the remaining EU would need to consider whether to operate distinct authorized entities in both the UK and EU. Some non-EU financial institutions, which have established subsidiaries in the UK as a base from which to passport into the EU, might need to consider whether to move their base elsewhere. However, much will depend on the extent to which arrangements can be implemented to replicate passporting between the UK and EU, including whether the UK will be part of the EEA and able to participate in the arrangements that facilitate the cross-border provision of financial services between EEA member states.

Apart from strategic implications for the structure of EU business operations, BREXIT will trigger a host of practical implications for how financial institutions operate their businesses. For instance, where financial institutions distribute their products in the UK and elsewhere in the EU, they will need to review product terms, distribution agreements, and marketing literature to consider whether these need to be amended or replaced as a result of a potential regulatory separation.

Employment Law

Although much of the UK’s current employment law framework derives from the EU, it is generally thought unlikely that the UK’s exit from the EU will result in significant legal changes, at least in the short term. There are several reasons for this.

First, the UK government will be concerned about the impact on its

“ Many firms have adopted a business model based upon passporting to conduct their EU-wide operations. ”

economy if sudden, wholesale changes to well-established employment principles were to be introduced at once. This would create a period of uncertainty for businesses at a time when economic confidence is already fragile. Many employment rights that originated at the EU level, such as paid holiday or the right not to be discriminated against, are generally considered to be “good things.” Even the Transfer of Undertakings (Protection of Employment) Regulations 2006 is now generally accepted (as shown by the recent government consultation on proposed changes) and many commercial agreements have been priced, drafted, and signed on the basis that it applies. The government may identify a handful of less popular pieces of legislation which it considers could be removed without too much disruption, such as the Agency Workers Regulations 2010 and even the limits on bankers’ pay contained in CRD IV, but it will be reluctant to implement a wholesale purge of any laws that have ever come from the EU.



Second, even when the UK leaves the EU, the desire to maintain some sort of free trade agreement with the EU (either by joining the EEA or negotiating bilateral agreements) will mean that the UK is still likely to be required by the EU to maintain minimum standards of employment protection to prevent the UK being able to undercut EU states through lower employment standards. Although the UK may be able to negotiate certain exemptions from the full range of EU laws, current EEA states (Norway, Iceland, and Liechtenstein) are obliged to accept the majority of EU regulations without being part of the EU decision making process, and the UK is unlikely to be much different if this is the path it chooses to follow. This would also apply to free movement of persons, which is an integral part of the EEA agreement.

Intellectual Property

BREXIT raises several complex legal issues in the field of intellectual property and related rights, both in terms of the applicable rules and in relation to the means for their enforcement. We refer here to four areas: patents, trademarks, copyright, and the protection of trade secrets.

On patents, the UK is a part of several international conventions unrelated to membership of the EU. This is essentially the case for the Convention on the Grant of European Patents of 5 October 1973, or European Patent Convention (EPC).

The EPC provides a legal framework for the granting of European patents via a single, harmonized procedure before the European Patent Office. None of this will be affected by the UK leaving the EU, as non-EU members are already part of this system, including Turkey and Albania.

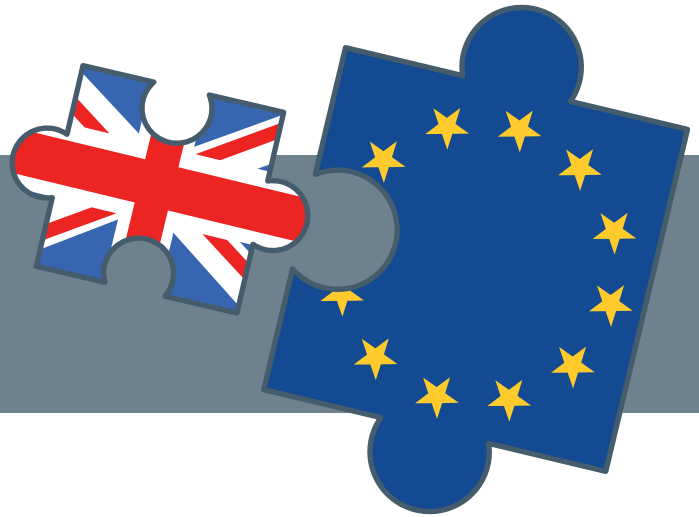
However, because this system is complex and expensive, a large group of EU members, including the UK in a leading role, promoted a new European patent with unitary effect, or “Unitary Patent”—one single title with one single registration and payment and a unified enforcement method under a unified court mechanism. This was viewed as being positive for SMEs and small innovative companies. Now that the UK has voted to withdraw from the EU, its

businesses will be excluded from the Unitary Patent system, unless a complex tailor-made solution can be agreed in the Withdrawal Agreement (including recognition of the jurisdiction of the Court of Justice of the EU in this matter).

Copyright remains an essentially territorial matter—titles and rights are created and enforced on a country-by-country basis, supplemented by several applicable international conventions that would not be affected by the BREXIT. However, UK copyright legislation is today the result of implementing the EU Copyright Directive; and while the UK could keep

that legislation internally and amend its laws in accordance to changes at an EU level, it will not be part of the EU internal negotiations to reform and modernize it and the UK’s copyright legal system will not have the final enforcement of the Court of Justice of the EU.

In the field of trademarks, there are currently two, parallel legal schemes. A UK trademark registration protects rights in England, Wales, Scotland and Northern Ireland. There is also the so-called “Community Trademark” (EU trademark registration), which protects trademark rights in the 28 member countries of the EU with a single title and a single enforcement mechanism. It is the usual cost-effective choice for businesses currently operating across



“BREXIT will have a transformative impact in the EU as we know it.”

the single market. A new Directive and a new regulation on EU trademarks were approved at the end of 2015. The new rules modernize the Community Trademark system in the Union as a whole and adapts it to the Internet era, while preserving the complementary relationship between the EU trademark system and national trademark systems.

Before BREXIT, the UK will have to negotiate with the EU, as part of the Withdrawal Agreement, a mechanism to remain part of the Community Trademark system. Without this, all companies operating across Europe would need a double trademark registration—one for the UK and one for the EU market. What would happen with Community Trademarks already valid would also be the object of any BREXIT negotiation.

A new EU directive on know-how and trade secrets was approved in 2016. Its objective is to put companies, inventors, researchers, and creators on equal footing through discouraging unfair competition and facilitating collaborative innovation and the sharing of valuable know-how. When the UK leaves the EU, the implementation of those new rules in the UK legal system (and thus, for the UK to have the same new, strong standards in this area) will be an independent

decision of its Parliament and the interpretation and enforcement of those rules would be limited to UK courts.

Dispute Resolution

As a result of its EU membership, the UK has been subject to harmonized rules about the enforcement of judgments. The Brussels I Regulation regulates the recognition and enforcement of civil and commercial judgments across member states. It achieves this by setting out general rules governing cross-border jurisdiction disputes. Other European regulations in this area are the Rome I Regulation, which allows contracting parties in a civil or commercial matter to choose the law that will apply to their contract and the Rome II Regulation, which achieves the same result for non-contractual cases.

Without these regulations, matters will be dependent on domestic rules of law in relevant countries, which can create uncertainty and disputes through a lack of harmonization, as well as potential difficulties in the enforcement of legal rights and obligations including debts.

The position might be mitigated by means of two existing international conventions: (1) the Lugano Convention has similar provisions to the Brussels


I Regulation and applies to European Free Trade Association (EFTA) countries; and (2) the Hague Convention on Choice of Court Agreements, to which all EU member states (bar Denmark) and Mexico are bound. Of course, that raises the question whether the UK wishes to mirror existing arrangements or negotiate something fresh.

CONCLUSION

As the official path towards BREXIT has been initiated, we enter into a period of legal uncertainty, not only in the UK but the EU as a whole, and for an undetermined duration. The scenarios examined here refer only to the impact of such a decision in the UK, but there is no doubt that an EU without the UK would not remain exactly as it is—BREXIT will have a transformative impact in the EU as we know it. There will probably be a push for a stronger integration in several fields (such as taxation, security, and others), a review of its decision making process, and who knows today what other consequences. Time will tell.

AUTHOR

Ignasi Guardans
Brussels
ignasi.guardans@klgates.com



“As the official path towards BREXIT has been initiated, we enter into a period of legal uncertainty, not only in the UK but the EU as a whole.”

U.S. White Collar Crime

2015 saw the Department of Justice (DOJ) in the United States continue its aggressive approach to white collar criminal cases, and we anticipate that DOJ will ramp up even further as we venture deeper into 2016.

Three areas are worth particular note: the government's laser-like focus on targeting individuals involved in alleged wrongdoing with both criminal and civil actions, its broad focus on alleged instances of fraud, and its focus on holding corporations responsible for the misconduct of their customers.

AGGRESSIVE FOCUS ON INDIVIDUALS

In 2015, DOJ revised the principles guiding criminal and civil enforcement in matters involving alleged corporate wrongdoing. In doing so, it announced a renewed and heightened focus on targeting individuals. One theme in this effort is new—DOJ will use both criminal and civil tools to drive the deterrence message home. This means that DOJ will pursue criminal indictments, but even where the evidence fails to establish sufficient proof of a criminal act, DOJ will pursue civil lawsuits against individuals DOJ believes are responsible for corporate misdeeds—even if the individual has an inability to pay. The message is clear and unmistakable—DOJ intends to target the conduct of individuals in cases that center on bad acts by corporations.

On 9 September 2015, DOJ issued a memorandum (the Yates Memo) authored by Sally Quillian Yates, the deputy attorney general, which arose from an internal working group of DOJ lawyers who reviewed DOJ's efforts to target corporate fraud and misconduct. The Yates Memo recognizes that "[o]ne of the most effective ways to combat corporate misconduct is by seeking accountability from the individuals who perpetrated the wrongdoing." The Yates Memo lays out measures—some familiar, some new—that are to be taken "in any

investigation of corporate misconduct," even ongoing investigations where it is "practicable" to apply these principles.

The six measures recommended by the Yates Memo are:

- That to obtain credit for cooperating in a criminal case, a corporation must provide to the DOJ all relevant facts relating to the individuals responsible for the misconduct;
- That DOJ's criminal and civil corporate investigations should focus on individuals from the inception of the investigation;
- That DOJ's criminal and civil attorneys handling corporate investigations should be in routine communication with one another;
- That absent extraordinary circumstances or approved departmental policy, DOJ will not release culpable individuals from civil or criminal liability when resolving a matter with a corporation;
- That DOJ attorneys should not resolve matters with a corporation without a clear plan to resolve related individual cases and should memorialize any declinations as to individuals in such cases; and
- That DOJ civil attorneys should consistently focus on individuals as well as the company and evaluate

whether to bring suit against an individual based on considerations beyond that individual's ability to pay.

DOJ later amended the United States Attorney's Manual, making these changes permanent.

DOJ's focus on targeting individuals—particularly in criminal cases—is not new. For years, and certainly since the financial meltdown of 2008, DOJ has emphasized prosecuting individuals in corporate criminal cases. The call for DOJ to pursue individuals in white collar cases has grown amidst strong criticism for its failure to bring individuals to account for the 2008 financial crisis. In September of 2014, then Principal Deputy Assistant Attorney General for the Criminal Division Marshall L. Miller emphasized prosecuting individuals: "If [companies] want full cooperation credit, make your extensive efforts to secure evidence of individual culpability the first thing you talk about when you walk in the door to make your presentation." Indeed, DOJ signaled in 2014 that it would take a more aggressive posture against individuals in white collar cases. For example, in September 2014, then-Attorney General Eric Holder suggested that Congress should expand the "responsible corporate officer" doctrine to financial services cases. The "responsible corporate officer" doctrine, which springs from the Supreme Court case styled *United States v. Park*, provides that strict criminal liability can be imposed under the Food, Drug and Cosmetic Act on senior corporate executives if, by reason of corporate position, the executive had the authority and responsibility to prevent or correct violations and did not, unless he or she was powerless to do so. Thus, even where the corporate officer had no knowledge of any wrongdoing, he or she could still be charged with a crime. The FDA has sought to reinvigorate

this little-used doctrine in FDA cases, where it was developed initially. The request by Attorney General Holder that Congress extend such individual liability to the financial services industry was an aggressive call to enhance the likelihood of imposing criminal responsibility in white collar cases.

Whether or not the legislature acts to expand such liability, the focus in the Yates Memo on the harmonization between criminal and civil investigators is a significant new development. The Yates Memo expressly directs civil and criminal attorneys at DOJ

to coordinate their efforts. This is often tricky legally, since the law governing the secrecy of materials gathered by criminal prosecutors through the grand jury process cannot be routinely shared with civil lawyers within DOJ. Nevertheless, the Yates Memo calls for

DOJ to put at the top of its agenda bringing both criminal actions against individuals allegedly responsible for corporate crime—which often produce significant financial penalties—and civil lawsuits. And the decision with respect to whether DOJ should bring a civil lawsuit is not to be governed solely by the ability to pay of a would-be individual defendant. As the Yates Memo puts it, “the fact that an individual may not have sufficient resources to satisfy a significant judgment should not control the decision on whether to bring suit.” Thus, civil actions may be considered or instituted by DOJ where the alleged misconduct is serious, actionable, provable, and

the pursuit of the action “reflects an important federal interest”—deterrence.

In short, DOJ has made targeting individuals in corporate criminal cases a priority. Those employees now must worry not only about indictments, but civil actions against them as well—which means their employers have a new worry, too. Corporations would be well-advised to review their policies and agreements respecting employee indemnification and decide how and whether they will address and pay for the defense of civil

the disruptive trading practice called “spoofing.” The *Sarao* case followed a similar case brought against Michael Coscia, who was convicted of criminal fraud and spoofing in November 2015 in Chicago. The key takeaways from the jury’s verdict are that criminal prosecutors now are more confident than ever that they can present complex commodity interest and securities trading cases to a jury in a clear and streamlined manner and they now have a blueprint of how the cases can be presented effectively. DOJ, the Commodity Futures Trading



actions against employees stemming from corporate criminal probes.

FOCUS ON FRAUD

DOJ recently has focused intently on fraud in many forms and showed its willingness to reach into new areas to develop such cases.

Commodities Fraud

Commodities fraud is one such area. In 2015, DOJ indicted a UK futures trader accusing him of contributing to the notorious “Flash Crash” of May 2010, and charging him with criminal fraud, market manipulation, and engaging in

Commission (CFTC), Securities Exchange Commission (SEC), and other regulators and financial exchanges on three continents have brought spoofing cases in the past few years, and there is no reason to think they will stop any time soon.

On 21 July 2010, President Obama signed the Dodd-Frank Wall Street Reform and Customer Protection Act, which amended the Commodity Exchange Act to criminalize certain disruptive trading practices in the U.S. futures markets, including “spoofing.” “Spoofing” is defined as bidding or offering with the intent to cancel the bid or offer before execution. The CFTC has stated

that spoofing includes “submitting or cancelling bids or offers to create an appearance of false market depth” and “submitting or cancelling bids or offers with intent to create artificial price movements upwards or downwards.” The SEC has been prosecuting spoofing using existing legislation since at least the early 2000s. In 2015 federal prosecutors in New Jersey charged Canadian securities trader Aleksandr Milrud with spoofing in the securities markets. U.S. criminal prosecutors charged Coscia, Sarao, and Milrud—two of them citizens of other countries, and all three charged in jurisdictions far from their homes—with the assistance of regulators and law enforcement authorities outside the United States. It is clear that law enforcement and regulatory authorities around the globe are looking harder than ever at open market trading strategies.

Not all spoofing cases are charged as criminal offenses. In 2015, the CFTC filed a civil enforcement action against 3Red Trading, and its principal Igor Oystacher, in federal court in Chicago. The CFTC also filed a civil regulatory action alleging spoofing in New York federal court against two traders from the United Arab Emirates. Also in New York, a group of Korean futures traders filed a class action lawsuit against a prominent New York-based trading firm for spoofing.

Futures exchanges in Europe have actively investigated and punished alleged spoofing conduct. In 2016 the Japanese Securities and Exchange Surveillance

Commission recommended the imposition of an administrative monetary penalty against an Australia-based trading firm that allegedly engaged in spoofing in securities traded on the Tokyo Stock Exchange. See Japanese Securities and Exchange Surveillance Commission, *Recommendation for Administrative Monetary Penalty Payment Order for Market Manipulation by Blue Sky Capital Management Pty Ltd*, (March 4, 2016), <http://www.fsa.go.jp/sesc/english/news/reco/20160304-1.htm>.

Three years ago, few traders had even heard of spoofing as a trading strategy, but since then we have seen an explosion of regulatory activity, including criminal prosecution and private litigation focused on spoofing. Traders and their compliance officers and risk managers need to stay abreast of exchange, regulatory, and criminal actions. They need to know *what* law enforcement and regulators investigate, and *how* they investigate. The government and the exchanges are using data mining to create “heat maps” to identify potential violations, and they are using whistleblowers to help them. Two of the CFTC’s spoofing enforcement actions—one of which has a parallel criminal case—were generated with the assistance of whistleblowers.

Both SEC Chair Mary Jo White and CFTC Chairman Timothy Massad have stated recently that they will be paying close attention to high-frequency and algorithmic trading. In fact, Mr. Massad recently was quoted as saying: “If your

trading firm is entering a lot of orders without the intention to consummate, you probably should go talk to your lawyers.”

The FIFA Prosecution

In 2015, DOJ brought criminal indictments against a number of individuals and entities related to the *Fédération Internationale de Football Association* (FIFA), the association responsible for the World Cup, for accepting bribes in the form of millions of dollars in kickbacks. It superseded the indictment in late 2015, adding more defendants and more charges. The aggressive pursuit by the United States of alleged frauds with comparatively little connection to the country illustrates the government’s willingness to reach far and wide to bring cases.

The U.S. government charged three groups of defendants in the FIFA cases: FIFA officials or officials of its constituent organizations; sports media and marketing companies and their officers; and businessmen, bankers, and others. In total, the defendants were charged with making or receiving well over \$200 million in bribes or kickbacks over two decades in connection with the commercialization of soccer tournaments, related media and marketing rights, the selection of a World Cup host country, and the election of the FIFA president. The U.S. government alleged a racketeering offense—essentially that FIFA, its related entities, and the charged wrongdoers formed a criminal conspiracy that was engaged in various forms of fraud, conspiracy, and money laundering, among other charges. Some were also charged with obstruction of justice—that after becoming aware of law enforcement scrutiny, certain persons allegedly tried to persuade another not to disclose everything he or she knew, alerting co-conspirators that they

“...in September 2014, then-Attorney General Eric Holder suggested that Congress should expand the “responsible corporate officer” doctrine to financial services cases.”

might be recorded making admissions of crimes, or destroying evidence of bribe payments—all offenses under U.S. law.

The government contends that there were 10 criminal schemes involving the payment of bribes to soccer officials in exchange for the procurement by sports marketing companies of media and marketing rights to various soccer tournaments. In one alleged scheme, South African officials purportedly agreed to pay Jack Warner and unnamed co-conspirators, all FIFA executive committee members, \$10 million in exchange for their agreement to vote for South Africa as the host for the 2010 World Cup (South Africa allegedly outbid Morocco, which offered a mere \$1 million). In another, officials of the Caribbean Football Union were sworn to secrecy, instructed to enter a room one at a time, and each received an envelope containing \$40,000 from a FIFA official to induce them to vote for him in a FIFA presidential race.

Why were these cases brought in the United States? This is difficult to answer. The vast bulk of the facts alleged by the U.S. government occurred in other countries. But the U.S. claims that the criminal activity occurred in the United States, in part, even though the strongest connection with the United States may concern the alleged use by the co-conspirators of the American banking system, payments of bribes in the United States, and some more attenuated impacts of the scheme in the United States. The reality is that the United States sees fewer and fewer

limits to its reach in criminal matters, a trend that is very likely to continue.

The techniques used by the United States to bring this case also shows an uptick in aggressiveness. Historically, the U.S. government has used undercover witnesses, known as “cooperators,” in blue collar criminal cases involving organized crime or narcotics trafficking. The government has shifted to using these witnesses in all manner of white collar cases, either as informants or whistleblowers—people who report alleged wrongdoing to the government—or full blown cooperators—undercover

Union (CPU), the Central American Football Union (UNCAF), and North American Football Union (NAFU). Blazer, who was formerly a member of the FIFA executive committee, secretly agreed to plead guilty and cooperate with the United States government. He eventually pled guilty to 10 criminal charges for fraud, racketeering, money laundering, and tax evasion and forfeited over \$1.9 million to the United States—and more when he is sentenced—but in the hope through his cooperation to earn a reduced sentence. In addition, two sons of Jack Warner, a member of the FIFA executive committee and FIFA vice-president,



witnesses working proactively for the government. Cooperators typically help the government not out of altruism, but out of their own desire to reduce their exposure to criminal charges in the United States. That appears to be the case regarding the FIFA prosecutions. Principal among the cooperators was Charles Blazer, the former general secretary of Confederation of North, Central American and Caribbean Association Football (CONCACAF), the 41 member organization within FIFA that oversees the sport in North America, Central America, the Caribbean, and South America, and which comprises the Caribbean Football

also cooperated. Daryll Warner, a former FIFA development officer, pled guilty to two-counts of wire fraud and “structuring” of financial transactions (making transactions in such a way so as to avoid regulatory scrutiny), and Daryan Warner, who pled guilty to wire fraud conspiracy, money laundering conspiracy, and structuring, and agreed to forfeit more than \$1.1 million and pay a second forfeiture at sentencing. Lastly, José Hawilla, the owner and founder of Traffic Group, a multinational sports marketing conglomerate and Brazil’s largest sports marketing company, pled guilty to four-counts of racketeering conspiracy, wire

fraud conspiracy, money laundering conspiracy, and obstruction of justice, and agreed to forfeit a total of \$151 million.

There will certainly be challenges to the exercise of extraterritorial jurisdiction by the United States in this case, but it is far from clear whether those challenges will succeed. The first hurdle the United States will face is extradition—many defendants have yet to answer or otherwise respond to the indictment and remain abroad. Whether the United States can extradite someone depends chiefly on whether the U.S. government has an extradition treaty with the relevant jurisdiction. Even where it does, DOJ must show “dual criminality”—that is, that the crimes alleged in the United States are also crimes in the country where the defendant is present. In Peru for instance, commercial bribery is not necessarily illegal, and for months its Supreme Court delayed extradition of Manuel Burga, a former president of the Peruvian soccer federation, until DOJ provided it with further evidence of dual criminality. Moreover, the ultimate decision whether to

they could be prepared to begin jury selection as early as 27 February 2017. See Letter Providing Case Update at 4, *USA v. Webb*, No. 15-252 (RJD-RML) (Document 304). However, citing “ongoing discovery and related complications, including the relatively recent arrival of some defendants,” the court decided that “the selection of a trial date [is] unrealistic at this time,” and that it would “revisit the question of a trial date after June 30, 2016.” See Minute Entry for proceedings held before Judge Raymond J. Dearie, *USA v. Webb*, No. 15-252 (RJD-RML) (Document 314). At the same time, the court also reportedly stated that it is “not waiting for [defendants who remain abroad]. We’re going forward.”

Even if a defendant successfully fights extradition, the United States can still make that defendant’s life very difficult. The United States can file what are known as “red notices” with Interpol, the international police organization. These red notices alert other Interpol members that there is an arrest warrant outstanding for the defendant and asking each

member country who finds the defendant to hold him for extradition to the United States. So even if a defendant resists extradition, he or she may become afraid to travel for fear that another Interpol

country will find and detain him for extradition to the United States.

Leaving extradition aside, the defendants can also attack the “extraterritoriality” of the crimes charged. Stated differently, questions may arise with respect to

whether the U.S. Congress intended the statutes at issue to apply outside the United States. For instance, wire fraud, a common offense pursued by the United States which criminalizes any scheme to defraud that uses such common systems as a telephone or the Internet, does not have extraterritorial reach, meaning an offense cannot occur entirely outside the United States. Although courts disagree on this point, the issue in the law is whether the prosecution must prove a United States nexus with respect to both the scheme to defraud and the use of wires. If the prosecution must only show a misuse of United States wires, its job and its burden are easier. Other statutes do apply outside the United States under some circumstances, including the statute criminalizing money laundering—which generally makes it illegal to conduct certain financial transactions with proceeds from a criminal venture—if the conduct is by a U.S. citizen or partially occurs in the United States.

In addition to questioning whether the statutes alleged to have been violated apply outside the United States, defendants may also challenge whether a U.S. court has jurisdiction over them. American federal law gives U.S. law enforcement agencies broad authority to pursue criminal investigations as long as there is some connection to the United States, even a tangential one such as the involvement of a bank, an Internet service provider, or a cell phone company. But the movement of money through U.S. banks alone may not be a sufficient basis for jurisdiction over a suspected individual or entity. And questions with respect to whether a defendant has sufficient “minimum contacts” with the United States to justify being hauled into court without violating the defendant’s right to due process are also not entirely settled.

What do these charges say about the future of law enforcement in this area? The clear answer appears to be that the

“... The investigations handled by ... AFMLS are increasingly global in nature,” according to Assistant Attorney General Leslie Caldwell.”

allow his extradition still rests with Peru’s president. Whether delays in extradition such as this will ultimately prevent defendants from being tried in the United States is still unclear. In a letter filed with the Court presiding over the case on 11 April 2016, prosecutors indicated that

United States, alone or in conjunction with other countries, has an appetite to charge those inside and outside the United States with crimes even if the connection to the United States is relatively weak. The FIFA indictment is consistent with the United States' recent efforts to increase international cooperation and coordination of anti-corruption enforcement efforts. Only two of the defendants in the FIFA prosecution are U.S. citizens and the alleged participation of these U.S. citizens in a conspiracy and movement of money through U.S. banks as grounds for the exercise of jurisdiction is aggressive. Indeed, FBI Director Comey made it clear that minimal contact with the U.S. will be enough to trigger an investigation like this: "If you touch our shores with your corrupt enterprise . . . you will be held accountable."

**FOCUS ON
HOLDING
CORPORATIONS
RESPONSIBLE
FOR THE
MISCONDUCT
OF THEIR CUSTOMERS**

DOJ also has signaled a trend to significantly broaden the scope of investigations and prosecutions by pursuing corporations (and individuals, as noted above) for derivative culpability based on customer conduct. That is, DOJ seems to suggest that a corporate defendant must not only be vigilant in ensuring that its own conduct does not violate federal law, but that it must now take an additional step and ensure that its customers are not misusing the corporate defendant's services; otherwise, they may face prosecution. Recent enforcement actions by two of DOJ's prosecution units, the Asset Forfeiture and Money

Laundering Section (AFMLS) and the Tax Division, may be signs of things to come.

AFMLS "pursues prosecutions against institutions and individuals engaged in money laundering, Bank Secrecy Act violations, and sanctions violations. AFMLS attorneys also forfeit the proceeds of high-level foreign corruption. . . . The investigations handled by . . . AFMLS are increasingly global in nature," according to Assistant Attorney General Leslie Caldwell. AFMLS also manages a victim compensation fund from which, according to DOJ, it has returned "more than \$4 billion in civilly

abetting the underlying fraud—meaning the money service business was equally culpable for the underlying fraud as the unknown international fraudsters themselves. By characterizing the conduct of the defendant as an aider and abettor of the underlying scheme, AFMLS was able to invoke its powerful forfeiture laws available for wire fraud prosecutions. Ultimately, the money service business entered into a deferred prosecution agreement with the United States (with an admission of guilt) including a \$100 million forfeiture penalty and an agreement to make significant enhancements and structural changes



and criminally forfeited funds to crime victims since fiscal year 2002, with \$723 million paid to over 150,000 crime victims in the last three years alone."

In a case that began in late 2012, AFMLS employed the traditional aiding and abetting statute to prosecute a money service business, alleging that the failure of the business to detect and prevent the use of its network by unknown international fraudsters who were convincing duped victims to transfer money overseas as a part of a variety of wire-fraud schemes. AFMLS chose to characterize the failure of the defendant to stop the use of its network for illicit purposes as amounting to aiding and

to its anti-money laundering program. Recent dealings with DOJ, and AFMLS in particular, indicate that DOJ's aggressive use of an aiding and abetting theory in this prosecution may not be an outlier.

Further, DOJ's Tax Division has steadily announced a series of non-prosecution agreements under its Swiss Bank Program, which "encourages Swiss banks to cooperate in the department's ongoing investigations of the use of foreign bank accounts to commit tax evasion." In essence, DOJ has required that the Swiss banks admit to aiding efforts by their U.S. customers to evade tax payments, in exchange for DOJ's agreement not to prosecute, the bank's full cooperation (i.e.,

sharing of information), and the payment of a monetary penalty. Here again, the Swiss banks are coming under scrutiny by DOJ not for their own conduct per se, but rather the alleged criminal conduct of their customers. In 2015 alone, 78 banks entered into non-prosecution agreements under this program, with one penalty as large as \$10.3 million. According to DOJ's press release, "Swiss banks continue to lift the veil of secrecy surrounding bank accounts opened and maintained for U.S. individuals in the names of sham structures such as trusts,

foundations, and foreign corporations." DOJ's Tax Division and the respective U.S. attorney's offices will undoubtedly leverage information obtained from the Swiss banks and to focus on individual tax evasion prosecutions.

The marketplace should understand and expect that the willingness of DOJ to impute a customer's conduct to a corporate defendant in these two discrete areas of consumer fraud and international tax evasion are not isolated. In fact, as we look forward, companies

should expect intense scrutiny not only of their conduct, but also of their efforts, through compliance programs, consumer outreach programs and the like, to understand, monitor, and ultimately ensure that customers are not misusing their services for illicit purposes.

“...the willingness of DOJ to impute a customer's conduct to a corporate defendant in these two discrete areas of consumer fraud and international tax evasion are not isolated.”

AUTHORS

Michael D. Ricciuti
Boston
michael.ricciuti@klgates.com

Mark A. Rush
Pittsburgh
mark.rush@klgates.com

Thomas Ryan
Pittsburgh
thomas.ryan@klgates.com

Clifford C. Histed
Chicago
clifford.histed@klgates.com

Patrick C. McCooe
Boston
patrick.mccooe@klgates.com

United States Supreme Court Poised to Consider “Personal Benefit” Test for Insider Trading Liability

On 19 January 2016, the U.S. Supreme Court agreed to evaluate the “personal benefit” element of insider-trading liability by granting *certiorari* with respect to an appeal involving an opinion of the U.S. Court of Appeals for the Ninth Circuit in *United States v. Salman*, 729 F.3d 1087 (9th Cir. 2015) cert. granted in *part*, 136 S. Ct. 899 (2016). *Salman* may resolve ambiguities that have arisen in the wake of a decision by the U.S. Court of Appeals for the Second Circuit in *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014) *cert. denied*, 136 S. Ct. 242 (2015).

The “personal benefit” test was first articulated by the Supreme Court in *Dirks v. Securities and Exchange Commission*, 463 U.S. 646 (1983). The *Dirks* Court held that a recipient of material nonpublic information from a corporate insider who trades on such information is liable for insider trading only when the insider “personally will benefit, directly or indirectly, from his disclosure” of the tip. *Id.* at 662. The Court stated further that the focus should be on “objective criteria, i.e., whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary or a reputational benefit that will translate into future earnings.” *Id.* at 663. While a personal relationship could satisfy this standard, the court required “objective facts and circumstances” to justify an inference of a *quid pro quo* or “an intention to benefit the particular recipient.” *Id.* at 663–64. Under certain circumstances, the “gift of confidential information to a trading relative or friend” could satisfy this requirement. *Id.* at 664.

In *Newman*, the Second Circuit held that there must be “proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similar valuable nature” in order for the court to infer a personal benefit

from the relationship between an insider and a tippee. 773 F.3d at 452. Mere friendship is not enough. The *Newman* decision, which seemingly requires more evidence of a personal benefit

decided, the United States filed a petition for *certiorari* in *Newman*, emphasizing that *Newman* conflicts with *Salman*. The Supreme Court denied the petition on 5 October 2015. Then, on 10 November



than the *Dirks* Court may have intended, is widely viewed as a setback to the government’s efforts to prosecute alleged insider trading. Officials at the U.S. Securities and Exchange Commission (SEC) have commented publicly that the decision may limit the scope of insider trading by increasing the government’s burden of proof in such cases.

The Ninth Circuit’s recent opinion in *Salman* has added to the uncertainty. In *Salman*, the Ninth Circuit found that an insider’s tip to his brother was a “gift of confidential information” that satisfied *Dirks*, rejecting the defendant’s argument that *Newman* required the government to prove that the insider received a “tangible benefit” in exchange for the tips. 792 F.3d at 1093. Several weeks after *Salman* was

2015, *Salman* filed a petition for *certiorari*, asking: “Does the personal benefit test to the insider that is necessary to establish insider trading under *Dirks*... require proof of ‘an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature,’ as the 2d Circuit held in *Newman*... or is it enough that the insider and the tippee shared a close family relationship, as the 9th Circuit held in this case?” Petition for Writ of Certiorari, *Salman v. United States*.

The Supreme Court elected to take the appeal in *Salman*. The court will hear the case during its October 2016 term. It is not entirely clear why the court granted *certiorari* in *Salman* but denied it in *Newman*. However, *Salman* seems

to present a “cleaner” case for the court to consider. Unlike *Newman*, *Salman* is outcome-determinative—in other words, the court’s decision will decide *Salman*’s fate. In *Newman*, the Second Circuit reversed the convictions for two reasons: (1) inadequate evidence of a personal benefit to the insiders, and (2) insufficient evidence of the defendants’ knowledge of a personal benefit to the insiders. However, the government sought to appeal the Second Circuit’s ruling only as to whether there was insufficient evidence of a personal benefit. If the Second Circuit were reversed by the Supreme Court on that issue, the outcome would have been the same given that there was also a lack of sufficient evidence of the defendants’ knowledge of the insiders’ personal benefit.

The potential impact of the court’s hearing of *Salman* also is unclear. Although *Salman*’s petition for certiorari identified an apparent circuit split, the two cases are different and may not actually conflict. In *Newman*, the friendships between the insiders and tippees were determined to be too casual to infer an intention to gift the information. By contrast, in *Salman*, the insider and the tippee were siblings. As a result, the Supreme Court could simply uphold *Salman* as a clear application of *Dirks* without addressing *Newman*. Alternatively, the Supreme Court could directly address the “circuit split” described in the petitions. It may be significant that the Court rejected the government’s petition for certiorari in *Newman*, as that case proposes a more stringent standard for the “personal benefit” element than had been advanced previously.

The timing of the Supreme Court’s hearing of this case makes this case even more noteworthy. After the Supreme Court refused to hear the government’s appeal of *Newman*, Democratic presidential candidate and former Secretary of State Hillary Clinton announced her plans to propose legislation to reverse the impact of the decision. Moreover, the death of Supreme Court Justice Antonin Scalia, who held firm against expanding the securities laws throughout his tenure on the court, and the court’s as-of-now empty ninth seat, potentially impact the court’s decision. Recent criticisms of the SEC, including highly publicized challenges to its ability to use administrative law judges to hear enforcement actions, have added to the interest in this area. Indeed, several prominent organizations and the well-known owner of the Dallas Mavericks, Mark Cuban, who at trial beat insider trading charges brought by the SEC, have filed amicus briefs with the court in connection with *Salman*.

Despite the uncertain legal landscape, it is clear that insider trading remains a major area of enforcement focus for the SEC, particularly as it continues to use and analyze market information and to identify outlier or suspicious trades. During fiscal year 2015, the SEC brought 87 cases involving allegations of insider trading. And just recently, a district court jury in the Southern District of New York awarded

the SEC a post-*Newman* victory against two second-line tippees with respect to investments in a software company just before it was acquired by IBM. Jury Verdict, ECF No. 136, *SEC v. Payton*, No. 14-cv-4644-JSR (S.D.N.Y. Mar. 3, 2016). In that case, which was presided over by Judge Rakoff, who wrote the *Salman* decision, the SEC lacked evidence of an obvious personal benefit, instead relying upon the friendship/roommate relationship between the original tipper and tippee. In the closing argument in that case, the SEC trial lawyer stated simply: “You don’t get something for nothing in this world.” Trial Tr. 912:3–14, *Payton*, No. 14-cv-4644-JSR (S.D.N.Y. Feb. 16–29, 2016). The court’s consideration of *Salman* may clarify whether that assumption—at least as it applies to the unsettled law of insider trading—is valid.

AUTHORS

Nicole A. Baker
Washington, D.C.
nicole.baker@klgates.com

Erin Ardale Koeppel
Washington, D.C.
erin.koeppel@klgates.com

Brought to You by the Letter “S”

2015 and early 2016 were peppered with firsts for the United Kingdom’s Serious Fraud Office (SFO), including:

- Its first Deferred Prosecution Agreement (DPA).
- Its long-awaited first proceedings against a company under Section 7 of the UK Bribery Act 2010 (the Bribery Act).
- Its first UK conviction for overseas bribery offenses after a contested trial.

These cases afford useful guidance about what to expect from the SFO going forward.

STANDARD BANK AND DPAS

DPAs were introduced into English law on 24 February 2014 by the Crime and Courts Act 2013 to enable more efficient and effective resolution of corporate wrongdoing in the United Kingdom. DPAs are agreements between prosecutors and

corporate organizations that charges will be presented but not pursued, provided that the organization complies with a set of agreed terms and conditions. Those terms generally involve payment of substantial fines and/or the implementation of remediation programs to prevent any repetition of the wrongdoing.

The first UK DPA has arisen out of a case involving Standard Bank plc (Standard Bank), now known as ICBC Standard Bank (ICBC). The brief facts of the case are that Standard Bank had within its group of companies a Tanzanian entity Standard Bank Tanzania Ltd (Stanbic). It was alleged that senior executives at Stanbic paid bribes to Tanzanian government officials so that



the government would raise financing from Stanbic and pay it a substantial fee.

In November 2015, Standard Bank admitted that it had breached Section 7 of the Bribery Act by failing to prevent bribes being paid for its benefit by persons acting on its behalf. Standard Bank also admitted that it did not have adequate procedures in place to prevent bribes being paid on its behalf and, therefore, had no defense to the charge. The SFO concluded that it was in the public interest to offer a DPA to Standard Bank. Its decision was influenced by a number of facts specific to the case and the way it was handled by Standard Bank, as follows:

- Standard Bank made a self-report to the SFO promptly, within days of

the suspicions coming to the bank’s attention and before its solicitors had commenced its own investigation. It was a genuine self-report of facts that were not public—this was not a case where the company’s hand was forced by press reports or leaks. In fact, without the self-report, the SFO may never have discovered the misconduct.

- Standard Bank was also given credit for the breadth of its internal investigation, which had been sanctioned by the SFO, and the Statement of Facts, which formed the

basis of the DPA, substantially relied-upon evidence voluntarily disclosed by Standard Bank.

- Standard Bank also agreed to continue to cooperate fully and truthfully with the SFO and any other agency or authority, domestic or foreign, as directed by the SFO in any and all matters relating to the conduct covered by the DPA.
- The bank had no previous convictions for bribery and corruption offenses nor had it been the subject of any other criminal investigations by the SFO.
- The SFO also accepted that the bank had made significant enhancements to its compliance policies and processes since a risk and supervisory review

conducted by the Financial Conduct Authority (FCA) in 2011.

- As part of the DPA, Standard Bank was also required to follow a “risk mitigation program,” which included an independent review by the accounting firm PwC of its anti-corruption policies, procedures, and training. In April 2014, PwC submitted its review. Although PwC

still expressed significant concerns, it highlighted that Standard Bank had taken extensive steps regarding recruitment, risk classification, and due diligence on its customers and set a very clear “tone from the top” to remedy the pre-existing failures.

- Finally, Standard Bank is a different organization in its current form from that which committed the offenses at

issue in the DPA. This weighed heavily in favor of the proposed DPA being in the interest of justice. On 1 February 2015, ICBC acquired a 60 percent majority shareholding in Standard Bank. Following the acquisition, a new board was appointed, the majority of whom are new appointments from outside the pre-acquisition Standard Bank. The business group involved in the conduct that is the subject of the

	Standard Bank	Sweett	Smith & Ouzman
Type of proceedings	DPA	Convicted after guilty plea	Convicted after trial
Culpability (including aggravating factors)	<p>Medium (but on the high side of medium)</p> <ul style="list-style-type: none"> corruption of public officials failings in internal controls (including previous FCA action for money laundering controls failings) 	<p>High</p> <ul style="list-style-type: none"> management willfully ignored concerns raised by external accountants offending took place over a prolonged period of time failings in internal controls deliberate attempts to mislead the SFO 	<p>High</p> <ul style="list-style-type: none"> corporate directors had a leading role in planning the bribes corruption of public officials offending took place over sustained period of time abuse of dominant market position motive of substantial financial gain
Mitigating factors	<ul style="list-style-type: none"> UK bank had no knowledge or direct involvement in paying the bribe one-off case very swift self-report to SFO cooperation 	<ul style="list-style-type: none"> no previous convictions recent cooperation with SFO 	<ul style="list-style-type: none"> the company was renowned for care of its staff and contribution to the local community the company had taken steps at remedial action issue in regaining market share
Multiplier	300 percent	250 percent (reduced from 300 percent due to mitigating factors)	300 percent
Financial harm (i.e., figure to which multiplier should be applied)	\$6million	£851,000	£438,933
Fine after multiplier	\$16.8 million (takes into account a one-third reduction for guilty plea and early cooperation with SFO)	£1.4 million (takes into account a one-third reduction for guilty plea at earliest opportunity)	£1.3 million
Confiscation calculated on the basis of	All profits resulting from the transaction	Gross fees received, less project costs, i.e., the gross profit on the corrupt deal	<p>Value of the contracts minus the value attributable to contracts where bribes were not paid, to determine the gross profit</p> <p>To that figure was then added the actual value of the bribe amounts</p> <p>There was then an adjustment for the change in the value of money since that date</p>
Compensation	\$7.05 million to be paid to the government of Tanzania	None	None—because the judge held it would be difficult to ensure that payments to the people of Kenya and Tanzania who were affected would get into the right hands
Monitor imposed?	Yes	No	No
Did the resolution result in Debarment?	No—no debarment with DPAs	No—no debarment for Section 7 offenses	Yes—Five-year debarment under EU procurement rules

DPA was transferred out of Standard Bank to a new entity, a separate, wholly owned subsidiary of Standard Bank Group. Standard Bank is therefore, in the words of the judge, a “substantially different entity to the one that failed to prevent the bribery.”

CORRUPTION PROSECUTIONS

Sweet—Guilty plea for s7 Bribery Act offenses

In February 2016, the SFO obtained its first conviction and sentencing of a company under Section 7 of the Bribery Act. Sweett Group PLC (Sweett) admitted that it had committed the Section 7 offense by failing to prevent the bribing of Khaled Al Badie by an entity connected with Sweett, namely Cyril Sweett International Limited. The bribing was intended to obtain and subsequently retain a contract with Al Ain Ahlia Insurance Company for project management and cost consulting services in relation to the building of a hotel in Dubai.

Smith & Ouzman Ltd—Guilty verdict at trial (pre-Bribery Act offenses)

Additionally, in December 2014, the United Kingdom saw its first conviction of a corporation for overseas bribery offenses contrary to Section 1 of the Prevention of Corruption Act 1906 (PCA), the precursor to the Bribery Act, following a trial rather than a guilty plea. Section 1 of the PCA made it illegal to offer or accept a bribe. While the PCA was revoked after the Bribery Act came into effect, the SFO already had a case pending against Smith & Ouzman Ltd (Smith & Ouzman) under the PCA and brought it to trial. The case is relevant because it signals that the SFO will bring criminal actions

against companies engaged in similar offenses under Section 1 or Section 6 of the Bribery Act. Section 1 of the Bribery Act makes it an offense to bribe another person, while Section 6 of the Bribery Act creates a specific offense of bribing a foreign public official in their capacity as a foreign public official.

WHAT HAVE WE LEARNED?

DPAs

The Standard Bank case suggests that DPAs require a great deal of coordination with the SFO. There has been commentary that this was the ideal test case for the SFO, as it was an almost

have to wait until the next DPA to see how the SFO deals with a company that fulfills most, but not all, of the criteria.

Sentencing

It is very difficult to draw a full set of conclusions by comparing these three cases. That said, some of the lessons that can be extracted thus far are summarized in the table above:

The apparent distinctions between the three cases are as follows:

- One factor in determining whether it is in the public interest for the prosecutor to offer a DPA is the seriousness of



perfect fit for the guidance published by the SFO and other prosecutors on the circumstances in which a DPA would be offered. For instance, the case involved a one-off corrupt transaction about which the UK bank had no knowledge, the behavior was discovered promptly, Standard Bank self-reported the misconduct almost immediately to the SFO, and thereafter, Standard Bank cooperated with the SFO extensively. In addition, there had also been a change in ownership and leadership at Standard Bank by the time it came before the court.

The chances that such circumstances will be regularly replicated in their entirety are slim. For example, often such behavior is more prevalent or comes to light long after the misconduct occurred. We will

the offense. The more egregious the conduct, the harder it will be for a prosecutor to justify offering a DPA. Standard Bank can be distinguished from Sweett and Smith & Ouzman because the culpability of Standard Bank was medium-high, rather than high.

- Bribery of public officials is generally considered more serious than bribery of private individuals. Standard Bank and Smith & Ouzman were distinct from Sweett because the former involved bribery of public officials; the latter was a private bribery case.
- In the SFO’s view, it appears that Standard Bank provided more comprehensive assistance to the SFO than Sweett.

- Standard Bank and Sweett received credit of one-third off their total sentences for their cooperation and their guilty plea, respectively. Smith & Ouzman took its case all the way to trial and, thus, qualified for no such discount.

It makes sense that Standard Bank would have received the most lenient sentence and Smith & Ouzman the most severe. Standard Bank had cooperated fully; that, together with the other factors listed above, meant that it was in the public interest for the SFO to offer a DPA and the court endorsed the approach. In contrast, Smith and Ouzman fought the prosecution until a guilty verdict was returned after a trial.

However, while there are quite clear distinctions in the severity of the three cases, all three fines were calculated on the basis of similar multipliers, and the fines worked out to be broadly similar multiples of the proceeds of the offending behavior. This is despite Standard Bank and Sweett receiving one-third reductions for their cooperation and their guilty plea, respectively, whereas Smith & Ouzman received no reduction. It is also notable that no greater reduction was available to Standard Bank for its extensive cooperation with the SFO, and Sweett received a full one-third reduction in fine despite one of the aggravating factors in its case being that it had actively sought to mislead the SFO in relation to some issues.

Related to this point is the fact that, despite appearing to have done everything right in its engagement with the SFO, Standard Bank in fact incurred a heftier penalty, proportionately, than either Sweett or Smith & Ouzman. This is in part

“... [While] the Bribery Act may now shrug off its reputation for being all bark and no bite, there is still a long way to go before we fully understand the impact of the statute.”

because those penalties decided by a judge were calculated using a multiplier of the *gross profits* from the tainted contracts, whereas the deal agreed with the SFO by Standard Bank was calculated using a multiplier of the turnover on the deals—obviously a higher figure.

It is also important to note that, whereas a judge is restricted to prescribing financial orders when sentencing a company pleading or found guilty, the DPA guidance allows for greater latitude regarding penalties, including making voluntary payments to victims. DPAs may also require the company in question to appoint a monitor to review its compliance procedures. A monitor is an independent third party appointed to oversee and report on a company's internal and compliance functions following a criminal or regulatory investigation. Standard Bank agreed to such an appointment as part of its DPA agreement, which will come at a significant cost to the company. Smith & Ouzman and Sweett, on the other hand, whose corruption took place over longer periods and were more endemic within those companies, will not have a monitor, as the imposition of a monitor is not a sentencing option available to the court when a company pleads or is found guilty.

That said, there are advantages to entering into a DPA. These include the ability to agree a statement of facts such that the judge will be endorsing what has been pre-agreed by the parties—reducing the levels of publicity and achieving an

expedient result. Standard Bank's case took just 18 months from start to finish, far quicker than either of the other cases or a standard SFO investigation. Whether this is sufficient to tempt companies to self-report in future is questionable.

While the SFO can breathe a sigh of relief that the Bribery Act may now shrug off its reputation for being all bark and no bite, there is still a long way to go before we fully understand the impact of the statute. We understand that more DPAs are in the pipeline, so we should be able to build on that understanding soon. What is clear now is that the SFO is hitting its stride when it comes to the prosecution of corporate bodies. Whereas U.S. authorities have traditionally focused on prosecuting companies and may now be increasing their focus on prosecuting individuals, in the United Kingdom, prosecutors are traveling in the other direction. Given the SFO's renewed vigor and the well-publicized enthusiasm of its director (whose contract has recently been renewed to 2018) for pursuing corporate prosecutions, a continuation of this type of activity would be unsurprising.

We will need to await further judgments before firm guidance can be given to clients about the effect upon sentencing of taking a particular course in this type of case. The ongoing uncertainty around the impact of the SFO's new tools means it is as important as ever for companies to remain alert to developments and review their compliance programs accordingly.

AUTHORS

Sasi-Kanth Mallela
London
sasi-kanth.mallela@klgates.com

Christine Braamskamp
London
christine.braamskamp@klgates.com

2015 U.S. Foreign Corrupt Practices Act Enforcement: Don't Be Lulled Into Complacency

The Department of Justice (DOJ) and the Securities and Exchange Commission (SEC) continually express their strong commitment to the enforcement of the United States' foreign anticorruption tool, the Foreign Corrupt Practices Act (FCPA), emphasizing the large number of cases in the pipeline and a recent commitment by DOJ and the Federal Bureau of Investigation (FBI) to increase resources allocated to global FCPA enforcement.

However, 2015 saw a notable decline in the total number of resolved enforcement actions under the FCPA brought by DOJ and a significant reduction in the amount of related penalties. While FCPA activity by the SEC remained on par with the last three years, with nine resolved corporate actions, DOJ resolved only two corporate enforcement actions this year, its fewest since 2003. Corporate FCPA penalties totaled roughly \$140 million, which is less than one-tenth of the total penalties from the prior year, 2014. Additionally, with the exception of one outlier, the SEC actions may be rightly characterized as “low impact” in terms of penalties, and the lack of parallel action by DOJ in these actions suggests perhaps a changing focus and dynamic between the two enforcement agencies. At least nine companies reported DOJ declinations during the past year—that is, cases where DOJ declined to bring charges—which is relatively consistent with recent years, but most seemed to be granted where other authorities (SEC, in particular) were actively pursuing enforcement actions, which is a bit unusual. Even though the number of

resolved FCPA enforcement actions and total penalties were relatively low last year, the facts suggest that the government is ramping up on these types of cases.



2015 FCPA ENFORCEMENT IN CONTEXT: DOJ RATCHETING UP, NOT RAMPING DOWN

The lower number of resolved FCPA enforcement actions and lower total penalties may reflect the increased complexity and geographic scope of DOJ's open matters and possibly a shift in the DOJ's focus from the lowest hanging fruit—i.e., smaller cases coming from corporate self-reporting—to more severe, longer-term, and egregious cases. Indeed, DOJ has expressed a commitment to focusing on bigger, higher-impact cases,

including cases against individuals, which often take longer to investigate and demand more resources to resolve.

Toward that end, DOJ is in the process of hiring 10 additional prosecutors in its FCPA unit, doubling the number dedicated to FCPA enforcement. DOJ has also hired a compliance counsel to help prosecutors evaluate corporate policies and procedures, in part to determine whether companies facing corruption allegations are victims of

rogue employees or are willfully blind to corruption risk because they have not taken sufficient steps to prevent and detect corruption. DOJ's compliance counsel will be expected to participate in every corporate criminal resolution. Additionally, the FBI established three new international corruption squads to focus on FCPA matters. This type of activity suggests that DOJ's appetite for enforcement is hardly in decline but rather is ratcheting up, notwithstanding the number of resolved actions and penalties in any given 12-month period.

THE YATES MEMO AND FCPA ENFORCEMENT

The Yates Memo reflects DOJ's long-standing commitment to pursuing individuals as part of its effort to ensure corporate accountability, but given the difficulties associated with securing successful individual FCPA convictions, it remains to be seen whether the Yates Memo will result in a substantial increase in FCPA prosecutions of individuals. The number of individuals charged in FCPA matters has not significantly increased in the months since the Yates Memo was issued, but the Yates Memo could be a factor in the reduced number of resolved FCPA enforcement actions against corporations in 2015, as prosecutors are now instructed that they should not resolve matters with a corporation without

corporate knowledge (e.g., in the absence of effective due diligence), and the evidence against individuals subject to FCPA jurisdiction is often circumstantial, particularly with regard to both the knowledge and intent elements of a violation. Given this common reality in the FCPA enforcement context, if cooperation credit is viewed as turning on the ability (let alone the willingness) of corporations to find and offer up a known or suspected wrongdoer, corporations will face even more pressure earlier in an investigation to develop evidence against individuals, and where that is not possible or desirable, the Yates Memo could change the voluntary disclosure and settlement dynamic. Indeed, the decision to voluntarily disclose actual or potential FCPA violations is already difficult enough, and the Yates

Memo does little to incentivize corporations to do so.

Perhaps in recognition of these concerns, Sally Yates herself clarified

in a 3 March 2016 statement that DOJ indeed is "asking you give us the facts[,] but DOJ is "not expecting you to build prosecutable cases against any individuals [or] to designate any of your employees as criminally or civilly culpable." Nonetheless, Yates acknowledged that companies could decide against self-reporting because of the requirement to turn over facts and evidence of potentially culpable employees to obtain cooperation credit. She noted that the use of separate factors to evaluate a voluntary disclosure and to evaluate cooperation credit was designed to increase self reporting incentives. In other words, if a company self-reports an issue but does not turn over facts regarding individuals, it may receive a reduction in its penalty because of its voluntary disclosure, but it would not receive a further reduction for cooperation credit.

WHAT TO LOOK FOR IN 2016

Time will likely show if 2015's enforcement record reflects any relaxation of FCPA enforcement standards—which we highly doubt. FCPA enforcement is well-established, routine, and increasingly complex, and the commitment of the enforcement authorities is as robust as ever. In fact, the first quarter of 2016 has already seen one blockbuster FCPA settlement with both DOJ and the SEC (Vimpelcom, US \$397.6 million), which lends credence to some of DOJ's recent claims that it continues to pursue high-stakes, complex, global enforcement actions against multinational companies, including companies established outside the United States. Accordingly, U.S. and multinational companies subject to FCPA jurisdiction are well-advised to continue to be proactive in developing and assessing their anticorruption compliance programs.

In 2016, the impact of the Yates Memo should become clearer, but this may not necessarily be demonstrated by a substantial increase in individual FCPA prosecutions. Rather, the effect may be most pronounced behind closed doors in the investigation and settlement dynamic between the agencies and their corporate targets, possibly manifesting in a continued reduction in the annual volume of resolved FCPA enforcement actions along with more active and aggressive involvement by DOJ earlier in the investigation process, for example, by requesting employee interviews sooner than has been customary.

Although the Yates Memo may be understood to reduce incentives to self report, the pressure to do so remains constant even as the benefits of voluntary disclosure to a corporation remain questionable. This calculus could change, however, if DOJ creates a fast track to resolve self-reported cases. Indeed, this possibility has been discussed within DOJ, but it seems somewhat at odds with the practical requirements of the Yates Memo, which may ultimately slow the process of resolving FCPA enforcement

“DOJ’s appetite for [FCPA] enforcement is hardly in decline but rather is ratcheting up.”

a clear plan to resolve individual cases. As such, the Yates Memo mandates a procedure that fundamentally reduces prosecutorial flexibility in dealing with a corporate defendant. Accordingly, delayed resolution of FCPA actions is perhaps a predictable outcome.

More significantly, however, the Yates Memo may also have an impact on a corporation's approach to internal FCPA investigations, voluntary disclosure, and settlement. Indeed, the Yates Memo requires corporations seeking cooperation credit to disclose all relevant facts relating to the individuals responsible for the misconduct. This mandate may be particularly problematic in the FCPA context, in which a majority of the resolved enforcement actions against corporations involve steep penalties for the alleged misconduct of third parties, based on theories of vicarious liability and imputed

actions with DOJ. That said, it is likely to be an entirely different story with the SEC, which is expected to continue on a steady diet of enforcement actions large and small, including the continued resolution of relatively low-impact FCPA matters in administrative proceedings.

The engagement of DOJ's new compliance counsel may result in a more even-handed and knowledgeable approach to evaluating the effectiveness of risk-based corporate anticorruption compliance programs in a manner consistent with the standards set forth in the U.S. Sentencing Guidelines. This increased scrutiny may perhaps result

in better guidance as to the acceptable scalability of compliance resources within small and mid-sized companies. It will also no doubt continue to reinforce the message that paper programs (i.e., robust written policies and procedures without sufficient oversight and resources), weak implementation, and poor leadership and commitment to compliance by senior management (i.e., "tone-at-the-top") will not benefit companies hoping to secure a meaningful settlement discount, nonprosecution agreement, deferred prosecution agreement, or even a declination to prosecute after an FCPA violation is discovered.

Finally, 2016 will likely see a continued evolution of non-U.S. enforcement activity as well as attendant cross-border cooperation, parallel proceedings, and the possibility of multijurisdictional exposure, as the authorities in other countries increase their enforcement efforts. This will add significant complexity to any internal FCPA investigation and disclosure calculus, as corporations will need to consider disclosure requirements in each country where there might be jurisdiction as well as the effects of such disclosure in multiple jurisdictions.



“...corporations will face even more pressure earlier in an [FCPA] investigation to develop evidence against individuals, and where that is not possible or desirable, the Yates Memo could change the voluntary disclosure and settlement dynamic.”

AUTHORS

Luke T. Cadigan
Boston
luke.cadigan@klgates.com

Bill Semins
Pittsburgh
william.semins@klgates.com

Brian F. Saulnier
Pittsburgh and Dubai
brian.saulnier@klgates.com

SEC Enforcement Update—An Uptick in Activity and Growing Challenges

The enforcement agenda and docket of the U.S. Securities and Exchange Commission (SEC) reflect a wide array of issues. Some are hardy perennials in terms of policing the securities industry, capital markets, and investor behavior, such as insider trading, the need for reasonable compliance and supervisory policies and procedures, and requirements with respect to adequate risk or other disclosures. But others reflect a set of emerging issues and growing challenges—including the swift pace of technological advances, the expanded use of highly complex financial instruments and strategies, and the increased globalization of financial systems and markets. And the agency's efforts in each of these areas must be examined against evolving and differing perceptions with respect to the standards that should be applied to various types of conduct, what sanctions are proportionate and reasonable, and what due process or other protections should be afforded to market participants, issuers, intermediaries, and others.

The following are some observations regarding the arc of the SEC enforcement program.

INCREASED NUMBER OF ENFORCEMENT ACTIONS

The number of SEC enforcement actions continues to grow. In 2015, the SEC filed 807 enforcement actions, of which 507 were independent actions for violations of the securities laws and 300 were either follow-on actions (e.g., seeking bars against individuals based on prior orders) or actions against issuers who were delinquent in making required filings. Press Release, "SEC Announces Enforcement Results for FY 2015" (Oct. 22, 2015), <http://www.sec.gov/news/pressrelease/2015-245.html>. This was up from 755 enforcement actions in 2014, of which 413 were independent actions, and those, in turn, were up from 676 enforcement actions in 2013, of which 341 were independent actions. Total monetary relief ordered rose from \$3.4 billion in 2013 to \$4.16 billion in 2014 to \$4.19 billion in 2015. We expect that this trend will continue in 2016.

GROWING RELIANCE ON BIG DATA

Over the past few years, the SEC has significantly increased its ability to analyze large volumes of data. The Enforcement Division works closely with the Division of Economic and Risk Analysis in that

regard. In 2015, the two divisions collaborated on over 120 projects involving analysis of potential market manipulation, insider trading, structured products, accounting fraud, and abusive practices by brokerage firms and investment advisers. SEC, "Fiscal Year 2015 Financial Report" (Nov. 16, 2015) at 16, <http://www.sec.gov/about/secpar/secapr2015.pdf> (hereinafter "2015 Financial Report").

The Office of Compliance Inspections and Examinations also relies extensively on its ability to aggregate and analyze massive amounts of data in its examination program. It uses such data to identify firms with aberrant changes in business activities, potential fraudulent or other suspicious activities, migration of bad actor industry participants, and other possible indicia of heightened risk.

THE WHISTLEBLOWER PROGRAM GAINS STEAM

Among the many changes contained in the 2010 Dodd-Frank Act was a whistleblower provision directing the SEC to make monetary awards to individuals who voluntarily provide original information that leads to successful SEC enforcement actions resulting in monetary sanctions over \$1 million. 15 U.S.C. §78u-6. Awards are required to be made in an amount equal to 10 percent to 30 percent of the monetary sanctions collected.

For the past four years, the number of whistleblower tips grew each year,

from 3,001 (2012) to 3,238 (2013), to 3,620 (2014), to 3,923 (2015). SEC 2015 Annual Report to Congress on the Dodd-Frank Whistleblower Program at 21 (Nov. 2015). Moreover, from the inception of the whistleblower program in 2011 through early June 2016, the program awarded more than \$102 million to 33 whistleblowers. On 9 June 2016, the SEC issued an award of \$17 million, its second largest such award.

In 2015 alone, the program awarded approximately \$38 million to eight whistleblowers. SEC, "SEC Accomplishments: April 2013 – June 2016," <https://www.sec.gov/about/sec-accomplishments.htm>. Also during 2015, the SEC brought the first action applying its Dodd-Frank whistleblower anti-retaliation authority, as well as the first action against a company for using improperly restrictive language in confidentiality agreements that potentially could derail the whistleblowing process.

The role played by whistleblowers in law enforcement efforts certainly is not confined to the SEC enforcement program. But the structural apparatus at the SEC with respect to the role of the whistleblower, and its statutory support and companion "bounty" program, seem certain to ensure that reports of wrongdoing by insiders who contact the SEC staff are likely to continue to impact the enforcement landscape for years to come.

HEIGHTENED RISK FOR COMPLIANCE PROFESSIONALS AND OTHER “GATEKEEPERS”

Perhaps no issue has provoked more recent public statements by SEC commissioners and staff than the current focus on compliance professionals. Compliance officers deal with literally hundreds of different policies and procedures. It simply is not realistic to expect that a compliance officer can guarantee that every single procedure is appropriately designed and enforced.

Chair Mary Jo White and director of Enforcement Andrew Ceresney have stated that compliance professionals should not fear enforcement “if they perform their responsibilities diligently, in good faith, and in compliance with the law.” Andrew Ceresney, “Speech: 2015 National Society of Compliance

Professionals, National Conference: Keynote Address” (Nov. 4, 2015), <http://www.sec.gov/news/speech/keynote-address-2015-national-society-compliance-prof-cereseny.html>. However, that is little comfort since such determinations are made with hindsight and are often the types of judgments on which reasonable people may disagree.

In that connection, we note that, in describing its “Accomplishments” between 2013 and May 2016, the SEC highlighted the actions it has filed against “gatekeepers” (e.g., attorneys, accountants, and compliance professionals) to hold them “accountable for the important roles they play in the securities industry.” SEC, “SEC Accomplishments: April 2013 – June

2016,” <https://www.sec.gov/about/sec-accomplishments.htm>. Moreover, between 2010 and 2014, the SEC brought over 70 cases against chief compliance officers alone. Public Statement of Commissioner Luis A. Aguilar, “The Role of Chief Compliance Officers Must be Supported” (June 29, 2015), avail. at <http://www.sec.gov/news/statement/supporting-role-of-chief-compliance-officers.html>.

We expect that this focus on “gatekeepers”—including lawyers and accountants—will continue. While the



SEC and senior staff currently seem intent on offering reasonable comfort to compliance professionals and other gatekeepers so as not provoke undue anxiety or concern, there are indications that the SEC seeks to identify gatekeepers for enforcement actions to serve as “poster children” to send the signal to the market that gatekeepers can and will be held accountable for transgressions committed by those whose conduct they oversee, monitor, or impact. As in other areas, future cases may center on line drawing and the degree to which attacks on the efforts or roles of gatekeepers are grounded in powerful hindsight as opposed to the real-time gravity of alleged lapses.

ENFORCEMENT ADAPTS TO CHANGES IN MARKET STRUCTURE

Technology, globalization, and evolving markets have all impacted the focus of the SEC enforcement program. The SEC staff has acknowledged that the equity markets have been dramatically transformed in less than a decade. Andrew Ceresney, “Market Structure Enforcement: Looking Back and Forward” (Nov. 2, 2015), <http://www.sec.gov/news/speech/ceresney-speech-sifma-ny-regional-seminar.html>. Less than a decade

ago, the New York Stock Exchange handled almost 80 percent of the volume for stocks listed on the exchange; today it handles less than 15 percent of that volume. Today’s equity trading volume is divided among 11 separate exchanges and 40 dark pool alternative trading systems. In addition, high frequency trading now accounts for 50 percent or more of the total market volume.

In this new market structure, the SEC’s enforcement program has been highly focused on fairness in trading markets, protection of confidential customer order information, manipulative activities such as spoofing and layering, and implementation of policies and procedures to guard against the risks of direct market access, including the risks of coding errors

“It is unclear what impact, if any, the “broken-windows” policy has had on the enforcement program.”

resulting in the transmission of erroneous orders. As part of these enforcement efforts, and in recognition of the fact that much of the high-volume manipulative trading is believed to come from overseas traders, the SEC has used the Market Access Rule and Regulation National Market System, among other tools, in seeking to stop violative conduct by persons who may challenge the reach of its jurisdiction and to ensure responsible practices by the intermediaries or other entities that facilitate their market activity.

UNCLEAR EFFECT OF “BROKEN WINDOWS” POLICY

In a 9 October 2013 speech, Chair White announced what became known as the “broken windows” policy, declaring that no infraction is too small to be uncovered and punished and that “it is important to pursue even the smallest infractions.” Chair Mary Jo White, “Remarks at the Securities Enforcement Forum” (Oct. 9, 2013), <http://www.sec.gov/News/Speech/Detail/Speech/1370539872100>. She stated that violations such as control failures, negligence-based offenses, and violations of rules with no intent requirement are examples of the types of cases that the SEC will bring.

It is unclear what impact, if any, the “broken-windows” policy has had on the enforcement program. The number of enforcement actions increased from 676 in 2013 to 755 in 2014 and 807 in 2015, which could be a consequence, at least in part, of the broken-windows

policy. But it is equally possible this increase is because of an increase in other types of cases. For example, the number of market manipulation cases increased from 46 in the year before the broken-windows speech to 63 in the year after, but manipulation cases are the antithesis of what might be characterized as broken-windows cases. We suspect that the broken-windows policy has had little impact on the aggregate enforcement numbers, but that in select areas, the policy may have resulted in a small number of “message cases” that might not have been brought in previous years.

ADMISSIONS IN SETTLEMENTS REMAIN THE EXCEPTION RATHER THAN THE RULE

In June 2013, the SEC changed its policy and decided to require admissions of wrongdoing in a limited number of settlements. Prior to that, the SEC only required admissions where there was a parallel criminal proceeding that resulted in an admission. Since the change in policy, there have been more than 30 enforcement settlements with admissions—a very small fraction of the roughly 700–800 enforcement actions that are brought each year. The SEC sometimes uses admissions in low-culpability cases—for example, when a firm’s “blue sheet” responses were deficient—in order to emphasize the SEC’s concerns in an area. In other situations, it requires admissions where it regards the conduct as particularly egregious, but

there are plenty of serious fraud cases that the SEC settles without an admission.

Unfortunately, despite the staff’s articulation of the factors it considers, there is not a great deal of predictability in this area. And the limited sample leaves unresolved certain related questions concerning the collateral consequences or other fallout that may flow from admissions in this context. There is lingering uncertainty regarding the “price of admission.” And the reality remains that the “neither admit nor deny” formulation is much more likely to facilitate the resolution of SEC enforcement matters short of litigation, and thereby, conserve both public and private resources.

THE COMMISSION SEEKS TO GIVE CREDIT FOR SELF REPORTING

Director Ceresney delivered two speeches in 2015 that focused on the credit that firms and individuals get for cooperation—by which he mostly meant voluntarily reporting wrongdoing rather than simply acting cooperatively with respect to an investigation by the SEC staff. Andrew Ceresney, “ACI’s 32nd FCPA Conference Keynote Address” (Nov. 17, 2015), <http://www.sec.gov/news/speech/ceresney-fcpa-keynote-11-17-15.html>; Andrew Ceresney, “The SEC’s Cooperation Program: Reflections on Five Years of Experience” (May 13, 2015), <http://www.sec.gov/news/speech/sec-cooperation-program.html>.

On 7 June 2016, the SEC sought to show the tangible benefits companies would receive for self reporting. It announced that it was giving nonprosecution agreements to two companies, including one represented by K&L Gates, that had self reported potential violations of the FCPA. “SEC Announces Two Non-Prosecution Agreements in FCPA Cases”

(June 7, 2016), <https://www.sec.gov/news/pressrelease/2016-109.html>. The companies had thereafter cooperated extensively with the government investigations, terminated the employees responsible, and engaged in numerous other remediation efforts, including bolstering their policies and procedures and conducting training. As a result, while the companies were required to pay disgorgement, the SEC agreed not to prosecute them or impose any financial sanctions or other remedies. In addition, the Department of Justice issued declination letters to the companies.

These trends can and should be expected to continue as we get deeper into 2016. The SEC has announced that the enforcement program will prioritize certain “current and emerging high-priority areas” throughout 2016. U.S. Securities and Exchange Commission, “Summary of Performance and Financial Information - Fiscal Year 2015” (Feb. 11, 2016) at 10, <https://www.sec.gov/reportspubs/annual-reports/sec-fy-2015-summary-of-performance-information.pdf>. As in 2015, the program will focus on issues relating to gatekeepers, “leveraging cutting-edge

technology and analytics,” and market structure concerns. *Id.* The SEC also indicated that the enforcement program will emphasize financial reporting, insider trading, investment advisers and private funds, and municipal securities.



“On 7 June 2016, the SEC sought to show the tangible benefits companies would receive for self reporting.”

AUTHORS

Jon Eisenberg
Washington, D.C.
jon.eisenberg@klgates.com

Luke T. Cadigan
Boston
luke.cadigan@klgates.com

Stephen G. Topetzes
Washington, D.C.
stephen.topetzes@klgates.com

SEC Steps Up Enforcement Efforts Related to Municipal Bonds

The past year has seen stepped up efforts by the U.S. Securities and Exchange Commission (SEC) to cast the enforcement spotlight on the area of municipal securities. During testimony given on 19 March 2015, the Director of the Division of Enforcement (the Division), Andrew Ceresney, noted that the Division intended to focus on, among other things, investigating potential “misrepresentations in connection with bond offerings, failures by underwriters to meet their obligations, undisclosed conflicts of interest, and pay-to-play violations.” Testimony of Andrew Ceresney, “Oversight of the SEC’s Division of Enforcement” (Mar. 19, 2015), <https://www.sec.gov/news/testimony/031915-test.html>. Consistent with this testimony, the Division has intensified its focus on the issuance and underwriting of these securities, completing a form of “sweep” relating to continuing disclosures made in connection with municipal bond underwritings, and bringing several “first” cases under certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank or Dodd-Frank Act).

MCDC INITIATIVE

The Division launched a new self reporting program, the Municipalities Continuing Disclosure Cooperation Initiative (MCDC Initiative). The MCDC Initiative was “designed to address widespread continuing disclosure violations by municipal bond issuers and underwriters.” *Id.* In order to incentivize self reporting, the MCDC Initiative offered “favorable settlement terms” to municipal bond underwriters and issuers that self reported certain material misstatements and omissions contained in municipal bond offering documents. Press Release, “SEC Completes Muni-Underwriter Enforcement Sweep” (Feb. 2, 2016), <http://www.sec.gov/news/pressrelease/2016-18.html>.

The MCDC Initiative has resulted in three waves of settled enforcement actions against 72 municipal bond underwriting firms from June 2015 through February 2016. *Id.* See *also* Press Release, “SEC Charges 36 Firms for Fraudulent Municipal Bond Offerings” (June 18, 2015), <http://www.sec.gov/news/pressrelease/2015-125.html>; Press Release, “SEC Sanctions 22 Underwriting Firms for Fraudulent Municipal Bond Offerings” (Sept. 30, 2015), <http://www.sec.gov/news/pressrelease/2015-220.html>.

Each underwriting firm paid civil penalties up to a maximum of \$500,000 based on the number and size of the allegedly fraudulent offerings. Collectively, the civil penalties associated with the 72 actions totaled more than \$17 million.

RECENT SETTLED ACTIONS

From January 2016 through June 2016, the Division announced at least seven other enforcement actions involving municipal securities against issuers, advisors, and related persons. Five of the actions resulted in settlements. The other actions currently are being litigated.

On 9 March 2016, the SEC charged California’s largest agricultural water district, its general manager, and former assistant general manager with misleading investors about the district’s financial condition. Press Release, “California Water District to Pay Penalty for Misleading Investors” (Mar. 9, 2016), <http://www.sec.gov/news/pressrelease/2016-43.html>. In that case, the SEC found that the district employed “extraordinary accounting transactions” to reclassify funds from reserve accounts to revenues in order to meet a specific debt service ratio established in prior bond offerings.

Securities Act Release No. 10053 (Mar. 9, 2016). The SEC also found that the district failed to disclose other accounting adjustments in 2012 that would have negatively impacted the debt ratio if they had been effected in 2010. *Id.* In settling the action, the district became the second municipal issuer to pay a financial penalty in an SEC enforcement action.

Shortly thereafter, the SEC announced the first action to enforce the fiduciary duty for municipal advisors created by Dodd-Frank. Press Release, “Municipal Advisor Charged for Failing to Disclose Conflict” (Mar. 15, 2016), <http://www.sec.gov/news/pressrelease/2016-54.html>. The Dodd-Frank Act requires these advisors to put their municipal clients’ interests ahead of their own. 15 U.S.C. § 78. In that case, a municipal advisor and three employees were alleged to have breached their fiduciary duties by failing to disclose a conflict to a municipal client. Exchange Act Release No. 77369 (Mar 15, 2016). The SEC found that two employees and the CEO of the municipal advisor arranged for a municipal bond offering to be underwritten by a broker-dealer that employed all of them as registered representatives. The individuals did not advise their client of

“their relationship to the underwriter or the financial benefit they obtained from serving in dual roles.” See Press Release.

On 19 May 2016, the SEC announced that the mayor of a city in Illinois agreed to settle fraud charges connected to a series of bond offerings that purportedly would be used to develop and construct a Holiday Inn. Press Release, “Mayor in Illinois Settles Muni Bond Fraud Charges” (May 19, 2016), <http://www.sec.gov/news/pressrelease/2016-93.html>. Instead, the SEC found that city officers used some bond proceeds to fund the city’s payroll and other costs unrelated to the hotel project. *SEC v. Kellogg*, Case No. 16-cv-5384 (N.D. Ill. May 19, 2016). That is, “[i]nvestors were told one thing while the city did another.” See Press Release. The SEC alleged that the mayor “exercised control over [the city’s] operations and signed important offering documents the city used to offer and sell the bonds.” *Id.*

The SEC recently announced the first enforcement action settled under the municipal advisor anti-fraud provisions of the Dodd-Frank Act. Press Release, “SEC: Muni Advisors Acted Deceptively with California School Districts” (June 13, 2016), <http://www.sec.gov/news/pressrelease/2016-118.html>. In that case, two California-based municipal advisory firms and their executives agreed to “settle charges that they used deceptive practices when soliciting the business of five California school districts.” *Id.* See

also Exchange Act Release No. 78053 (June 13, 2016); Exchange Act Release No. 78054 (June 13, 2016). The SEC found that the advisory firm that advised the school districts with respect to their hiring process for financial professionals shared confidential information with a second municipal advisor, including questions to be asked during interviews with the school districts and the details of proposals submitted by competitors. The SEC also alleged that the school districts were not aware that the second advisor had received the confidential

schools’ multimillion-dollar contracts with two brothers of the chief operating officer of the charter school operator.” The complaint further alleges that these were conflicted transactions that could have limited the ability of the charter school operator to repay investors. *SEC v. Rangel*, Case No. 1:16-cv-06391 (N.D. Ill. June 21, 2016). The SEC previously had entered into a settlement with the charter school operator for defrauding investors in connection with the same offering. Press Release, “SEC Charges Charter School Operator in Chicago with Defrauding



information. The second advisor ultimately won the municipal advisory contracts.

On 21 June 2016, the SEC announced that the former president of a charter school operator agreed to settle fraud charges connected to a large bond offering to build three charter schools. Press Release, “Former CEO of Chicago Charter School Operator Settles Muni-Bond Fraud Charges” (June 21, 2016), <http://www.sec.gov/news/pressrelease/2016-125.html>. The SEC’s complaint posits that the former president “negligently approved and signed a bond offering statement that omitted the charter

Bond Investors” (June 2, 2014), <https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541965772>.

ONGOING LITIGATION

Two other enforcement actions concerning municipal bond offerings are being litigated in U.S. district courts. The first matter involves a town, its local development corporation, and four town officials who allegedly hid the “strain” in the town’s finances caused by the construction of a baseball stadium and the town’s declining tax revenues, from their municipal bond

investors. The litigation is ongoing with respect to each of the parties.

In the second matter, the SEC has alleged that a state agency and its bond underwriter engaged in fraud relative to a municipal bond offering to finance a startup video game company. The SEC brought charges against the state agency, two agency executives, the underwriter, and the lead banker on the deal. Although the executives settled the charges brought against them, litigation involving the lead banker, the underwriting firm, and the state agency is ongoing.

Municipal bond issuers, underwriters, financial advisors, and individuals associated with those entities should be mindful of the recent uptick in enforcement actions relating to municipal bond offerings. As in the past, enforcement actions have focused on lack of transparency and alleged failures to disclose certain information to potential investors; however, in doing so, the SEC has invoked authority granted to it by Dodd-Frank. Recent enforcement efforts also suggest that the SEC may be more willing to impose penalties on entities that historically were not the subject of enforcement actions.

“Municipal bond issuers, underwriters, financial advisors, and individuals associated with those entities should be mindful of the recent uptick in enforcement actions relating to municipal bond offerings.”

AUTHORS

Stephen G. Topetzes
Washington, D.C.
stephen.topetzes@klgates.com

Nicole A. Baker
Washington, D.C.
nicole.baker@klgates.com

Rights Against Self-Incrimination in U.S. and Canadian Securities Regulatory Investigations

With an ever-expanding global economy, the U.S. securities enforcement regime increasingly looks to foreign jurisdictions in search of evidence during its investigations. In particular, the U.S. Securities and Exchange Commission (SEC) frequently directs requests for assistance to regulators in offshore jurisdictions and other countries as it seeks to gather documents and testimony from companies, banks, other regulated entities, or individuals.

One key jurisdiction with which the SEC frequently interacts is its neighbor to the north—Canada. Requests for assistance from the SEC to Canada are directed to the securities commissions of the individual Canadian provinces, as there is no national securities regulatory agency in Canada akin to the SEC. The SEC is party to separate Memoranda of Understanding (MOU) with the regulators from each Canadian province such as the British Columbia Securities Commission (BCSC), the Ontario Securities Commission (OSC), and the Alberta Securities Commission (ASC). The SEC makes a request for assistance to the provincial regulator under the MOU, and the Canadian regulator then uses its authority under Canadian and provincial securities laws to seek documents or investigative testimony from entities or individuals in the province.

Significant questions may arise, however, once an individual is in receipt of such a request or demand for documents or testimony. What rights are possessed by the recipient of the demand? And whose law determines those rights? If the request or demand by the Canadian regulator is derivative of a request for assistance by the SEC, are the rights of the recipient determined by reference to U.S. law? The answers to these questions can be critical.

In many respects, the rights afforded the recipients of investigative requests or demands are similar in Canada and the United States. But they are different in one key respect that can have severe



consequences for a person served with a demand for documents or testimony.

Canadian and U.S. law differ with respect to the right of individuals to refuse to testify or produce documents because doing so may incriminate them. In the United States, the Fifth Amendment to the United States Constitution affords individuals a right against self-incrimination. Thus, in the United States, individuals can invoke their rights under the Fifth Amendment in response to demands for information from any government agency, whether in a civil investigation by the SEC or a criminal investigation by the Department of Justice (DOJ).

Canada also values the right against self-incrimination, but it does so in a

different way that leaves a significant gap between the rights afforded individuals in each country. Under the Canadian Charter of Rights and Freedoms, an individual can be compelled to testify or provide documents to a regulator even if it might incriminate them. However, if an individual is compelled to provide evidence, that evidence cannot be used against him or her in a criminal matter. It can only be used in the context of civil enforcement proceedings brought by a civil regulator.

The distinction was summarized by the

Ontario Court of Appeal in *Catalyst Fund General Partner I Inc. v. Hollinger Inc.* (2005), 79 O.R. (3d) 70 at para. 4:

In both Canada and the United States, the right to protection from self-incrimination is an important right that is safeguarded. The difference between how that right is protected in Canada and in the United States lies at the heart of this appeal. In Canada, a person has the right not to have any incriminating evidence that the person was compelled to give in one proceeding used against him or her in another proceeding except in a prosecution for perjury or for the giving of contradictory evidence. Thus, in Canada, a witness cannot refuse to answer a

“...the SEC can share information provided by the Canadian securities regulator with U.S. criminal agencies such as the DOJ...”

question on the grounds of self-incrimination, but receives full evidentiary immunity in return. In the United States, a witness can claim the protection of the Fifth Amendment and refuse to answer an incriminating question. Once the answer is given, however, there is no protection.

A challenge is created when the SEC, a civil agency of the United States government, requests assistance from a Canadian provincial securities regulator, a civil agency of Canada, who then serves a demand for information on an individual in Canada. Under U.S. law, the SEC cannot compel information from an individual if that evidence might tend to incriminate him or her. But under Canadian law, that individual cannot refuse to cooperate on the basis that it might incriminate him or her, even though the demand by the Canadian regulator was directed by the SEC, which lacks an ability to compel the individual to provide the information under U.S. law.

The predicament becomes drastically worse when one considers what may happen once the information compelled by the Canadian regulator is passed along to the SEC. Among other things, the SEC can share information provided by the Canadian securities regulator with U.S. criminal agencies such as the DOJ, and there is no prohibition on the United States government’s use of that information against the individual in a subsequent criminal prosecution.

The SEC’s standard supplemental information form provided to all

individuals from whom it seeks information, known as Form 1662, contains the following warning:

Information you give may be used against you in any federal, state, local or foreign administrative, civil, or criminal proceeding brought by the Commission or any other agency. You may refuse, in accordance with the rights guaranteed to you by the Fifth Amendment to the Constitution of the United States, to give any information that may tend to incriminate you.

The same form lists as one of the SEC’s “Routine Uses of information,” that the SEC may furnish the information obtained “to other federal, state, local, or foreign law enforcement agencies.” Therefore, there is cause for concern that once information compelled by a Canadian securities regulator is in the SEC’s possession, it may be used against the individual in a U.S. criminal prosecution.

Given the history between the neighboring nations, one might think that such a critical issue that touches upon basic notions of individual rights and liberties would long ago have been resolved through U.S. or Canadian jurisprudence. Or one might think that U.S. government agencies such as the SEC or DOJ would have adopted rules or procedures governing the use of such information compelled by a Canadian regulator at the request of the SEC. Neither is the case. Canadian jurisprudence, which varies by province, is unsettled regarding the right of an individual served with a demand for information by a Canadian securities regulator, which is plainly acting as a foreign agent of the SEC, to refuse to provide the information on the ground that the information could be used against him or her in a U.S. criminal prosecution.

Courts in Canada undertake a fact-specific inquiry and decide on a case-by-case

basis whether the predominant purpose of the investigation is criminal. But such analyses may not address critical issues. Serious and prejudicial challenges may exist because the SEC often conducts civil investigations and then makes a referral to the DOJ pursuant to which it sends along all evidence, including data obtained by compulsion in Canada, where perhaps the predominant purpose of the investigation, at the time, was only civil and not criminal.

Courts of appeal in Canada have touched upon the issue only episodically and with varied results or conclusions. In British Columbia, for example, the issue has not yet been addressed with any certainty by the British Columbia Court of Appeal, the highest court in the province. The BCSC takes the position that all SEC requests are, by definition, sent in furtherance of a predominantly civil or regulatory purpose merely because the requests come from the SEC, a civil regulatory agency. This position raises obvious concerns for the recipient of a BCSC demand for information.

For now, uncertainty remains and challenges persist for persons who receive requests for information from a Canadian securities regulator at the instance of the SEC. The future will tell whether determinations by U.S. or Canadian courts or agencies will provide greater clarity for recipients of such requests or demands. Unless and until they do so, individuals and companies in Canada, or Canadian divisions or subsidiaries of U.S. companies that receive subpoenas, demands, or informal requests for information from a Canadian securities regulator that may be assisting the SEC must give careful consideration to their rights relative to the Canadian regulatory request. They must also consider how those rights may differ from those they have grown to expect in the United States and whether and how their rights might be impacted by their response to the Canadian regulator.

AUTHOR

Michael J. Quinn
Los Angeles
michael.quinn@klgates.com

EU Competition Authorities Focus on E-Commerce

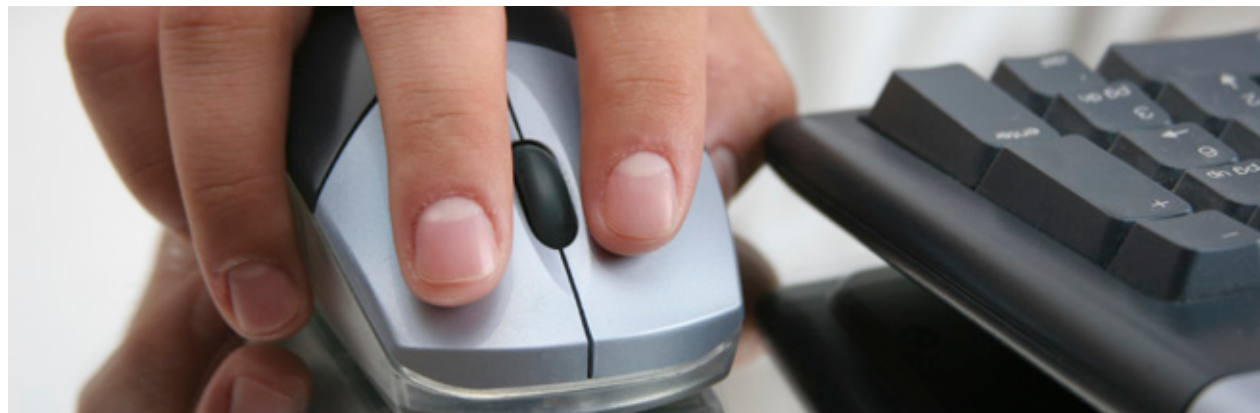
The online sector has been rising in economic significance at an extraordinarily rapid pace in the last several years. Consequently, national competition authorities in the EU member states and the EU's competition watchdog, the EU Commission, have intensified their regulatory focus on e-commerce, weighing the risks and the specific challenges of online markets and taking action on barriers under EU competition rules.

These developments should be monitored closely by all companies distributing products and services in the European Union.

The EU Commission's key initiative for a Digital Single Market, adopted in May 2015, set ambitious objectives to further and improve the exploitation of the full potential of the digital market and to achieve a digital single market within the European Union. EU competition law plays an important role in reaching these goals:

- The EU Commission has targeted competition restrictions affecting ecommerce through a number of competition law proceedings it has opened in the recent past, such as its action regarding Google's use of search algorithms.
- The EU Commission has also proactively attacked barriers affecting an internal European online market such as the practice of restricting access to Internet content based upon the user's geographical location ("geo-blocking"). In a press release issued 6 May 2015, the European Commissioner in charge of competition policy, Margrethe Vestager, stated: "European citizens face too many barriers to accessing goods and

services online across borders. Some of these barriers are put in place by companies themselves. With this sector inquiry, my aim is to determine how widespread these barriers are and



what effect they have on competition and consumers. If they are anti-competitive, we will not hesitate to take enforcement action under EU antitrust rules."

- In 2015, the EU Commission launched an inquiry into the ecommerce sector with questionnaires going out to a number of companies active in different areas of the online sector. A preliminary report of the EU Commission's findings is expected to be published in mid-2016.

In line with the EU Commission, a number of member states' competition authorities have also intensified their focus on ecommerce. As an example, so-called most favored customer or price parity clauses (i.e., obligations

not to grant better conditions in any other sales channel) imposed by online platforms were assessed and found to be anticompetitive by national competition authorities in Germany and the United Kingdom. In particular, the German competition authority, the Federal Cartel Office (FCO) and courts in Germany have pursued a strict approach with regard to restrictions of online distribution. In several case studies and decisions, the FCO and German courts emphasized that so-called dual-pricing systems, which differentiate between online and offline retail pricing, as well as blanket bans of

online resale via third-party platforms, are in breach of competition law. A total third-party platform ban was regarded as being anticompetitive even if the manufacturer implemented a selective distribution system, i.e., a system where only distributors or retailers who meet certain minimum criteria are to be supplied with the products. However, the Higher Regional Court of Frankfurt am Main recently concluded that a ban on online resale via a specific third-party sales platform within a selective distribution system was permissible because consumers see this specific platform as being the reseller itself and not only a marketplace. As the platform was not admitted to the selective distribution system, the manufacturer did not have to accept sales via that

platform. On the other hand, the court regarded the blanket ban of the use of price search engines also imposed by the manufacturer to be in breach of competition law and not justifiable based on the selective distribution criteria. The recent referral by a German court for a preliminary judgment by the European Court of Justice on questions regarding the admissibility of online sales restrictions in selective distribution systems shows that the discussion is ongoing.

Although developments in case law remain to be seen, we do not expect that the focus on e-commerce in the European Union will decrease anytime soon. Quite the contrary. On 2 March 2016, the FCO announced that it has initiated proceedings against Facebook, Inc., the Irish subsidiary of the U.S. company, and Facebook Germany GmbH, the German subsidiary. The FCO is assessing whether Facebook's potential use of unlawful terms and conditions (i.e., those in violation of data protection provisions) could "represent an abusive imposition of unfair conditions on users." Andreas Mundt, president of the FCO, commented: "Dominant companies are subject to special obligations. These include the use of adequate terms of service as far as these are relevant to the market. For advertising-financed internet services such as Facebook, user data are hugely important. For this reason, it is essential to also examine under the aspect of abuse of market power whether the consumers are sufficiently informed about the type and extent of data collection." The FCO has also announced that it is conducting its investigations in close contact with the EU Commission and the competition authorities of the other EU member states.

The specific challenges in e-commerce markets have also led to modification of traditional competition law approaches. With regard to online platforms, the FCO in a background paper dated 1 October 2015, pointed out that "traditional methods to determine relations of competition and market power are not entirely applicable to platforms and data driven offers of the digital economy and thus impose significant challenges to competition law application." The EU Commission has recently reversed its former view and stated that market relationships without monetary consideration constitute markets that are subject to competition law review—as in the merger cases of Microsoft and Skype and Facebook and Whatsapp as well as in the ongoing Google investigation. The FCO and German courts are expected to follow suit given the new FCO investigation against Facebook.

Additionally, the traditional concept of turnover thresholds for merger control filing obligations might soon be modified to adjust to the particularities of the online sector. The European Union and the EU member states' merger regulation prohibit mergers and acquisitions that would significantly reduce competition in a single market—such as when the merger would create dominant companies that are likely to raise prices for consumers. Traditionally, the EU Commission and EU member states' competition authorities only examine mergers when the merging firms reach significant turnover thresholds. This approach, may not be appropriate for online companies. The German Monopolies Commission summarized the problem in its Special Report No 68 of 2015:

"The consequence of the regulatory technique used in both European and German law is that the acquisition of a company which previously had little or no

turnover can also remain exempt from control if the purchaser is a world market leader with turnover in the billions. This is, first, relevant to business models which involve the formation of commercially valuable data inventories without the individual companies' data inventories already having impacted turnover to a considerable degree. Second, the current notification system is unable to cover cases where young companies acquired, for instance in the technology sector, which have considerable market potential, but so far only little turnover. Thus, market-leading companies can eliminate up-and-coming competitors from the market at an early stage of development by acquiring them before they grow to serious competitors."

On the basis of these considerations, the German Federal Ministry for Economic Affairs and Energy highlighted in its annual economic report in 2015 that:

"the German Government is of the opinion that it should be assessed whether for merger control purposes on an EU level the size of the transaction also needs to be taken into account, which can essentially depend on the number of users and the value of data which it has proposed to the EU Commission."

These developments are still in flux and should be monitored closely by all companies using online channels for distribution of products and services. This means that a wide variety of companies will have to keep these developments uppermost in mind—not only when structuring their distribution system in the European Union.

AUTHORS

Dr. Annette Mutschler-Siebert,
M.Jur (Oxon)
Berlin
annette.mutschler-siebert@klgates.com

Marion Baumann
Berlin
marion.baumann@klgates.com

Identification of Third Parties by the UK's Financial Conduct Authority

As part of its enforcement system, the UK's Financial Conduct Authority (FCA) issues public warning notices or decision notices against financial entities under its supervision. The FCA issues a warning notice to a party against which it proposes to take action; final notices are issued by the FCA once it has taken action. Both notices are public. Section 393 Financial Services and Markets Act 2000 (Section 393) provides that a third party prejudicially identified by the FCA in a warning notice or decision notice must be given a copy of that notice and receive disclosure of all relevant material on which the FCA relied in

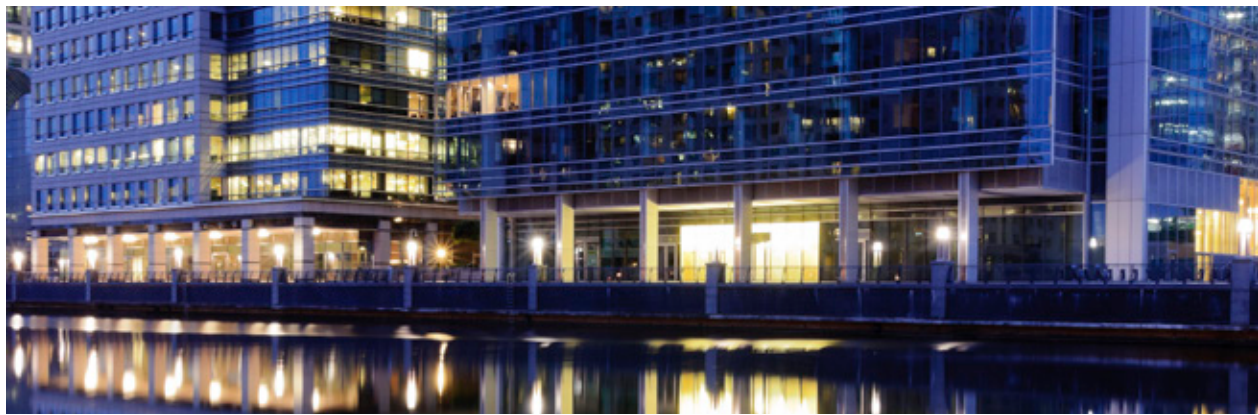
making its decision and any secondary material which might undermine it. These provisions enable individuals to refer the notice to the Upper Tribunal (Tribunal) to challenge the FCA's criticisms or opinions expressed about them in the notice before it is published. The term "prejudicial" is not defined within

the Financial Services and Markets Act 2000. It is likely to encompass any references that could harm the third party's reputation, could damage the view of the third party by jurors in future criminal proceedings, or could lead to civil claims being brought against the third party. Because, in many cases, it appears the FCA will concede that the reference is "prejudicial" and the case will turn on whether the third party has been identified, we focus on the current test and guidance on identification as set out in recent decisions and discuss what some of the key implications might be. In *Achilles Macris v The Financial Conduct Authority* [2015] EWCA Civ 490, the FCA appealed a decision in the Tribunal that Mr. Macris had been identified in certain notices given to JPMorgan Chase Bank, N.A (JP Morgan). The FCA had imposed

a financial penalty on JP Morgan for trading losses incurred by the Bank's Synthetic Credit Portfolio (SCP), a trading portfolio in the Bank's Chief Investment Office (CIO). Mr. Macris had a role in the management structure of the SCP as International Chief Investment Officer, based in London. Mr. Macris contended that the term "CIO London management" in the notices referred to him. The investigation into *Macris* was part of the investigations into the large trading losses which occurred at JPMorgan's Chief Investment Office in April and May 2012. A number of transactions

properly be construed as a reference to an individual (or corporate) person, then the first stage of the test was met. The fact that a criticism of a corporate could be read as casting a slur, say, on the CEO or CFO of a company was not sufficient to identify a person. Applying the test above, the CA held that the reference to "CIO London management" was clearly a reference to a particular individual and not a body of people.

Second, the correct test for identification was an objective one:



involving credit default swaps (CDS) were entered on which a trader, nicknamed "the London Whale," adopted outside positions in the market. These positions gave rise to a trading loss of US\$6.2 billion. In *Macris*, the Court of Appeal (CA) held that the question of whether a notice identifies an individual is to be determined by the application of a two-stage test, and that the word "identifies" within Section 393 was not held to have any special or limited meaning.

First, it must be the "matter" referred to in the relevant notice that "identifies" the third party. The third party did not have to be mentioned by name. As long as the relevant description in the "matters" (whether by reference to an office, a job description, or simply "Mr. X") could

Are the words used in the "matters" such as would reasonably in the circumstances lead persons acquainted with the claimant/third party, or who operate in his area of the financial services industry, and therefore would have the requisite specialist knowledge of the relevant circumstances, to believe as at the date of the promulgation of the notice that he is a person prejudicially affected by matters stated in the reasons contained in the notice?

The CA held that the Tribunal below had stated the test too broadly and that there could not be ex post facto unlimited reference to external material in order to identify the individual. Nevertheless,

the CA upheld the Tribunal’s decision that Mr. Macris had been identified, finding that on an objective basis, persons acquainted with Mr. Macris or who operated in his area of the financial services industry would reasonably have been able to identify Mr. Macris from the statements made in the notice.

Two recent decisions have provided clarity as to the practical application of the CA’s decision in *Macris*.

In *Christian Bittar v The Financial Conduct Authority* ([2015] UKUT 602 (TCC)), Christian Bittar, who was (and continues to be) represented by K&L Gates, made a reference to the Tribunal under Section 393(11) on the basis that he had been identified as “Manager B” in a final notice to Deutsche Bank. Mr. Bittar had been a manager of Deutsche Bank’s Money Markets Derivatives desk in London.

The Tribunal stated that the correct test: “focuses on the knowledge that could be reasonably expected to have been obtained by well-informed market participants in the relevant area by the time of the publication of the notice and retained by them without having to do an extensive forensic exercise.” The Tribunal considered that “relevant readers” did not include those with intimate knowledge of the relevant events (e.g., in this case, those people who worked in Mr. Bittar’s immediate team), but rather those who worked directly in the relevant sector, including Mr. Bittar’s counterparts in

other banks operating in the same area. The scope of the test is limited to what relevant readers would reasonably know and conclude, not whether it is logically possible to work out the person’s identity from publicly available material, say, through a process of investigative journalism. The judge found that the details of Mr. Bittar’s employment would be known and remembered by a relevant reader at the time he read the notice, which provided a substantial level of information about “Manager B.” It was therefore inevitable that the relevant reader would conclude that Manager B could not be anyone other than Mr. Bittar.

In addition, *Bittar* recognises that “relevant readers” might be aware of the content of foreign regulatory orders. In *Bittar*, the publication of the notice was coordinated with the publication of three U.S. regulatory notices, which were referred to by the FCA in its press release accompanying the final notice. The Tribunal, following *Macris*, expected that the relevant reader would be likely to read the accompanying press releases and relevant passages in the U.S. regulatory notices. As a result, the Tribunal concluded that *Bittar*’s rights had been violated by the FCA.

A few weeks after *Bittar*, the Tribunal heard a further third-party reference in *Christopher Ashton v The Financial Conduct Authority* [2016] UKUT 0005 (TCC), which arose in the context of FCA final notices against UBS and Barclays for

foreign exchange manipulation. The FCA submitted that the first stage of the test in *Macris* could not be satisfied, because the references in the UBS and Barclays Notices criticised the financial institutions (UBS and Barclays, respectively), rather than an individual. The Tribunal disagreed and held that these terms were in fact used to describe the actions of a particular individual. This ruling means that the FCA cannot avoid having regard to the rights of a third party simply by describing the actions of that third party (which are identifiable for the purposes of Section 393) as attributable to a “firm.” The Tribunal went on to find that Mr. Ashton had not been identified in the notices issued against UBS and Barclays. The Tribunal submitted that, although the relevant reader would have been aware through press reports of Mr. Ashton’s involvement in a trader’s chat room known as “the Cartel,” the relevant reader would not reasonably conclude that the notices were describing conversations that took place in the Cartel. There were numerous chat rooms in which conversations between traders took place, and there was no information to suggest that Mr. Ashton was a member of the Cartel at time of the relevant conduct.

The decision in *Macris*, and as applied in *Bittar*, will be welcomed by third parties that believe that they may have been identified in an FCA notice, of which their current or former employer is the subject. Indeed, *Macris* and *Bittar* are likely to increase the number of individuals claiming to be prejudiced by FCA notices. Under these decisions, third parties who can be identified from the notice—even if only by specialist people with knowledge in the relevant industry—will be able to challenge the FCA’s criticism of them. The FCA cannot simply investigate and engage in settlement with the financial institution that is the subject of the Notice, but will have to consider more carefully the rights of any third party to which it refers, even where anonymous.

Whether a notice identifies a third party, however, “is largely, if not entirely, a question of fact.” *Macris* and *Bittar* do not

The term “prejudicial” is not defined within the Financial Services and Markets Act 2000.



offer a carte blanche to any third party that seeks redress under Section 393. Indeed, as Mr. Ashton, and subsequently Mr. Vogt (*Joerg Vogt v the Financial Conduct Authority* [2016] UKUT 0103 (TCC)), discovered, there are real risks to making an application under Section 393. In these cases, prior to the reference, there was no publicity linking Mr. Ashton specifically to the UBS notice. In bringing the reference, however, Mr. Ashton publicly identified himself in the notice, thereby suffering exposure but being denied an opportunity to challenge the criticisms of him contained in it. Any decision by a third-party to challenge a reference must be considered carefully, not least because of the potential to create substantial and irrecoverable harm by pursuing the matter at all. Further, as a third-party reference is public, the third party may unwittingly bring themselves to the attention of other regulatory authorities, such as the Serious Fraud Office or the U.S. Department of Justice or Securities and Exchange Commission.



Macris, as applied in *Bittar and Ashton*, will force the FCA to reconsider the way it drafts notices. The FCA will have to be more cautious about the language it uses if it wants to avoid identifying “third parties” for the purposes of Section 393. Identification of third parties could seriously frustrate the FCA’s desire to strike speedy settlements with financial institutions. Where third parties are identifiable, the FCA will have to consider their rights and respond to them before publishing any decision. Equally, if individuals are not granted third-party rights and make a reference, the notice will not take effect until the reference, and any subsequent appeal, has been disposed of, which will also cause delay.

The prospect of such delays will also concern financial institutions that are the subject of a notice and engaged in settlement negotiations with the FCA, as it could impact their ability to conclude a speedy settlement.

The FCA has appealed the decision in *Macris* to the Supreme Court, whose decision will determine whether the wider *Macris* interpretation of section 393 will be upheld. Whether the Supreme Court finds in favor of the FCA or not, the legislation will continue to offer protection. However, the Supreme Court’s judgment is likely to provide guidance on how the legislation is to be interpreted and, therefore, the extent of the protection afforded by Section 393.

“ Identification of third parties could seriously frustrate the FCA’s desire to strike speedy settlements with financial institutions.”

AUTHORS

David A. Savell
London
david.savell@klgates.com

James G. Millward
London
james.millward@klgates.com

Jonathan A. Graham
London
jonathan.graham@klgates.com

A New Compliance Culture in Brazil

Amidst the largest corruption scandal in Brazil's history involving the payments of bribes made by several companies to officers of the Brazilian state-owned oil giant Petrobras, which has been investigated since the end of 2014 and that carries the peculiar name of "Lava Jato" ("Car Wash" in English), a new corporate compliance culture has emerged with force in Brazil and is affecting in significant ways how companies conduct business and interact with the government.

Prior to the Lava Jato investigations, it was extremely rare that high-ranking Brazilian executives of companies caught in corruption scandals were sent to jail or that the companies themselves collaborated with police investigations in anticorruption matters. With Lava Jato, this scenario changed. Executives of some of Brazil's largest construction groups involved in the payment of bribes to Petrobras' officials have been imprisoned, and the companies have cooperated and begun or already closed leniency arrangements with local authorities.

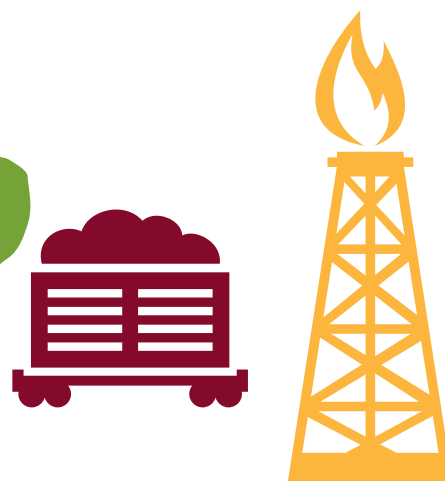
This scenario now serves as an incentive for the adoption by Brazilian companies of a stronger ethics model. Brazil has been preparing itself for this change for some time with the strengthening

of its anticorruption laws. The main regulatory change behind this effort was the enactment the Clean Company Act in February 2013 (Federal Law 12.846/13), which addresses corporate corruption-related misconduct.

The Clean Company Act targets the corrupt acts against any legal entity, regardless of its corporate form, jurisdiction of formation, or industry. The Clean Company Act is considered a "civil law," since in Brazil, companies are not subject to criminal liability under most laws. The Clean Company Act does not apply to individuals involved in corruption wrongdoing, however, and such individuals are prosecuted under the local criminal laws.

A key aspect of the Clean Company Act is its application of the theory of strict liability on a legal entity for unlawful acts attributable to it. For example, a company may be deemed liable for the mere fact that an unlawful act was committed by one of its employees or agents (e.g., an improper payment was made to a public official), as long as it can be shown that the unlawful act was done for the benefit of the company, even if the company prohibits such misconduct, and without any need to show that the company's directors or officers were aware or had a corrupt intent.

Penalties for violating the Clean Company Act can be significant, including fines of up to 20 percent of a company's gross revenue and disbarment from entering into agreements with the government and participating in public bids. There is a complex formula in the regulations of the Clean Company Act to calculate the exact applicable penalties based on a number of aggravating and attenuating factors. A major attenuating factor taken into account by the enforcement authorities in determining sanctions for



violations is the extent of a company's cooperation in the investigation and the existence and effective implementation of internal compliance mechanisms and procedures. Cooperation usually requires the company to provide a detailed account of the misconduct, the disclosing of the identity of the individuals involved, and the delivery of corporate documents and records that may support the disclosed facts. Other relevant attenuating factors are whether the company has a compliance program in place and whether it voluntarily reported the misconduct to the authorities.

Another important aspect of the Clean Company Act is the possibility that a company could enter into a leniency arrangement with the Comptroller's Office, which is the authority responsible for the law's enforcement. In order to be entitled to leniency, the company must

admit its participation in the wrongdoing and cooperate with the investigation at an early enough time to be considered relevant by the authorities. A leniency agreement will usually result in a company avoiding or limiting application of the harshest sanctions, such as a disbarment from participating in public bids.

The recent, demonstrated enforcement of the Clean Company Act, coupled with the possibility of reducing exposure

if violations exist, has caused local companies to be rightfully concerned about timely identifying hidden anticorruption liabilities in their day-to-day business. Companies doing business in Brazil are increasingly adopting strict compliance programs, engaging in internal investigations for suspected wrongdoings, and undertaking anticorruption due diligence in their M&A transactions. These are recommended actions in tune with the new compliance culture of the country.



AUTHORS

Juliana Araujo
São Paulo
juliana.araujo@klgates.com

Marc Veilleux
São Paulo
marc.veilleux@klgates.com

Tremors in the U.S. Government Contracts Compliance World: The Yates Memo and the U.S. Supreme Court’s Analysis of Key Aspects of the Civil False Claims Act

Over the past few years, U.S. federal procurement budgets have been stagnant. All eyes are on the presidential, and to a lesser extent, congressional elections, waiting to see whether federal procurement spending will climb or fall in coming years. Election of a Republican as president will likely mean increased defense and intelligence agency procurement budgets. Election of a Democrat as president will likely introduce reductions in defense procurement spending, at least for large-ticket items, and renewed focus on spending for intelligence and cybersecurity activities and domestic needs.

But one thing is certain—regardless of which party is in power, new developments in the world of compliance for companies performing U.S. federal prime or subcontracts will change the U.S. government contracts landscape. In recent years, U.S. government contractors have been subjected to evermore demanding ethics and compliance regimes. Among them is a mandate that all prime contractors and subcontractors maintain robust internal compliance programs that include mechanisms for detecting and reporting to the U.S. government criminal and civil fraud violations. Two new developments are likely to have a significant effect on how contractors administer their compliance and mandatory disclosure programs.

THE YATES MEMO—A RENEWED FOCUS ON LIABILITY FOR INDIVIDUALS

In September 2015, the U.S. Department of Justice (DOJ) announced its intention to increase its focus on individuals involved in corporate crimes and civil fraud when Deputy Attorney General Sally Quillian Yates issued a memorandum to the Attorneys General for the six divisions of the DOJ (antitrust, civil, criminal, environment and natural resources, national security, and tax), the directors of the FBI and Executive Office for the U.S. Trustees, and all U.S. lawyers. The so-called “Yates Memo” directed the DOJ lawyers and investigators to substantially increase their focus on targeting individuals and not merely

companies in resolving both criminal and civil matters. The Yates Memo set out six principles regarding the DOJ’s renewed focus on individuals:

- **Principle 1:** To be eligible for any cooperation credit, corporations must provide to the DOJ all relevant facts about the individuals involved in corporate misconduct.
- **Principle 2:** Both criminal and civil DOJ investigations should focus on investigating individuals from the inception of the investigation.
- **Principle 3:** Criminal and civil lawyers handling corporate investigations should be in routine communication with one another.
- **Principle 4:** Absent extraordinary circumstances, no corporate resolution will provide protection from criminal or civil liability for any individuals.
- **Principle 5:** Corporate cases should not be resolved without a clear plan to resolve related individual cases before the statute of limitations expires and declinations as to individuals in such cases must be memorialized.
- **Principle 6:** Civil lawyers should consistently focus on individuals as well as the company and evaluate whether to bring suit against an individual based on considerations beyond that individual’s ability to pay.

Deputy Attorney General Yates delivered a speech at New York University (NYU) the day after she issued the Yates Memo, which amplified points stated in the Yates Memo.

“The so-called “Yates Memo” directed the DOJ lawyers and investigators to substantially increase their focus on targeting individuals and not merely companies in resolving both criminal and civil matters.”

All six principles should cause concern for corporations and their counsel. Two principles in particular, however, stand out for government contractors when coupled with comments Ms. Yates provided in her NYU speech.

First, with regard to Principle 1, the Yates Memo stated, “In order for a company to receive any consideration for cooperation under the Principles of Federal Prosecution of Business Organizations, *the company must completely disclose to the Department all relevant facts about individual misconduct.*

Companies cannot pick and choose what facts to disclose. That is, to be eligible for any credit for cooperation, the company must identify all individuals involved in, or responsible for, the misconduct at issue, regardless of their position,

status or seniority, and provide to the Department all facts relating to that misconduct.” (emphasis added). In her NYU speech, Ms. Yates elaborated on this point: “The rules have just changed. Effective today, if a company wants any consideration for its cooperation, it must give up the individuals, no matter where they sit within the company. And we’re not going to let corporations plead ignorance. If they don’t know who is responsible, they will need to find out. If they want any cooperation credit, they will need to investigate and identify the responsible parties, and then provide

all nonprivileged evidence implicating those individuals.” (emphasis added).

Second, the Yates Memo provided the following explanation of Principle 6: “The Department’s civil enforcement efforts are designed not only to return government money to the public fisc, but also to hold the wrongdoers accountable and to deter future wrongdoing. These twin aims—of recovering as much money as possible, on the one hand, and of accountability for and deterrence of

what they have and ensure that they don’t benefit from their wrongdoing. These individual civil judgments will also become part of corporate wrongdoers’ resumes that will follow them throughout their careers.” (emphasis added).

While the actual effects of the Yates Memo remain to be seen as individual prosecutors and offices implement it, the Yates Memo could have potentially far-reaching implications for U.S. government contractors. For one, the



individual misconduct, on the other—are equally important...*Pursuit of civil actions against culpable individuals should not be governed solely by those individuals’ ability to pay.*” (emphasis added). In her NYU speech, Ms. Yates added, “There is real value, however, in bringing civil cases against individuals who engage in corporate misconduct, even if that value cannot always be measured in dollars and cents...while we may not be able to satisfy the entire judgment with an individual’s resources, if that individual is liable, *we can take*

new policy could have a chilling effect on internal investigations, with corporate counsel receiving less cooperation from employees, especially highly placed employees, fearful of implicating themselves. It is conceivable that such employees may insist that companies offer them separate counsel before cooperating. Many private bar and corporate lawyers are anticipating delays in resolving matters investigated internally and disclosed to the U.S. government. Those performing U.S. government contracts will need to consider carefully how they conduct

and resolve internal investigations. Corporations should pay close attention in the coming months and year to the DOJ's practices as the department implements the Yates Memo principles.

THE U.S. SUPREME COURT'S CONSIDERATION OF THE IMPLIED CERTIFICATION CONCEPT UNDER THE CIVIL FALSE CLAIM ACT

U.S. government contractor obligations to investigate and disclose possible noncompliances with respect to performance of federal contracts and subcontracts centers on the civil False Claims Act (FCA), 31 U.S.C. §§ 3729 et seq. Specifically, contractors are required to disclose "credible evidence" of possible FCA violations—that is, they have overcharged the government and submitted a "false" claim for payment. This has proved in recent years to be incredibly challenging, as the 12 U.S. Courts of Appeals have articulated markedly diverging interpretations of the statute. Among the most controversial interpretations is the concept of "implied certification." The theory provides a U.S. government contractor can be subjected to FCA liability even where it is alleged that the contractor failed to comply with a specific contract requirement or regulation but did not expressly certify to such compliance when it submitted a request for payment to the U.S. government. On 4 December 2015, the U.S. Supreme Court agreed to address this important issue by granting *certiorari* in the case of *U.S. ex rel. Escobar v. Universal Health Services, Inc.*, 780 F.3d 504 (1st Cir. 2015).

The FCA exposes contractors who submit false claims for payment to the government to significant civil penalties and treble damages. Federal caselaw has followed a path that places potential FCA liability into two categories: claims that are "factually false" and claims that

are "legally false." Factually, false claims include claims containing an incorrect description of the goods or services provided or claims for goods and services that the contractor never provided. The premise of the theory of legal falsity is less straightforward. In some jurisdictions, legal falsity creates FCA liability if a contractor provides a false representation of compliance with a federal statute or regulation or a prescribed contractual term that has a material effect on the government's decision to pay a claim. This may be so even where the contractor makes no representation of compliance when it submits its request for payment. This implied certification doctrine posits that even where a contractor does not *expressly* certify its compliance with a certain contract requirement when it submits a request for payment to the government, it *impliedly* certifies that it has complied with all contractual and regulatory requirements that are (1) a prerequisite to payment, or (2) material to the government's decision to pay a claim. The majority of federal circuit courts have ruled that liability attaches only when the falsely certified requirement is a condition of payment, as opposed to a condition of participation, in the government contract.

Several recent decisions have highlighted the divergence that has emerged in courts' interpretations of the implied certification theory. In *United States v. Sanford-Brown, Ltd.*, 788 F.3d 696 (7th Cir. 2015), the Seventh Circuit wholly rejected the implied certification theory, stating that the FCA is "not the proper mechanism" for the government's enforcement of regulations. Other circuits, such as the First, Second, Fourth, and D.C. Circuits, have adopted the implied certification theory but differ in their interpretations of its application. In one of the most narrow interpretations, the Second Circuit in *Mikes v. Straus*, 274 F.3d 687, 696–97 (2d Cir. 2001), held that a claim is only impliedly false where an underlying statute or regulation expressly mandates

that the party comply with specific obligations as a precondition of payment.

The Fourth Circuit, however, adopted a broader view of the implied certification theory in *United States ex rel. Badr v. Triple Canopy Inc.*, 775 F.3d 628 (4th Cir. 2015). The alleged fraudulent scheme in that case involved a year-long effort to falsify records in personnel files for Ugandan guards serving as primary security forces on U.S. airbases in Iraq for the purpose of satisfying marksmanship requirements in the contract. The contractor asserted in defense that the failures amounted merely to potential noncompliances with certain terms of the contract, not false claims under the FCA. Ruling on a motion to dismiss, the U.S. Court of Appeals for the Fourth Circuit held, "the Government pleads a false claim when it alleges that the contractors, with the requisite scienter, made a request for payment under a contract and withheld information about its noncompliance with material contractual requirements." With respect to materiality, the Fourth Circuit stated, "common sense strongly suggests that the Government's decision to pay a contractor for providing base security in an active combat zone would be influenced by knowledge that the guards could not, for lack of a better term, shoot straight." 775 F.3d at 638.

Similarly, in *U.S. ex rel. Heath v. AT&T, Inc.*, 791 F.3d 112 (D.C. Cir. 2015), the D.C. Circuit held that the implied certification theory applied if a defendant knowingly withheld information about its noncompliance with material contract requirements. In that case, the relator alleged that AT&T fraudulently overbilled the government, not through affirmative misrepresentations, but by knowingly failing to enforce compliance with a program that entitled schools and libraries to discounted phone and Internet service rates. The D.C. Circuit ruled that the FCA case could proceed against AT&T. Yet, in a subsequent case,

the D.C. Circuit interpreted the implied certification theory somewhat differently following a trial in *U.S. ex rel. Purcell v. MWI Corp.*, 807 F.3d 281, 2015 WL 7597536 (D.C. Cir. Nov. 24, 2015). There, the D.C. Circuit held that where the law or regulation at issue is ambiguous and the defendant's interpretation of the ambiguity is reasonable, the defendant as a matter of law lacks the requisite *scienter* (intent) necessary for a false claim.

Finally, in the case taken up by the Supreme Court, the First Circuit in *U.S. ex rel. Escobar v. Universal Health Services, Inc.* dismissed distinctions between factual falsity and legal falsity and between express certification and implied certification and adopted a more direct and practical approach: “[w]e ask simply whether the defendant, in submitting a claim for reimbursement, knowingly misrepresented compliance with a material precondition of payment.” The court found that the relator’s complaint

stated a claim because it adequately alleged that the defendant had knowingly failed to comply with preconditions of payment. The court “eschewed” distinctions between implied and express certification theories, however, because “they create artificial barriers that obscure and distort [the statute’s] requirements.”

In response to these circuit splits, the Supreme Court has agreed to hear arguments on two specific issues:

1. Whether the “implied certification” theory of legal falsity under the FCA—applied by the First Circuit below but rejected by the Seventh Circuit—is viable.
2. If the “implied certification” theory is viable, whether a government contractor’s reimbursement claim can be legally “false” under that theory if the provider failed to comply with a statute, regulation, or contractual provision that does not state that it is a condition of payment, as held by the First, Fourth, and D.C. Circuits; or whether liability for a legally “false” reimbursement claim requires that



the statute, regulation, or contractual provision expressly state that it is a condition of payment, as held by the Second and Sixth Circuits.

The Supreme Court heard arguments on 19 April 2016, with a decision expected in June 2016. The decision will have a significant impact on FCA litigation.

For government contractors, 2016 promises to be a watershed year. How the DOJ and U.S. government procurement agencies apply the Yates Memo principles, and how the U.S. Supreme Court articulates its view of the implied certification FCA theories, will significantly influence how companies performing U.S. government contracts conduct internal investigations and report suspected noncompliances to the U.S. government and when they can be subjected to penalties and damages for noncompliances when performing U.S. federal contracts and subcontracts.

AUTHORS

Stuart B. Nibley
Washington, D.C.
stu.nibley@klgates.com

Amy M. Conant
Washington, D.C.
amy.conant@klgates.com

The Medicare Audit Program: Opportunities for Providers to Tackle Claim Denials

Every day for the next 19 years, 10,000 Baby Boomers in the U.S. will turn 65, and with few exceptions, upon turning 65, they will be eligible for Medicare. As a result, the cost of the federally funded Medicare program, the primary health care coverage for the elderly, will increase dramatically. In 2015, the Medicare program cost the federal government US\$560 billion and accounted for 3 percent of the gross national product. In 2024, government actuaries project that the Medicare program will cost almost US\$900 billion annually and account for 3.4 percent of the gross national product. The Medicare Trustees project that the Medicare trust fund will become insolvent by 2028.

Over the next five years, the U.S. Congress will enact legislation to reduce Medicare expenditures and postpone insolvency. In all likelihood, expanding the Medicare audit programs will be a key part of any Congressional strategy for reducing Medicare outlays. Although health care providers have had some success challenging proposed legislation to cut rates of payments, it is difficult to publicly challenge legislation advertised as strengthening audit programs designed to “weed out” fraud and abuse.

However, based on past experience with Medicare auditors, health care providers believe that an expanded Medicare audit program will go beyond weeding out fraud and waste. New audit programs predicated on rewarding auditors for denying payments to health care providers only result in denying legitimate benefits to Medicare beneficiaries and become a quasi-legitimate approach to rationing medical care.

To compound this problem, health care providers no longer have an effective mechanism for appealing a denial of claims for medical services. The Medicare program simply does not have the mechanisms in place to hear appeals. The Secretary of the U.S. Department of Health and Human Services (HHS) has acknowledged that there are over 800,000 appeals waiting to be heard and health

care providers should expect to wait over 10 years before seeing any action on an appeal. The backlog in appeals also allows the Medicare program to withhold and delay paying tens of billions of dollars to health care providers.

Faced with a broken administrative process, many health care providers have found that retaining lobbyists to ask Congress or senior officials at HHS to intervene in the appeals process may be the only effective means of circumventing a broken system.

BACKGROUND: FROM FISCAL INTERMEDIARIES TO MEDICARE ADMINISTRATIVE CONTRACTORS

Congress created the Medicare program in 1965 using Blue Cross and Blue Shield health plans as the model. Blue Cross provided hospital insurance and Blue Shield provided insurance for physician care, diagnostic tests, and medical equipment. Following this model, Congress bifurcated the Medicare program: hospital insurance was covered in Medicare Part A and supplemental medical insurance for physician services, some drugs, and medical equipment was covered in Medicare Part B. Congress also directed the Medicare program to contract with the Blue Cross/Blue Shield plans in each state to serve as the fiscal intermediaries for the Medicare program.

The fiscal intermediaries processed Medicare claims and audited the financial statements of health care providers.

Until the late 1980s, auditing financial statements was the key component of the audit process because the Medicare program paid health care providers based, in whole or in part, on the provider’s costs. By the late 1990s, Medicare no longer relied on financial statements or costs as the basis for computing payments to health care providers and the need to audit financial statements became relatively unimportant.

In 1999, the Government Accountability Office and a number of Members of Congress openly criticized the Blue Cross plans for focusing on financial statements and not on the real drivers of health care services: unnecessary medical care and fraudulent claims. From 2000 through 2002, a number of Members of Congress proposed legislation to address this problem. In 2003, Congress passed Section 911 of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 establishing a new mechanism for paying Medicare claims and conducting audits.

In particular, Section 911 required the Secretary of HHS to replace the fiscal intermediaries, primarily Blue Cross Plans, with Medicare Administrative Contractors (MACs). Like the fiscal intermediaries, the MACs are private health care companies that contract with the Medicare program to process Medicare claims for a defined geographic area. In addition, Congress required the Medicare program to consolidate the audit programs and award contracts for large geographic regions (e.g., the southeast U.S.) rather than on state-by-state basis.

Unlike the fiscal intermediaries, the MACs do not perform financial audits. The MAC audit is based on:

- i. reviewing claims for completeness and being “filled out” correctly
- ii. assuring technical compliance with various Medicare requirements (e.g., state license requirements)
- iii. making judgements about medical necessity (i.e., coverage determinations)

Notably, the 2003 statute also offered private contractors a bonus for increasing the number of denied Medicare claims. Critics of this approach argue that the promise of bonus payments has given the private contractors an incentive to deny sizable numbers of legitimate claims oftentimes based on arbitrary standards or by creating administrative hurdles.



THE RIGHT TO APPEAL CLAIM DENIALS

Federal law affords health care providers the right to appeal claim denials through an administrative appeals process and requires the Medicare program to hear an appeal in 90 days. However, the administrative law judges have a substantial backlog of cases and, currently, there are over 800,000 appeals pending before HHS. A health care provider challenging the decision of a Medicare auditor or claims denial during 2016 cannot expect the Medicare program to hear the appeal before 2024 or 2026.

Hospitals and other health care providers have asked the U.S. courts to require the Medicare program to redirect its resources

to allow for a more timely appeals process. In February 2016, the U.S. Court of Appeals for the District of Columbia Circuit said in *American Hospital Ass’n v. Burwell* that the Medicare program had a “clear duty” to comply with the 90-day deadline to hear an appeal and “appeal escalation” was not an adequate remedy. However, the court also noted that Congress established two requirements for the Medicare program: to hear appeals in a timely manner and to protect the financial solvency of the

program’s argument that “the Medicare statute does not confer on [the hospital system] a right to a hearing within 90 days that is enforceable through mandamus.” The court further noted that the prolonged wait for an administrative hearing does not afford the hospital the right to seek judicial review before exhausting administrative remedies.

Given the time consuming nature and cost of filing an appeal, many health care providers choose not to appeal

program. Importantly, the court said that it was up to Congress to determine which requirement was more important.

In January 2016, in *Cumberland v. Burwell*, the United States court of Appeals for the Fourth District held that a hospital asked the court to issue a writ of mandamus compelling the secretary of HHS to adjudicate its administrative appeals of Medicare audit denials. The hospital argued that the statute explicitly required the Medicare program to hear an appeal in 90 days. The court agreed that the statute does require the agency to hear appeals in a timely manner and that there is currently a 10 year backlog in hearing appeals. However, the court agreed with the Medicare

small audit disallowances. This, in turn, has increased the bonuses available to the Medicare contractors.

CLAIM DENIALS: COMMON JUSTIFICATIONS CONTRACTORS USE TO DENY CLAIMS

Complete Information

Medicare contractors reject more claims because of “incomplete information” than for any other reason. For example, in 2014, NHIC, Corp., a Medicare Administrative Contractor, reported that it rejected more than 50 percent of the claims for homecare services because the initial claim was incomplete. The contractor denied the claim pending the

receipt of additional information from the provider. However, many health care providers quickly discovered that after sending additional information, the contractor either ignored the additional information or lost it. Recently, a contractor reviewing hospitals' claims for long-term care hospital services rejected almost all of the claims based on the need for additional information. The hospital sent the additional information by certified mail, but the contractor refused to acknowledge receipt of the information or pay the claim.

Technical Compliance

Too often, Medicare contractors are either unfamiliar with Medicare technical requirements or interpret them incorrectly. Recently, a Medicare Administrative Contractor rejected the claims of a provider of medical equipment arguing that the provider did not have the appropriate state licenses. For example, many Medicare beneficiaries living in the cold state of New York spend winters in warm Florida. While in Florida, beneficiaries often receive medical services, drugs, and medical equipment. The Medicare program explicitly requires the provider of these services or devices to be licensed in the state the service was provided or product dispensed (in our example, Florida). However, the Medicare program requires the provider to send a bill (the claim) to the Medicare contractor serving the beneficiary's legal residence (in our example, state of New York). Although nothing in statute, regulation, or policy supports this position, some Medicare Administrative Contractors believe that the provider must possess a state license both in the state the service was provided or product dispensed, as well as in the

state claimed by the beneficiary as their legal residence. Medicare Administrative Contractors frequently deny claims based on this flawed interpretation of the law.

Medical Necessity

The federal law governing the Medicare program does not permit payment for a service unless the service was "reasonable and necessary" (also called medical necessity). Both the MACs and the federal administrative agency responsible for administering the program (i.e., the Centers for Medicare & Medicaid Services or CMS) develop policies and standards for defining when a medical service is medically necessary. The Medicare Administrative Contractors issue local coverage determinations that limit coverage for a particular item or service in their jurisdictions. In some instances, this has led to state-by-state variation in Medicare coverage for similar items and services. Recently, a Medicare Administrative Contractor imposed an arbitrary standard for determining when a patient appropriately needed a medical device. The contractor publicly admitted that the standard was not supported by clinical evidence and placed some Medicare beneficiaries at risk. However, the contractor maintained that it had no intention of changing the standard and continued to deny Medicare claims related to this medical device. Looking Towards the Future

As Congress and HHS struggle to reduce the cost of the Medicare program and postpone the date of insolvency, audits will play an increasingly important role in their strategies. The Medicare program, not unlike private health insurance plans, will provide auditors with new incentives or bonuses for denying claims

and delaying "pay out." To complicate this problem, health care providers will continue to encounter backlogs and other administrative barriers that will limit the value of the appeals process.


Congress has repeatedly reprimanded the Medicare program for the backlog in processing appeals, but many Members of Congress are reluctant to weaken the Medicare audit program. For fiscal year 2016, Congress increased funding for the appeal process, allowing the agency to hire more administrative law judges. However, health care providers have called the funding a token measure and point to the continued increase in the number of backlogged appeals.

Over the past several years, health care providers have retained lobbyists to urge Congress and senior officials at the Medicare program to address the most egregious or flagrantly unlawful audit denials. In many instances, either based on the facts (e.g., with regard to what constitutes appropriate state licensure) or based on Congressional pressure (e.g., with regard to medical coverage determinations), senior officials at the Medicare program have overturned Medicare contractor decisions. In all likelihood, this case-by-case approach to solving audit problems will become even more commonplace.

AUTHORS

Stephen H. Cooper
Washington, D.C.
stephen.cooper@klgates.com

Victoria Hamscho
Washington, D.C.
victoria.hamscho@klgates.com



“ In 2015, the Medicare program cost the federal government \$560 billion dollars and accounted for 3 percent of the gross national product.”

SEC and Global Regulators Moving Forward on Risk Management Initiatives for Investment Managers and Fund Complexes

Since the 2008 financial crisis, global regulators have sought to heighten regulation of the asset management industry generally, and the fund industry in particular, aiming to identify and regulate key players and financial instruments, products, and activities that may pose significant risks to investors and to the financial system as a whole. The regulatory focus on risk management is a critical issue for the asset management industry given the nature of the industry and its reliance on risk-taking to generate returns.

Globally, the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO) continue to center on the asset management industry as a source of systemic risk. While the FSB/IOSCO have temporarily softened their push to designate asset management firms as Global Systemically Important Financial Institutions (G-SIFIs), they have turned their focus to asset management activities and products in the broader global financial context and are expected to publish additional consultation papers later this year. The specter of G-SIFI designations also remains, as both the FSB and IOSCO have indicated that they expect to return to work on methodologies to identify G-SIFIs after their current review of financial activities and products.

Likewise, in the United States, the Financial Stability Oversight Council (FSOC) and the Office of Financial Regulation have been assessing risks in the asset management industry and

designating SIFIs for heightened regulation by U.S. banking regulators. Some nonbank financial services companies have received SIFI designations and have taken steps to restructure their businesses in response. In one case, the FSOC responded to a SIFI-designated firm's restructuring by rescinding the designation. However, to date, the FSOC has declined to rescind other designations. One firm has successfully challenged its SIFI designation in court, but the FSOC has appealed the court's decision. In addition, it has been reported that another firm is also seeking to have its SIFI designation rescinded.

Like global regulators, the FSOC also is reviewing risks posed by financial activities and products in the asset management industry, including risks associated with liquidity and redemptions, leverage, operational functions, and processes to wind down troubled firms. The FSOC has yet to formally pinpoint any risks to U.S. financial stability arising from asset

management products or activities, but at its April 2016 meeting, the FSOC provided an update on its review. The FSOC issued a statement outlining its recent analysis of risks related

to (1) liquidity and redemption, (2) leverage, (3) operational functions, (4) securities lending, and (5) resolvability and transition planning. Among other things, in the liquidity risk management area, the FSOC recommended a series of policy initiatives, including (1) robust liquidity risk management practices for mutual funds, (2) the establishment of clear regulatory guidelines addressing limits on the ability of mutual funds to hold assets with limited liquidity, (3) enhanced reporting and disclosures by mutual funds of their liquidity profiles and liquidity risk management practices, (4) steps to allow and facilitate mutual funds' use of tools to allocate redemption costs more directly to investors who redeem shares, (5) additional public disclosure and analysis of external sources of financing, and (6) measures to mitigate liquidity and redemption risks that are applicable to collective investment funds and similar pooled investment vehicles offering daily redemptions.

Similarly, with respect to leverage risks, the FSOC announced the creation of an interagency working group to analyze information collected by regulators and to assess leverage and other financial stability risks in the hedge fund industry. According to the FSOC, the working group will (1) use regulatory and supervisory data to evaluate the use of leverage in combination with other factors to assess potential risks to financial stability, (2) assess the sufficiency and accuracy of existing data and information, including data reported on Form PF, to evaluate risks to financial security and consider how existing data reports could be modified to improve the ability to make this evaluation, and (3) consider potential enhancements to and the

“Some nonbank financial services companies have received SIFI designations and have taken steps to restructure their businesses in response.”

establishment of standards governing the current measurements of leverage. The working group is expected to report its findings by the fourth quarter of 2016.

At the U.S. Securities and Exchange Commission (SEC), pressure to enhance systemic regulation of investment products led to the adoption, after a prolonged fight, of the SEC's money market fund reforms in 2014. However, the SEC has not stopped there and is moving forward on a variety of risk management initiatives that will impact investment managers and fund complexes. In response to intense pressure from systemic regulators and a difficult political environment for the SEC, in December 2014, SEC Chair Mary Jo White delivered a speech in which she declared that the SEC is "now embarking on a new period of regulatory change, driven by long-term trends in the [asset management] industry and the lessons of the financial crisis." The speech set the stage for a series of five SEC regulatory initiatives primarily aimed at enhancing risk management. If adopted, the proposals could change mutual fund and investment adviser regulation in fundamental respects.

To date, the SEC has proposed four high-profile rulemakings in the risk management area: (1) liquidity risk management for open-end mutual funds, (2) new derivatives regulations, (3) data reporting modernization, and (4) business continuity and transition

plans for SEC-registered investment advisers. Chair White has stated that the SEC expects to finalize the first three of these rule proposals in 2016. The fifth proposal, which will address stress testing requirements for large investment managers and funds required under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA"), is expected later this year. While key questions linger about what the rules will require



in their final form, these proposals, once adopted, will impose significant cost and regulatory burdens on fund complexes and investment managers. The FSOC took notice of these proposals in its April 2016 statement, but left the door open to taking additional regulatory action itself if risks to financial stability remain.

LIQUIDITY RISK MANAGEMENT

On 22 September 2015, the SEC proposed new regulations under the Investment Company Act of 1940 (the 1940 Act), designed to standardize liquidity risk management by open-end

mutual funds. In addition to requiring enhanced disclosure and reporting about fund liquidity, the primary elements of the proposal would:

- Require open-end mutual funds (including certain exchange-traded funds (ETFs) but excluding money market funds (MMFs)) to adopt a written liquidity risk management program with two key elements: first, requiring a fund to classify the liquidity of each fund holding into one of six prescribed categories, and second, requiring a fund to establish a minimum amount of assets it must hold in so-called "three-day liquid assets"—assets that can be readily liquidated in three business days without materially affecting the assets' market value prior to the sale; and
- Permit open-end funds (other than MMFs and ETFs) to use "swing pricing"—a process of adjusting the net asset value (NAV) of fund shares so that purchasing or redeeming investors bear a portion of the costs of entering or exiting the fund during periods of heightened share transaction activity.

The SEC's prescriptive approach to classifying investments into very specific liquidity buckets will force funds into using a single risk management approach that may not be as effective in evaluating liquidity as other methods more narrowly tailored to a particular fund's investment strategy and exposures. In addition, the costs of implementing liquidity risk management programs and making required reports and disclosures are likely to be substantial. Funds that elect to use swing pricing will face challenges in setting the mechanism for adjusting NAV and communicating this new process to shareholders. Fund boards are also likely to face significant new oversight responsibilities and challenges that increasingly veer into highly technical subject matter.

DERIVATIVES REGULATION

- The SEC's derivatives proposal, issued on 11 December 2015, aims to reduce leverage risks associated with derivatives and to impose a more standardized treatment of derivatives transactions under the senior securities provisions of 1940 Act Sections 18 and 61. New Rule 18f-4 would apply to mutual funds, closed-end funds (including business development companies) and most ETFs and has three main elements:
 - o **Leverage Limits**—A fund that enters into any derivatives transaction would have to comply with one of two alternative leverage limits: (1) an “exposure-based” limit that would

cap a fund's aggregate exposure at 150 percent of its net assets, and (2) a “risk-based” limit that would allow a fund's aggregate exposure to be up to 300 percent of its net assets but only if the fund satisfies a “Value at Risk” test showing that the fund's use of derivatives has lowered its overall portfolio risk (i.e., this limit is available only to funds using derivatives for risk-reduction—generally, hedging—purposes). The rule would base the calculation of derivatives exposure on the notional amount of the derivatives transaction at the time of the transaction.

- o **Asset Segregation Requirements**—For derivatives transactions, a fund would have to segregate the mark-to-market coverage amount (i.e., the amount to unwind the position) plus a risk-based amount (i.e., an estimate of what the fund would have to pay to exit the position under stressed market conditions), each determined daily. For financial commitment transactions (which includes short sales, reverse repurchase agreements, firm or standby commitment agreements, or similar agreements), a fund would have to segregate the full amount it is obligated to pay under the transaction or, if the fund's obligation is to deliver a particular asset, the value of that asset, determined daily.
- o **Risk Oversight**—Fund boards would face new oversight obligations,

which could include the adoption of a formal derivatives risk management program overseen by a designated “derivatives risk manager.”

- Compliance with Rule 18f-4 would require some funds to significantly alter their investment strategies and could result in certain funds, particularly managed futures funds or leveraged ETFs, having to choose between changing their investment strategies and deregistering from the 1940 Act. In addition, many fund boards will face new challenges as they are brought more directly into portfolio management decisions in setting derivatives limits, which is a departure from a fund board's traditional oversight function.

DATA REPORTING MODERNIZATION

The SEC's May 2015 proposals to modernize reporting requirements for registered funds and advisers are part of an effort to capture key information about funds' and advisers' investment practices more frequently and in a format that better enables the SEC staff to aggregate and analyze the data.

The proposal would broaden the nature of information the SEC receives about funds and advisers by (1) mandating reporting of information not previously reported to the SEC (such as risk metrics, detailed derivatives information and liquidity of portfolio positions), (2) requiring advisers to report information about their separately managed accounts, and (3)



The costs of implementing liquidity risk management programs and making required reports and disclosures are likely to be substantial.

converting certain of the information currently reported to the SEC into a modernized, structured data format. For registered funds, the SEC proposed two new reporting forms—Form N-PORT, which would replace current Form N-Q and require detailed monthly reporting of fund portfolio holdings and other information, and Form N-CEN, which would replace current Form N-SAR and require annual reporting of census data. The new reporting requirements would assist the SEC staff with assessing regulatory compliance, identifying firms for examination, pursuing enforcement actions, and monitoring trends and risks on a firm, fund, and industry-wide basis.

An updated reporting regime, while generally supported by the industry, would bring with it significant burdens that the SEC may not have completely addressed in the proposal, including the substantial costs of producing information, operational complexities in developing systems to capture the information, concerns about public availability of certain information, and issues related to the SEC's ability to maintain the security of confidential information collected in an active cybersecurity threat environment.

BUSINESS CONTINUITY AND TRANSITION PLANNING

In June 2016, the SEC proposed a new rule and rule amendments under the Investment Advisers Act of 1940 which would require SEC-registered investment advisers to adopt written business continuity and transition plans to mitigate operational risks that could disrupt their business. Under the proposal, registered investment advisers have to adopt (and

review at least annually) written policies and procedures reasonably designed to address risks of significant disruptions in the investment adviser's operations, including policies and procedures that address (1) business continuity after a significant disruption, and (2) business transition in the event the investment adviser is unable to continue providing advisory services to clients.

These policies and procedures must be tailored to the particular risks associated with the adviser's business model and activities, and must cover the following five areas:

- maintenance of critical operations and systems, and the protection, back-up, and recovery of data, including client records
- pre-arranged alternate physical locations of the adviser's office and employees
- communications with clients, employees, service providers, and regulators
- identification and assessment of third-party services critical to the operation of the adviser
- a plan of transition in the event the adviser is winding down or is unable to continue to provide investment advisory services

Transition plans would be required to address the following:

- the safeguarding, transfer, or distribution of client assets during transition
- procedures for promptly generating any client-specific information necessary to transition each client account
- information regarding the corporate governance structure of the adviser
- identification of any material financial resources available to the adviser
- an assessment of the applicable law and contractual obligations governing



the adviser and its clients, including pooled investment vehicles, implicated by the adviser's transition

Simultaneously with the proposed rule, the SEC's Division of Investment Management issued guidance addressing fund business continuity plans (BCPs). While the SEC has long considered BCPs a required element of fund (and investment adviser) compliance programs, the guidance underscores the importance of robust BCPs for funds, and lists "notable practices" of fund complexes that the SEC staff has encountered in its outreach activities. In particular, the guidance emphasizes the need for thorough initial and ongoing due diligence of funds' third-party service providers,

and advises boards to discuss the fund's BCP with the investment adviser and other critical service providers.

If adopted, the new rules and guidance will lead to additional costs for advisers and funds to ensure compliance with the updated BCP guidance and to formulate transition plans that previously have not been required. Likewise, new rules in this area are likely to increase advisers' and funds' exposure in SEC staff examinations and potentially enforcement actions.

FUTURE INITIATIVES— DODD-FRANK STRESS TESTING

The SEC's stress testing proposal expected later this year would propose to implement the requirements of DFA Section 165(i)(2), which requires the SEC to establish methodologies for stress testing of financial companies, including registered funds and advisers with US\$10 billion or more in total consolidated assets—using baseline, adverse, and severely adverse scenarios—and to design a reporting regime for this stress testing, which must be reported to the SEC and the Federal Reserve Board. Among the questions the SEC faces are how the US\$10 billion threshold for stress testing will be applied—for example, for a mutual fund complex, the threshold could be applied complex-wide or fund-by-fund.

Developing appropriate standards of regulation will require a meaningful focus on the types of risks and risk management approaches in the mutual fund and broader investment management industry. The SEC's "one size fits all" approach to liquidity management and its derivatives proposal, which may regulate out of existence innovative investment products, could undermine reasonable alternative risk management approaches used across the industry and, from an investor perspective, limit product innovation and investor choice. With the public comment periods on the liquidity, derivatives, and reporting proposals closed, the industry has been reading the regulatory tea leaves to ascertain whether the final rules, expected later this year, will reflect more flexible and less burdensome approaches. SEC staff members have so far made

limited public remarks about next steps. The specific requirements of the stress testing proposal also remain to be seen. Lastly, the FSOC's continuing focus on the asset management industry leaves open the possibility of additional regulatory initiatives from systemic regulators, with more information on the direction of the FSOC's activities expected later this year.

AUTHORS

Mark C. Amorosi
Washington, D.C.
mark.amorosi@klgates.com

Fatima S. Sulaiman
Washington, D.C.
fatima.sulaiman@klgates.com

The European Banking Authority Shadow Banking Guidelines: Unintended Consequences

At the end of 2015, the European Banking Authority (the EBA) published its Final Guidelines on Limits to Exposures to Shadow Banking Entities (the Guidelines). Shadow banking often complements traditional banking by engaging in “credit intermediation activities,” thereby contributing to market liquidity and providing broader access to funding. This can enhance efficiency and not only contributes to the growth of the financial sector but to overall growth in the “real” economy, for example, by providing increased funding resources to small- and medium-sized enterprises and individuals.

In setting exposure limits on regulated entities, the EBA seeks to maximize the ability of an institution to bear the burden of an economic downturn and to minimize the contagion effect. The EBA's aim to minimize risk posed to institutions through their exposures to shadow banking entities is laudable. However, the EBA's mandate limits the regulatory tools at its disposal.

DEFINING SHADOW BANKING

“Shadow banking” is a term that is highly resistant to definition. The term is related to a broad spectrum of activities and entities that are usually posited as falling outside traditional “banking.” However, traditional and shadow banking overlap in many areas. The myriad of considerations are well illustrated by the table on the following page, which summarizes the effort at distinguishing between shadow and traditional banking from a number of authorities.

In its Guidelines, the EBA defines a shadow banking entity as an entity that carries out “credit intermediation activities.” Credit intermediation activities are defined as “bank-like activities involving maturity transformation, liquidity transformation, leverage, credit risk transfer or similar activities” and “are neither within the scope of prudential consolidation nor subject to solo prudential requirements under specified EU regulation.”

The Guidelines do not provide more detailed guidance, and it is difficult to be precise about what the EBA intends with its definition. However, market commentators have already noted that such a definition may capture,

- Exposure limits: Set aggregate and individual exposure limits to the shadow banking sector. According to the Guidelines, institutions should limit their exposure to individual shadow banking entities with an



for example, the treasury department of a corporate engaging in liquidity transformation by investing cash in bonds.

THE GUIDELINES AND POTENTIAL CONSEQUENCES

The Guidelines require banks to:

- General principle: Develop a risk framework, forcing banking institutions to look more closely at their relationships and commitments in order to develop an “internal framework for identification, management, control, and mitigation of risk” and “implement a robust process for determining interconnectedness between shadow banking entities and between shadow banking entities and the institution.”

“exposure value, after credit risk mitigation, and exemptions, equal to or in excess of 0.25 percent of the institution’s eligible capital.” If an institution is unable to apply the aggregate and individual limits, their aggregate exposures to shadow banking entities should be subject to limits on large exposures, which the EBA called the “fallback approach.”

Developing and implementing a risk framework and setting exposure limits will necessarily incur costs associated with new processes in relation to risk management, due diligence, disclosure, training, and internal and investment monitoring. Further, management liability is increased with the requirements to inform itself of and assess the frameworks, limits, and processes being implemented.

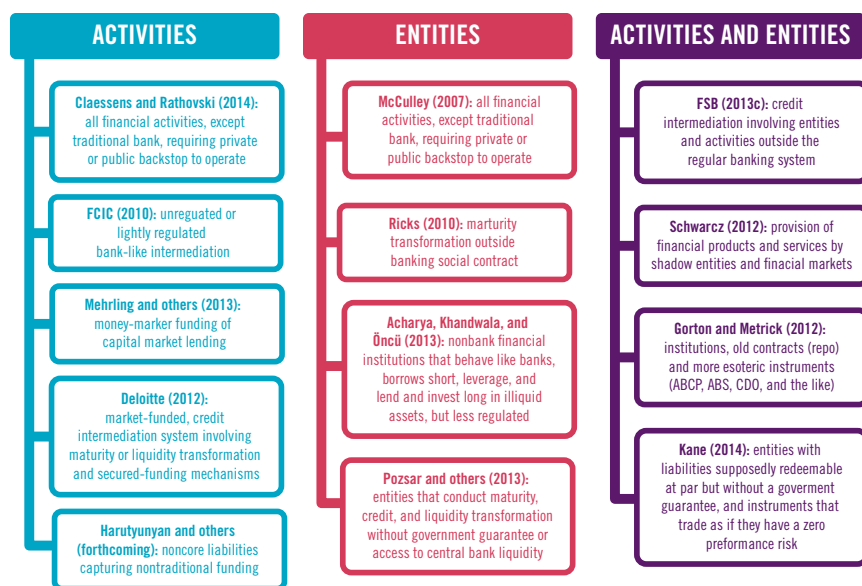


Figure 1: Different Definitions of Shadow Banking, IMF Global Financial Stability Report, “Risk Taking, Liquidity, and Shadow Banking Curbing Excess while Promoting Growth,” October 2014, 91.

It is likely that market participants will seek efficiencies and synergies with other applicable regulations where compliance procedures have already been implemented (e.g., in relation to MiFID, Basel III, and other risks such as data protection or antimoney laundering). However, in a sector as amorphous as shadow banking, costs can quickly spiral due to the complexity and opacity of the market and its participants. Determining that there is an exposure is usually straightforward; however, analyzing the quantitative effects of an exposure to shadow banking is not. Consider, for example, the analysis that will need to be conducted at various points along the intermediation change in a synthetic securitization.

The shadow banking sector contains sophisticated and specialist participants with high-risk appetites. It is likely that

much of the regulatory burden will either be shifted contractually or will be circumvented by novel techniques. There may also be a migration of business to other parts of the market creating further “shadowy” pockets and having a negative impact on the regulated sector through a decrease in competition.

CONSIDERING OTHER TOOLS

The compliance and cost burden of the Guidelines primarily falls on regulated entities. It is likely that traditional institutions will demand information and assistance with their compliance requirements if shadow banks want to access the facilities that they require from regulated banks. This may have the effect of forcing shadow banks further into the “shadows” and mean that traditional banks reduce their contact with shadow banks or spin-off their more risky arms.

Therefore, the interaction that could force shadow banks to raise regulatory standards from their end could be reduced while at the same time increasing the regulatory burden on conventional banks. The overall effect may be a reduction in the interaction between banks and shadow banks and a lack of promotion of transference of regulatory insights and culture from the traditional to the shadow sectors.

Instead of this approach, the better method may be to place the regulatory burden on the market. Participants could not then contractually offload obligations. This may encourage the market to raise compliance standards as a whole, ultimately stabilizing the risk profiles of financial institutions.

Further, it may be better to designate entire intermediation markets for prudential oversight rather than focusing oversight on single institutions. This could capture migration of risk away from regulated banks through trading markets. Such regulation would, in effect, limit the leverage available through collateralized lending generally, no matter which entity is involved. It would also enable regulators to evaluate trends and mitigate the risk of bubbles forming by communicating with the whole market.

CONCLUSION

Risks will not disappear and guidelines will not stop new risks from occurring or old risks re-emerging. Regulated or unregulated, banking or shadow banking, credit intermediation occurs wherever there is demand. It is perhaps worth considering that in today’s sharing economy, many business processes are inverted, where new methods of delivering financial services such as marketplace lending platforms appear before they are regulated. In such instances, there are no longer significant barriers to entry, but barriers may arrive after the event. Although the Guidelines attempt to tackle the issues posed, they should be viewed as the starting point, not the destination.

AUTHORS

Shehram A. Khattak
London
shehram.khattak@kligates.com

Dr. Ronnie R. Yearwood
London
ronnie.yearwood@kligates.com

Jonathan Lawrence
London
jonathan.lawrence@kligates.com

The Asia Region Funds Passport

The Asia Region Funds Passport (ARFP or Passport) is a multilateral regulatory framework that will facilitate the cross-border marketing and distribution of collective investment schemes within the Asia Pacific region, specifically in the countries of Australia, Japan, Korea, New Zealand, the Philippines, Singapore, and Thailand. The ARFP will be a key development in growing the investment management industry in the Asia Pacific region, as it will be the most far-reaching multilateral arrangement of its kind in the region.

The Asia Pacific Economic Cooperation (APEC), the premier Asia Pacific economic forum, estimates that the introduction of the ARFP will create approximately 170,000 new jobs in the Asia Pacific region over the next five years and save Asian investors US\$20 billion per annum in investment management costs. The ARFP is widely seen as a key building block to increase financial integration across the region and, in particular, to facilitate the flow of capital into the region's equity and debt markets. It is also seen as a key enabler for the growth of regional savings and the creation of investment products specifically designed for the region's growing retirement population and wealthy middle class looking for investment solutions to meet their specific needs.

WHAT IS THE ARFP?

Conceptually, the ARFP will be similar to Europe's Undertakings for Collective Investments in Transferrable Securities (UCITS). Under the ARFP rules, a collective investment scheme that meets an agreed set of regulatory requirements will be entitled to be registered by the relevant regulatory authority in its home jurisdiction as a "Passport Fund" eligible to be offered both in its home jurisdiction and throughout the participating economies (Passport Fund).

WHICH ECONOMIES ARE INVOLVED?

On 11 September 2015, Japan joined the list of participating economies when it signed the ARFP Statement of Understanding at the APEC Finance Ministers' Meeting in Cebu, the

the Passport. While Australia, Japan, South Korea, and New Zealand are the initial signatories to the MoC, it is expected that Thailand, Singapore, and the Philippines will also sign on shortly.



Philippines. At the time of this writing, the nations committed to participating in the ARFP include Australia, Japan, Korea, New Zealand, the Philippines, and Thailand. While Singapore did not sign the ARFP Statement of Understanding at the APEC Finance Ministers' Meeting in the Philippines, Singapore has from the outset been heavily involved in the ARFP consultations.

WHEN WILL THE ARFP COMMENCE?

On 28 April 2016, representatives from Australia, Japan, South Korea, and New Zealand signed the final Memorandum of Cooperation (MoC) setting out the internationally agreed rules and cooperation mechanisms for

THE REGULATORY FRAMEWORK

The ARFP will be governed by a multi-layered set of regulatory instruments, laws, and rules, including:

- MoC: The MoC between participating nations establishes the governing framework and sets out the eligibility criteria for economies wanting to participate in the ARFP.
- Regulators' MOU: An MOU between the relevant regulators of the participating economies entered into in accordance with the MoC will facilitate cooperation between regulators responsible for the ARFP and the exchange of information between those regulators.

- Common regulatory arrangements: A set of common regulatory arrangements as set out in the MoC will establish the application process for investment managers wanting to offer a Passport Fund along with the administrative, supervisory, and enforcement powers of the various regulators in relation to Passport Funds. Under the common regulatory arrangements, operators of Passport Funds will be required, among other things, to have a principal place of business in a participating economy.
- The ARFP rules: The ARFP rules as set out in the MoC establish a common set of regulatory requirements for Passport Funds. The ARFP rules contain minimum requirements for:
 - o the constituent documents of Passport Funds
 - o the operators of Passport Funds, including requiring Passport Fund operators to have key staff who meet minimum qualification and experience requirements, financial and other resourcing requirements, have appropriate organizational arrangements in place, have a track record with an agreed minimum level of assets already under management, and be of good standing. Delegation will be permitted but with some limitations on the delegation of key functions to entities outside the participating economies

- o accountability and reporting
- o custody of Passport Fund assets
- o governance, oversight, and compliance standards for Passport Funds
- o financial reporting and auditing requirements for Passport Funds
- o redemption processes, valuation, and pricing methodology for Passport Funds

The ARFP rules also establish the criteria for permitted investments for Passport Funds. Permitted investments include highly liquid securities, including currency, deposits, depository receipts over gold, transferable securities, and money market instruments. There are also position and portfolio limits, limitations placed on the use of derivatives, and short selling is prohibited.

- Home economy laws: The laws needed to bring into effect the ARFP in each participating economy, which must not be inconsistent with the ARFP rules.
- Host economy laws: The laws that may be imposed by host economies, such as product distribution and disclosure laws, which sit outside the scope of the ARFP rules.

NEXT STEPS

Following signing of the MoC and the release of the final ARFP rules, the initial signatories now have 18 months to pass the enabling legislation to bring into force the laws needed for the ARFP to operate within their jurisdiction. Once two participating economies are ready, the ARFP can commence.

Participating economies have already begun examining their domestic laws to determine what enhancements may be needed to enable their economies to fully participate in the ARFP. In Australia, a bill is currently being debated in Parliament that will clarify the taxation system for Australian collective investment vehicles, and the Australian government is considering whether to expand the types of collective investment vehicles that can be established in Australia, including a form of corporate collective investment vehicle. Singapore is also considering a proposal to introduce a form of corporate collective investment vehicle. In addition, Korea has recently announced a raft of legal reforms relating to the distribution of financial products, which may facilitate the distribution of Passport Funds in its jurisdiction.

CONCLUSION

The ARFP is a significant undertaking that has required many thousands of hours work by many people within the governments and the industries of the participating economies and will soon become a reality. With the continued goodwill of the governments and the industries of the participating economies, the ARFP not only has the potential to fundamentally change the investment management industry in the region, it may also deliver significant benefits to the participating economies and investors in the region.

AUTHORS

Liz Hastilow
Sydney
elizabeth.hastilow@klgates.com

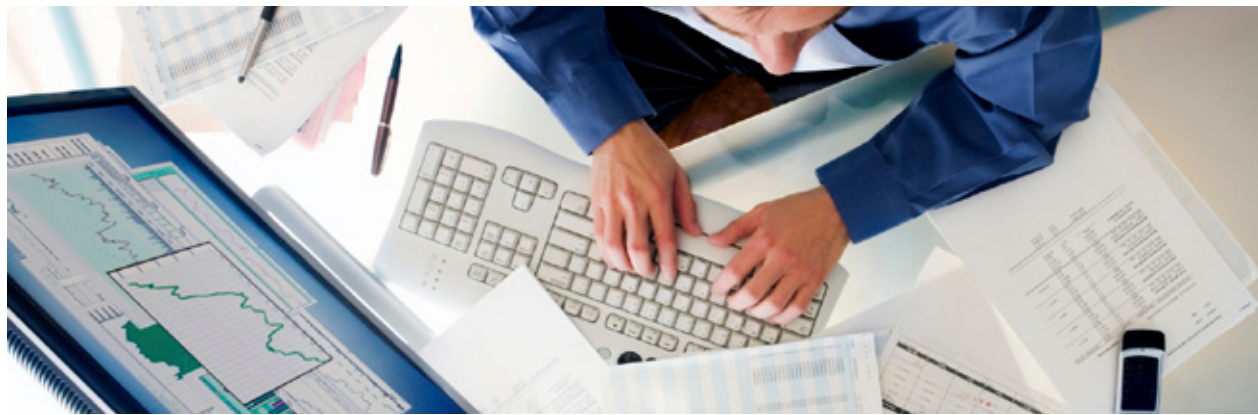
Ed Vassie
Sydney
edward.vassie@klgates.com

Conflicts of Interest—U.S. Securities Regulatory Focus on Intermediaries

Early each year, U.S. securities regulators—namely the U.S. Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA)—announce their examination priorities. The staffs of the SEC and FINRA identified, among other things, conflicts mitigation and management as examination priorities for 2016. Indeed, conflicts management has been described by one former SEC commissioner as “a topic of perpetual importance” and more recently by a current SEC official as a “perennial priority” for examination review. Our experience in advising securities intermediaries subject to FINRA and/or SEC oversight is that regulators are taking detailed and careful looks at potential conflicts and the process by which those conflicts are recognized and either mitigated by eliminating them or managed by disclosing them.

Conflicts of interest arise where a securities intermediary or one of its professionals has an incentive (or apparent incentive) to serve its own self-interest over the interests of clients or to serve the interests of one client over the interests of another.

Under the U.S. federal securities laws, securities intermediaries, such as asset managers and broker-dealers, have duties to serve the interests of their clients over the self-interest of the firm or its professionals. These duties are well established. The U.S. Supreme Court long ago held that the U.S. Investment Advisers Act of 1940 (Advisers Act) establishes a federal fiduciary duty derived from the Advisers Act’s general antifraud provisions, as well as from the relationship of trust between an asset manager and its clients. Similarly, securities broker-dealers have a common law duty to deal with



their clients fairly and in accordance with industry standards pursuant to the “shingle theory”—that is, when a firm hangs out its shingle, it agrees to treat its customers fairly and in accordance with just and equitable principles of the trade. FINRA has codified the shingle theory into a general business conduct rule.

To satisfy these duties, in part, securities asset managers and broker-dealers are required to establish a compliance program of oversight. Asset managers are further required to adopt a code of

ethics designed to address fair dealing with clients, among other issues. As part of their examination processes, both the SEC and FINRA look to the enterprise-wide culture of compliance to determine the effectiveness of identifying and addressing potential conflicts of interest. There are, of course, a myriad of potential conflicts that arise in the securities industry. Among the recent areas of focus by the SEC and FINRA are “differential compensation” programs, “special compensation structures,” differing share class fees, and potential

inflation of asset management fees in the case of purportedly inflated valuations.

DIFFERENTIAL COMPENSATION

Securities regulators have increasingly focused on internal compensation structures and the extent to which they can create incentives for securities professionals to favor their economic interests over a client’s best interests. Last year, FINRA conducted a concentrated sweep examination of the retail brokerage business to understand the extent to

which compensation programs may create structural conflicts of interest with retail clients. Of particular interest to FINRA are compensation and bonus programs that award higher payouts to sales professionals for sales of proprietary (house) products over nonproprietary products. Of course, FINRA's interest in "differential compensation" programs is not new. Indeed, at one point FINRA considered prohibiting them outright, and in 2003, it proposed a specific rule requiring "point-of-sale" disclosure regarding differential compensation. Current rules neither prohibit nor mandate specific disclosure regarding differential compensation, although FINRA's general business conduct rule could arguably be interpreted to require some form of disclosure. This is true because the mere existence of "differential compensation" may be said to erode an independent recommendation by implicating the economic self-interest of the sales professional and unduly clouding his or her judgment.

"Differential compensation" programs also raise questions regarding the suitability obligations of securities broker-dealers. Broker-dealers and their professionals are subject to suitability duties when recommending securities or an investment program to a client. Although the duty does not require that any particular recommendation be for the *most* suitable investment, there must be a reasonable basis to believe that an investment is suitable given available information regarding the client and the context of the investment. Economic considerations to the sales professional

alone are never permissible grounds for a recommendation, which is a presumptive area of focus for FINRA relative to its recent sweep examination. FINRA announced that it will publish the results and recommendations of its sweep later this year.

REVENUE SHARING AND SHARE CLASSES

Revenue sharing arrangements between securities broker-dealers and investment companies remain a hearty perennial in terms of the regulatory agenda. These arrangements are distinguished from "differential compensation" programs in that revenue sharing constitutes payments to a firm as opposed to sales revenues passed-through to individual sales professionals. Revenue sharing arrangements, or "special compensation" (as referred to by FINRA), are common in the mutual fund industry and generally cover payment arrangements by a fund complex to various selling firms for fund distribution. Of course, not all revenue sharing arrangements are created equal in that a fund complex may pay some firms greater amounts for distribution than it pays other firms. These payments can raise potential conflicts of interest because a firm may establish sales goals with respect to products that pay more than other similarly situated products.

Given these potential conflicts and the suitability stresses they create, it is not surprising that FINRA has long focused on regulating how "special compensation" arrangements are disclosed. FINRA's

investment company distribution rules currently require, as a condition to a firm participating in fund distribution, that the particulars of "special compensation" arrangements be disclosed in the fund's prospectus. But this disclosure is not uniform across the industry and tends to be more general than specific. In the current environment, a greater emphasis is being placed on the disclosure of specifics in contract negotiations between fund complexes and selling firms.

The regulatory focus has concentrated more on recommendations of funds with varying share classes. The SEC and FINRA scrutinize investment recommendations in which investors are placed in more expensive mutual fund share classes over other less expensive classes absent legitimate countervailing considerations. Already this year, the SEC settled actions against three asset managers (that were also registered securities broker-dealers) for, among other things, breaches of fiduciary duty with respect to placing wrap-account investors in share classes that paid the firms higher fees rather than other share classes that were available at lower expenses to the investor. The SEC alleged that the firms failed to disclose adequately to investors the economic effects of these higher-expense recommendations and the availability of lower-expense alternatives. The settlements emphasize the focus of the SEC on conflicts raised by compensation structures and the need for securities firms to adopt reasonable systems to identify them and, where eliminating them is not feasible, managing them through disclosure.

“Conflicts management has been described by one former SEC commissioner as “a topic of perpetual importance” and more recently by a current SEC official as a “perennial priority” for examination review.”

VALUATION

The misvaluation of assets can also raise conflicts of interest because the more inflated the valuation of a portfolio, the higher the management fees that can be earned by an asset manager. As a result, SEC examiners focus on the valuation process implemented by securities firms, as well as their procedures to test the validity of valuations, particularly with respect to hard-to-value assets. The SEC has brought several enforcement actions against asset managers because of valuations that allegedly had no reasonable basis, with the result being the apparent artificial inflation of the portfolio and, therefore, higher management fees to the asset manager.

Regulators are currently looking at all aspects of valuation and, even though the valuation of an asset may be reasonably justified, the SEC staff may scrutinize the valuation process itself, particularly if it believes the firm's policies or processes are not sufficiently detailed or documented or if the valuation process or methodology deviates from firm policy.

cases of undisclosed outside business activities that raise actual conflicts of interest. Most recently in March 2016, the SEC settled an action against a municipal advisor for breach of fiduciary duty (the first such case since Dodd-Frank created the regulatory regime for municipal advisors) for undisclosed conflicts where professionals of the municipal advisor directed municipal bond offerings for underwriting to securities broker-dealers with which those professionals were associated as registered representatives.

The repeated and, in some respects, reinvigorated message from U.S. securities regulators regarding these purported conflicts of interest is a signal for broker-dealers and asset managers. In some respects, the line drawing regarding certain of these issues, arrangements, and disclosures remains a bit unclear for industry participants. But it is plainly the case that securities intermediaries should be on notice of the need to evaluate their oversight of the conflicts and suitability compliance policies and procedures.



GOING FORWARD

Compensation structures are not the sole conflicts-related area subject to SEC scrutiny, but they can be expected to continue to attract regulatory attention, particularly in light of a recently published academic study looking at employment rates of securities professionals with records of misconduct (see *The Market for Financial Adviser Misconduct* (26 February 2016)). The SEC's Division of Enforcement has been bringing conflicts cases in several related areas, including

AUTHOR

C. Dirk Peterson
Washington, D.C.
dirk.peterson@klgates.com

Momentum Continues in the European Capital Markets Union

On 30 September 2015, the European Commission (Commission) launched the action plan for a Capital Markets Union (CMU) as part of the Commission's effort to strengthen Europe's capital markets and establish a true single market for capital—a CMU for all 28 member states. In the Commission's view, Europe's capital markets are relatively underdeveloped and fragmented, amounting to less than half the size of the U.S. capital markets, with its debt markets amounting to less than one-third of that in the United States. The CMU includes a large number of medium- to long-term reforms that will be developed and implemented over the coming years. The following is a summary of the progress made and a look at the steps ahead.

PROGRESS ON THE FIRST MEASURES

The Commission has published various initiatives in the framework of the CMU Action Plan.

Securitization

The Commission began by publishing a regulatory proposal to develop simple, transparent, and standardized (STS) securitization for the European Union (EU). The proposed regulation sets common rules and criteria for the new STS securitization label. While the Council of the EU (the Council) has already adopted its general approach, the European Parliament (Parliament) has started working on the proposal under the leadership of Rapporteur Paul Tang. Despite the Commission's hope for the file be fast-tracked through the legislative process, it may be expected to continue to work on these issues until the end of 2016. The STS securitization text is accompanied by

another proposal to amend the Capital Requirements Regulation in order to make the capital treatment of securitizations more risk-sensitive and to reflect STS securitization features. While the Council already agreed on a common approach on this proposal as well, Pablo Zalba has been named Rapporteur and will lead the Parliament's work.

Prospectus Regulation

In November 2015, the Commission put forward a proposal to replace the existing prospectus directive. This initiative broadly aims at reducing the costs and burdens associated with issuing prospectuses, particularly for small and medium companies. While some contentious issues have emerged during the discussions, including matters related to the prospectus summary, as well as the retail/wholesale disclosure regimes, both the member states and the Parliament seem broadly favorable to the key objectives of the proposal. Negotiations will continue over the

coming months and, from July 2016, the Slovak Presidency of the Council will take over the work on these issues.

Solvency II

The Commission also made a number of amendments to the Solvency II Delegated Regulation, providing for a lower risk calibration to be applied to qualifying infrastructure investments, as well as preferential capital charges for investments in European Long-Term Investment Funds. The legislative process related to these amendments was completed in early April.

BUILDING ON STAKEHOLDERS' INPUT—PUBLIC CONSULTATION ON RELEVANT ISSUES AND REFORMS

As part of the first set of CMU initiatives, the Commission launched various public consultations with the aim to gather stakeholders' feedback on elements of the CMU. These public consultations are key channels for stakeholders to convey suggestions and specific concerns.

The first two policy consultations, on covered bonds and venture capital, closed on 6 January 2016. Responses to the consultation on covered bonds have already been published by the Commission on its website.

In addition, the Commission launched a broader call for evidence on the EU regulatory framework for financial services. The consultation, which closed on 31 January 2016, sought to gather views and feedback on potential overlaps, loopholes, and inconsistencies of the post-financial crisis EU regulatory framework. The Commission received nearly 300 responses to its call for evidence, which are available online. The Commission is now analyzing the responses, and it is expected to produce reports addressing future actions.

“In the Commission's view, Europe's capital markets are relatively underdeveloped and fragmented...”

The Commission also reached out to stakeholders with a green paper on retail financial services. The green paper included questions on how to address challenges brought by the digitalization of retail financial services and how to increase the cross-border dimension of the single market. This work stream is particularly interesting for banks, payment companies, insurance companies, and fintechs. The consultation period is now over, and the Commission is expected to publish an action plan.

The Commission also launched a public consultation on the insolvency framework in the EU. The lack of a harmonized approach to insolvency is considered to be an impediment to the proper functioning and development of EU capital markets. Through the consultation, which runs until June 2016, the Commission seeks feedback on specific issues such as the efficient organization of debt restructuring procedure, as well as common EU principles and standards that could ensure that national insolvency frameworks function well, especially in a cross-border context. The Commission is expected to present a legislative initiative on business insolvency in the framework of CMU.



report on crowdfunding was released in early May. The input of financial services providers, particularly those engaging in cross-border activities, will be key to the development of these initiatives. The Commission also intends to address key issues, such as the debt-equity tax bias, and to foster support for equity financing. Elements in this direction should be included in the legislative proposal on a Common Consolidated Corporate Tax Base, which is expected to comprise wider measures to bring harmonization in EU corporate tax regimes.

will be needed, and all parties involved must remain fully committed to the project. Importantly, the Commission just published the first CMU status report. It is expected that financial stakeholders will continue to make their voice heard on the various CMU work streams, through public consultations, hearings, and calls for evidence. Given the long-term, iterative nature of the CMU process, it is paramount that stakeholders continue playing an active role to ensure that policymakers remain strongly focused and deliver on the CMU priorities.

CONCLUSION

The Commission has invested a great deal of political capital in the CMU project, and it has been effective and timely in its actions since the CMU launch. Clearly, momentum is building around the CMU project in recent months, and it is important that this energy be sustained. Strong political will by all co-legislators

KEY STEPS AHEAD

The Commission is expected to put forward various initiatives on other aspects of CMU during 2016, including initiatives related to facilitating cross-border investment (e.g., a consultation on barriers to the cross-border distribution of investment funds), in a package of measures to stimulate venture capital in the EU. A

AUTHORS

Giovanni Campi
Brussels
giovanni.campi@klgates.com

Mark Roszak
Washington, D.C.
mark.roszak@klgates.com

Daniel F. C. Crowley
Washington, D.C.
dan.crowley@klgates.com

Financial Regulation in the Euro Zone: Update on the Banking Union

Over the last four years, in response to the crisis in the euro zone, enormous efforts were taken to implement a Banking Union with a view to ensuring stability of the financial markets. As of 2016, two of the three pillars are now fully operational: (i) the European Central Bank (ECB) assumed supervision of all credit institutions in the euro zone, and (ii) an efficient cross-border resolution mechanism for failed credit institutions came into force. The third pillar, a common deposit insurance scheme, is anticipated in the near future.

SINGLE SUPERVISORY MECHANISM AND SUPERVISORY FOCUS 2016

The first major element of the reform, the Single Supervisory Mechanism (SSM) of the Banking Union was implemented in November 2014. At that time, the ECB assumed direct supervision over the 123 most significant banking groups

requirements to a point where all risks would be eliminated. Nevertheless, in 2016 credit institutions will face significant scrutiny by the ECB under a program comprising five supervisory priorities: business model and profitability, credit risk, capital adequacy, risk governance and data quality, and liquidity.

Credit risk is a major issue, as many credit institutions in the euro zone account for a high volume of sub-performing or nonperforming loans. The ECB will examine whether credit institutions maintain sufficient capital to cover those risks. In view of the stock market downturn in the beginning of this year,

with credit institutions losing almost half of their value, credit institutions may have had difficulty raising additional capital. This circumstance makes it more likely that some institutions will work to clear their balance sheets to remove these risks, particularly in view of the fact that the ECB announced that capital requirements are envisioned to increase by 0.5 percent in 2016. This will also impact smaller credit institutions only indirectly supervised by the ECB. For example, in Germany, the regulator BaFin announced that it will take a closer look at interest rate risks in the trading books affecting small and medium sized credit institutions and impose or require additional risk buffers designed to protect institutions relative to sudden increases in interest rates.

SINGLE RESOLUTION MECHANISM

The second pillar of the Banking Union, the Single Resolution Mechanism (SRM), became operational on 1 January 2016. Its purpose is to ensure the efficient resolution of failed credit institutions in the Banking Union with minimal costs for taxpayers and reduced disruption to the broader economy. A primary focus of the SRM is to provide for resolution plans with respect to the potential failure of covered institutions. For 2016, there is emphasis on collecting data for the resolution planning and the determination of minimum requirements for funds and eligible liability (MREL) regarding individual credit institutions.

The financial backbone of the SRM, the Single Resolution Fund (SRF), will be built up gradually by mandatory contributions by credit institutions to be made through the end of 2023. The overall volume of the SRF will correspond to 1.0 percent of covered deposits, which equates to approximately €55 billion. As of 31 January 2016, an initial amount of €4.3 billion comprised of 2015 ex-ante contributions was transferred to the SRF.

EUROPEAN DEPOSIT INSURANCE SCHEME

While the SSM and the SRM were implemented with reasonable efficiency, the third pillar, the European Deposit Insurance Scheme (EDIS), remains a bone of contention and a work in progress.

The plan of the European Commission is to socialize national deposit guarantee proposals in order to ensure equal protection of deposits throughout the Banking Union and to prevent the vulnerability of local deposit guarantee programs to disruptive local events. EDIS is expected to develop in three stages over time. As a first step, EDIS will start as a re-insurance of current

“Two of three pillars of the Banking Union are now operational.”

consisting of approximately 1,100 credit institutions within the euro zone. Following the annual assessment in 2015, this number increased to 129 banking groups. The total assets under the supervision of the ECB amount to more than €26 trillion and account for more than 85 percent of the balance sheet totals of all credit institutions in the euro zone. In addition, the ECB is now responsible for the indirect supervision of about 3,500 smaller, so-called less significant, credit institutions through regulators in the individual member states.

Sabine Lautenschläger, the vice chair of the SSM, has stated that it is the intention of the ECB to implement “tough and fair supervision,” but that the ECB does not seek to tighten rules and

national deposit guarantee schemes. Thereafter, it will move to a co-insurance scheme after three years, as to which the contribution of EDIS will progressively increase. A full insurance by EDIS is eventually contemplated for 2024. For this purpose, a European Deposit Fund will be created, which will be financed directly by ex-ante bank contributions, based on covered deposits and the degree of risk ascribed to individual credit institutions.

EDIS will be mandatory for participating member states. Currently, certain institutions, including savings banks and mutual banks in Germany, openly resist the plans of the European Commission because of fears that insurance fund contributions made in Germany will be used to cover insolvencies of credit institutions in other member states that have taken lesser or different precautions. Still, the draft bill continues to receive significant support in the European Parliament.

this agreement ceased to exist. However, currently it is provided that npMS are not accorded any veto rights with respect to matters of the Banking Union. In particular, they are unable to assert rights to prevent the adoption of decisions by the Council on resolution actions regarding financial institutions in participating member states. Nonetheless, npMS may voice their interests, particularly in the rules adopted by the European Banking Authority in the Single Rulebook, which applies to all of the European Union.

CONCLUSION

The implementation of the third pillar, the European Deposit Insurance Scheme, is the current challenge in creating a robust Banking Union. Credit institutions, whether directly or indirectly supervised by the ECB, have to stay abreast of the increased regulatory requirements to ensure they are in compliance. Many of them may even have to adapt their business models to become more resilient, which will obviously open opportunities for other market participants.



HOW ABOUT THE NONPARTICIPATING MEMBER STATES?

As part of the European Union, the Banking Union will inevitably affect the interests of the nonparticipating member states (npMS). While a *modus vivendi* was agreed in the summit of the Council in Brussels on 18 and 19 February 2016, to ensure that the interests of the so-called permanent opt-outs like the United Kingdom and Denmark will be safeguarded, with the result of the referendum in the United Kingdom for it to leave the European Union (Brexit)

AUTHORS

Dr. Christian Büche
Frankfurt
christian.bueche@klgates.com

Anne Thümmel
Frankfurt
anne.thuemmel@klgates.com

Japan Introduces “Real” Regulations on Virtual Currencies

Until the New PSA (defined below) passed the Diet in May 2016, virtual currencies and related service providers remained unregulated in Japan. Even upon the collapse of “Mt. Gox,” the Tokyo-based bitcoin exchange that filed for bankruptcy in early 2014, the Japanese government left the industry virtually unregulated. At that time, Prime Minister Shinzō Abe stated in a Diet session that virtual currencies were not something directly regulated under existing Japanese laws. However, at the 2015 G7 Summit, the representatives of the world’s largest economies called for appropriate regulations for virtual currencies. This came amid growing money laundering concerns concerning virtual currencies, including a 2015 guidance issued by the Financial Action Task Force, an international task force against money laundering, which called for a “risk-based approach” to virtual currencies. In response, the Financial Services Agency of Japan (FSA) proceeded with a legislative effort to seek appropriate regulations on virtual currencies service providers.

On 25 May 2016, an amendment to the Payment Services Act of Japan (Act No. 59 of 2009) (New PSA) passed the Diet, and was promulgated on 3 June 2016. The New PSA aims to bring the virtual currency industry under the supervision of the FSA and introduce new registration requirements for virtual currencies exchanges, including those based outside of Japan, that provide services to customers in Japan.

REGISTRATION REQUIREMENT FOR VIRTUAL CURRENCIES EXCHANGES

Definition of Virtual Currencies

The New PSA defines “Virtual Currencies” to be:

- i. anything of financial value (limited to those that are recoded electronically on electronic devices or other means, other than currencies issued by governments and assets denominated by such government currencies) that (a) can be used to pay unspecified parties generally consideration for purchasing or renting goods, or receiving services, (b) can be purchased from or sold to unspecified parties generally, and (c) can be transferred through electronic data processing system
- ii. anything of financial value that (a) can be used to exchange with or into financial value of aforementioned nature with unspecified parties generally and (b) can be transferred through electronic data processing system

Registration Requirement for Exchange

Under the New PSA, any party who engages in any of the following virtual currencies exchange business (Exchange) is required to be registered with the Japanese government:

- i. sale/purchase or exchange of virtual currencies
- ii. acting as an intermediary, brokerage, or agency of aforementioned
- iii. managing money or virtual currencies of customers in relation to any of the above

Eligibility Requirement for Exchange Registration

The New PSA requires that, to be eligible for registration, an Exchange must, among others, (a) hold minimum capital and (b) have appropriate policies and procedures in place, the failure of which would result in disqualification. Also, Exchanges that meet certain bad actor provisions would be disqualified. With respect to (a), the minimum capital requirement, it is expected that the amount of minimum capital would be set as JPY10 million. While this is not an “excess” capital requirement or reserve requirement, thereby requiring Exchanges to reserve the amount in cash or other liquid assets at all times, this may become a barrier to entry for some startups. With respect to (b), the appropriate policies and procedures requirement, the level of FSA’s expectations on policies and

procedures is not clear, and we expect that the FSA will present its guidance through proposed rules or guidances following the expected public consultation.

Registration Requirement for Exchanges Based Outside of Japan

Importantly, under the New PSA, Exchanges based outside of Japan are required to be registered in Japan if they intend to provide services to customers in Japan. The consequences of failing to register include administrative sanctions by the FSA and criminal action resulting in a fine for corporations and a fine and/or imprisonment for individuals involved. Exchanges based outside of Japan may be registered as a “Foreign Exchange” if they are appropriately registered or licensed in their home jurisdiction. However, nonJapanese Exchanges must have an office in Japan and designate a “representative of Japan,” the failure of which would result in disqualification. The New PSA prohibits nonJapanese Exchanges that do not register with the Japanese regulator from advertising their services to residents of Japan.

OBLIGATIONS FOR VIRTUAL CURRENCIES EXCHANGES

In addition to the registration requirement, the New PSA would also subject Exchanges to various additional obligations, including:

- i. prohibiting the commingling of customers’ assets and funds; more

specifically, Exchanges must segregate their customers' money and virtual currencies from the Exchange's own money and virtual currency, which will be subject to periodical review and audit by a public accountant

- ii. ensuring adequate data security
- iii. providing customer disclosure of certain information, such as nature of certain transactions and applicable fees
- iv. establishing antimoney laundering procedures, including "know your customer" procedures, recordkeeping, and reporting mechanisms
- v. providing annual business reports to the FSA
- vi. conducting periodic audits by public accountants
- vii. participating in certain designated dispute resolution systems for customer

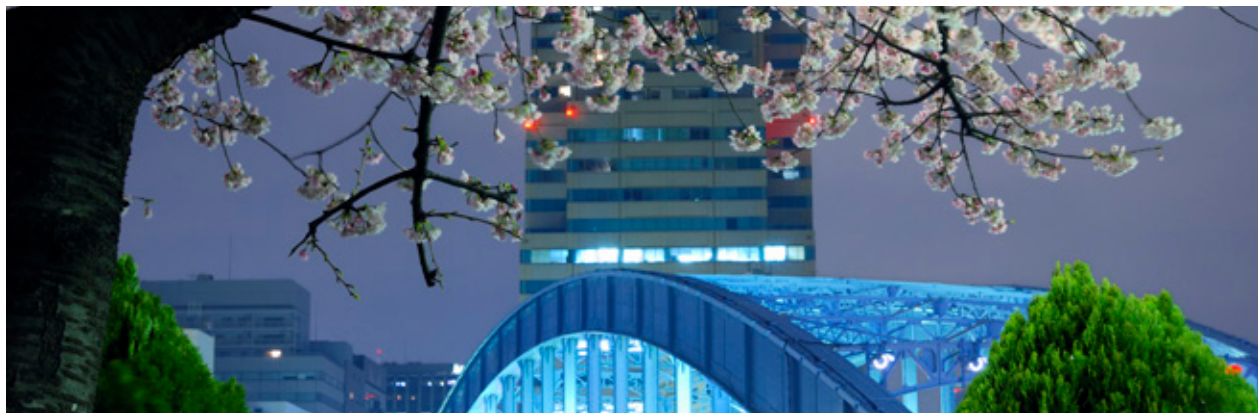
protection. Under the New PSA, if the FSA in the future designates an alternative dispute resolution institution, an Exchange would have to participate in such an institution; if not, an Exchange would have to establish adequate dispute resolution systems

WHAT TO EXPECT NEXT

The New PSA will come into effect within one year after the promulgation. The grandfathering provision provides that Exchanges engaging in businesses at the time of effectuation of the New PSA may provide services without registration for six months or longer until an application for registration is acted on by the FSA, provided

that the Exchange files an application for registration within the first six months.

Since the New PSA passed the Diet, the FSA will likely propose rules thereunder to implement these amendments and lay out the details of the registration requirement and other obligations set forth above. The FSA will likely hold a public consultation period at the time it proposes the rules, which gives the industry as well as consumers and investors an opportunity to directly address their views. For businesses involved in virtual currencies, regardless of their geographical location, the new regulatory landscape under the New PSA will



require them to consider whether they will be subject to the requirements and obligations of the proposed statute. In particular, those businesses based outside of Japan providing services that may characterize themselves as "Exchanges" should determine whether they will likely be subject to Japanese regulations. Those businesses that service customers in Japan should expect and prepare

resources to complete the registration and create certain infrastructure within the organization to comply with expected obligations to be imposed upon Exchanges.

Future Regulations on Evolving Technologies and Services

It is important to note that the FSA so far has limited its regulatory reach under the New PSA to Exchanges and is not seeking to directly regulate virtual currencies, virtual currencies derivatives, or related investment vehicles or other evolving technologies such as the emerging distributed ledger technology known as "blockchain." As the virtual currency industry evolves, we

expect that the regulatory framework may also evolve and expand to cover these areas. This was also part of the discussion at the G7 Finance Ministers and Central Bank Governors' meeting, which was held in Japan in May 2016 in conjunction with G7 Ise-Shima Summit.

AUTHORS

Tsuguhito Omagari
Tokyo
tsuguhito.omagari@klgates.com

Yuki Sako
Tokyo
yuki.sako@klgates.com

Ayuko Nemoto
Tokyo
ayuko.nemoto@klgates.com

China: Keeping Nervous Horses from Bolting

An extremely volatile securities market and a rollercoaster ride in the performance of its currency, the Renminbi (RMB), was brought to the People's Republic of China (the PRC) in 2015. While there was never any doubt that the PRC policymakers would step in, the speed and manner with which they responded was unprecedented. Among other things, in August 2015, PRC regulators amended the basis for determining the onshore RMB's daily reference rate to a more market-based approach, which led to a swift depreciation in the value of the RMB. More significant for clients was the easing of restrictions with respect to foreign investments in the PRC interbank bond market and the relaxation of investment quotas and foreign exchange controls for Qualified Foreign Institutional Investors (QFIIs), both of which appear to have been intended to invigorate foreign interest in the RMB and its much-less-volatile bond market.

While the PRC policymakers clearly recognize that to internationalize the RMB and have it universally recognized as an international currency, it is necessary to have it free-floating and unrestricted, this must be balanced against the volatility that would almost certainly arise from short-term investment and speculation. Though many restrictions on capital flows remain, these recent announcements demonstrate the commitment of PRC policymakers to liberalising the RMB.

EASING OF RESTRICTIONS IN RESPECT OF THE PRC INTERBANK BOND MARKET

Some history of the PRC interbank bond market trade and its gradual liberalization would be useful as background.

1. In 2010, the People's Bank of China (the PBOC) issued the *Notice of the People's Bank of China on Issues Concerning the Pilot Program on Investment in the Interbank Bond Market with RMB Funds by Three Types of Institution Including Overseas RMB Clearing Banks* (PBOC

Document [2010] No. 217), which allowed the following three types of institutions to use the RMB to invest in the onshore interbank bond market within their individual approved investment quotas, subject to the prior approval of the PBOC:

- i. foreign central banks and monetary authorities
 - ii. clearing banks for RMB business in Hong Kong and Macau
 - iii. overseas participating banks for RMB settlement of cross-border trade
2. In 2013, the PBOC issued the *Notice of the People's Bank of China on Relevant Matters Concerning Investment in the Interbank Bond Market by Qualified Foreign Institutional Investors* (PBOC Document [2013] No. 69) and the *Notice of the People's Bank of China on Relevant Matters Concerning the Implementation of the Measures for the Pilot Program of Domestic Securities Investment by RMB Qualified Foreign Institutional Investors*

(PBOC Document [2013] No. 105), which, respectively, permitted QFIIs and RMB-Qualified Foreign Institutional Investors ("RQFIIs") to invest in the onshore interbank bond market within their individual approved investment quotas, subject to the prior approval of the PBOC.

3. On 14 July 2015, the PBOC issued the *Notice of the People's Bank of China on Issues Concerning Investment of Foreign Central Banks, International Financial Institutions and Sovereign Wealth Funds with RMB Funds in the Inter-bank Market*, which permitted foreign central banks, monetary authorities, international financial institutions, and sovereign wealth funds to engage in trading of cash bonds, repurchases, bond lending, bond forwarding, interest rate swaps, forward rate agreements, and other transactions permitted by the PBOC in the onshore interbank bond market, upon registration with the PBOC but without prior approval from the PBOC and without being subject to any quota restrictions.

“An eligible Relevant Entity must appoint an approved onshore settlement agent to conduct trading and settlement in the onshore interbank bond market.”

So far, so good—but prior registration by a regulatory authority, and the subtle “approval” that it engendered, still applied.

Then, on 17 February 2016, the PBOC issued Announcement of 2016 No. 3 (the Announcement), which resulted in eligible offshore commercial banks, insurers, securities companies, asset managers, and other medium- to long-term institutional investors to now be able to access the PRC onshore interbank bond market without being restricted by quotas or going through any separate application procedures with the PRC regulatory authorities.

While such investors are subject to assessment by an onshore settlement agent through whom trades in the onshore interbank bond market will be conducted, this is far less cumbersome and formal than the previous registration and approval procedures with the PRC regulators.

Relevant Entities

The Announcement applies to participation in the onshore PRC interbank bond market through or by:

1. commercial banks, insurance companies, securities companies, fund management companies, and other asset management institutions established outside of the PRC (Financial Institutions)
2. “investment products” legally sold to clients by Financial Institutions—presumably, this refers to the underlying product or contract upon which the interbank bond trade is being conducted, but this has not been clarified

3. other medium- to long-term institutional investors approved by the PBOC, such as pension funds and charitable funds

Although it is assumed that the Announcement would apply to all nonPRC institutional investors, the Announcement makes specific reference only to institutional investors from Hong Kong, Macau, and Taiwan, as well as QFIIs and RQFIIs (each a Relevant Entity).

Interestingly, hedge fund managers are not explicitly included on the list, which



would appear to be in line with the PBOC’s clear and stated intention, as set out in the Announcement, to attract medium- to long-term investors to the PRC onshore interbank bond market.

Eligibility Requirements

The Announcement sets out the necessary eligibility requirements of a Relevant Entity—aside from the expected basic legal and compliance requirements for an investing entity, it must have the ability to identify and assume the relevant risks and acknowledge and assume the risks associated with bond investments, with the PBOC retaining their usual overriding right to set other requirements as necessary. The assessment of a Relevant Entity’s eligibility to access the

PRC onshore interbank bond market will be conducted by the PRC onshore settlement agent proposed to be appointed by the entity, which may only accept its appointment upon a satisfactory assessment of the Relevant Entity.

Onshore Settlement Agents

An eligible Relevant Entity must appoint an approved onshore settlement agent to conduct trading and settlement in the onshore interbank bond market. Upon appointment by an eligible Relevant Entity, the onshore settlement agent must make an investment filing to the

Shanghai headquarters of the PBOC on behalf of the Relevant Entity. The onshore settlement agent will provide the following services to the Relevant Entity:

1. make investment filings on behalf of the Relevant Entity
2. assist the Relevant Entity in opening, amending, and closing RMB deposit accounts, bond accounts, settlement accounts, bond trading accounts, and other accounts
3. conduct trades and settlements on behalf of the Relevant Entity pursuant to instructions from the Relevant Entity
4. assist the Relevant Entity on matters relating to interest payments and principal payments of bonds

Certain approved onshore settlement agents may also provide asset custody, accounting and valuation, report processing, and other custodial-related services to the Relevant Entity. The PBOC will announce the detailed implementation rules and the investment reporting template in due course.

Trading and Settlement

An eligible Relevant Entity may access the interbank bond market upon the appointment of the onshore settlement agent without any further applications or approvals being required. Under the terms of the Announcement, Relevant Entities, through their onshore settlement agent, may carry out such types of trades on the PRC onshore interbank bond market as are permissible by the PBOC, which, in the first instance, appear to be spot trades of bonds only. It is expected that these will be expanded and/or varied by supplemental rules or announcements from time to time.

Termination of Access

A Relevant Entity will be prevented from further access to the onshore interbank bond market upon the occurrence of one of the following circumstances:

1. the Relevant Entity is subject to dissolution, winding up, revocation, or bankruptcy
2. the relevant “investment product or contract” has expired—presumably, this refers to the underlying product or contract upon which the interbank bond trade is being conducted but this has not been clarified
3. other circumstances as designated by the PBOC

RELAXATION OF INVESTMENT QUOTAS AND FOREIGN EXCHANGE CONTROLS FOR QFIIS

By its Announcement of 2016 No. 1, dated 3 February 2016, the State Administration of Foreign Exchange (SAFE) published the revised *Foreign Exchange Administrative Rules on Domestic Securities Investment by Qualified Foreign Institutional Investors* (the Revised Rules), which took effect immediately. Under the Revised Rules, investment quotas and foreign exchange controls for QFIIs have been relaxed in order to attract further foreign investment into the onshore capital markets in the PRC.

Relaxation of Investment Quotas

Under the previous rules, after obtaining approval from the China Securities Regulatory Commission, a QFII had to make an application to SAFE for approval of an investment quota prior to making any investments. Under the Revised Rules, instead of obtaining prior approval, a QFII may obtain an investment quota by completing a filing with SAFE for record (and not for prior approval) through its onshore custodian, so long as the investment quota sought is (i) within a designated percentage of the QFII's asset value or assets under management (AUM) (see below), and (ii) between US\$20 million and US\$5 billion (the Basic Quota). The specific maximum Basic Quota is calculated as follows:

- For QFII (or its corporate group) with assets (or AUM) mainly outside the PRC:
 - o US\$100 million, plus 0.2 percent of average asset size in the last three

years, minus RQFII quota obtained (in U.S. dollar equivalent)

- For QFII (or its corporate group) with assets (or AUM) mainly within the PRC:
 - o \$5 billion Renminbi, plus 80 percent of the previous year's asset size, minus RQFII quota obtained (in U.S. dollar equivalent)

An application to SAFE for its approval by the QFII is only required if the investment quota sought exceeds the Basic Quota. However, the Basic Quota restriction does not apply to QFIIs that are sovereign wealth funds, central banks, or monetary authorities, which may obtain an investment quota of up to US\$5 billion by completing a filing with SAFE for record.

The aforementioned filing procedure also applies to any QFII seeking to increase its investment quota, unless the increase results in the QFII's cumulative investment quota exceeding the Basic Quota, in which case the QFII will have to apply to SAFE for approval. Further, under the Revised Rules, a QFII's investment quota is monitored based on its cumulative net capital inflows, which means that a repatriation of investment capital will no longer lead to a reduction in its investment quota as it did under the previous rules.

Shortening of the Lock-Up Period

Under the previous rules, the repatriation of the investment capital of QFIIs (except for certain types of QFIIs, including open-ended funds) was subject to a 12-month lock-up period. Under the Revised Rules, this has now been shortened to three months.

In addition, under the previous rules, the lock-up period only commenced upon the remittance by the QFII of the full amount of the investment quota into the PRC. Under the Revised Rules, the lock-up period will instead commence upon the remittance of a minimum of US\$20 million by the QFII into its account with its onshore custodian. In effect, this lowering of the remittance threshold upon which the lock-up period commences will further shorten the lock-up period.

Relaxation of Restrictions on Remittances of Funds

Under the previous rules, a QFII had to remit the full amount of the investment quota into the PRC within six months of obtaining approval from SAFE. This six-month period has been removed under the Revised Rules (although SAFE reserves the right to cancel a QFII's investment quota in whole or in part if the investment quota has not been “effectively utilized”—or fully used—within a year from (i) in the case of a Basic Quota, the date of completion of the filing of the investment quota with SAFE, or (ii) in any other case, the date of approval of the investment quota from SAFE).

In addition, under the Revised Rules, QFIIs that are classified as “open-ended China funds” (defined in the QFII rules as an open-ended securities investment fund set up for public offering outside China, where at least 70 percent of the fund assets are invested in China) may now remit their funds in or out of the PRC on a daily basis, rather than on a weekly basis under the previous rules.

SIGNIFICANCE

The efforts of PRC policymakers appear to have been recognized on the international front. On 30 November 2015, the International Monetary Fund announced that with effect from 1 October 2016, RMB would be accepted into the Special Drawing Rights (SDR) basket, which it initially established in 1969. This marks a milestone for RMB with respect to its status as one of the leading international currencies, since a currency must meet the IMF's definition of “freely usable” to be included in the SDR basket. Although it is unlikely to lead to a sudden surge in demand for the RMB, as central banks

A-shares inclusion. This suggests that the PRC will not have to wait until the MSCI's annual review in June for consideration, and A-shares could be included as early as May 2017. Many expect the PRC's equities weighting to become so massive that it will eventually require its own stand-alone benchmark—certainly, the result that the PRC policymakers hope their latest measures will assist in achieving.



have already been accumulating the RMB for some time, these changes do add much-needed credibility to the RMB. They will also certainly be a persuasive factor in MSCI's decision to include A-shares (PRC-listed shares) in its global emerging market index, as evidenced by MSCI's comments that it would offer a flexible timetable on the timing of the

AUTHOR

Choo Lye Tan
Hong Kong
choolye.tan@kllgates.com

Fintech Innovations—Australian Regulatory Responses

Public policy and regulators in Australia have begun the reform journey in response to the rapid change of pace generated by Fintech innovation. Market developments in key areas such as equity crowdfunding, marketplace lending, robo-advisers, and online payment systems have underlined the need for Australia's financial services regulatory regime to adapt and better facilitate the consumer and business solutions that these technologies present. The Australian regulatory regime has also taken the bold step of proposing to create a regulatory "sandbox," which would temporarily relax licensing and other compliance obligations to enable Fintech innovators to test market their products.

While some in the Fintech startup community argue that regulatory barriers need to come down faster, the Australian government's recent policy announcements on innovation are a good platform for Australia's financial service industry to build a competitive response both regionally and globally in a number of key Fintech markets.

Key Australian Fintech regulatory and policy developments include the following:

REGULATORY SANDBOX CONSULTATION

Australian Fintechs are closer to getting a regulatory "sandbox" after the Australian Securities and Investments Commission (ASIC) released its detailed consultation paper in June. The paper details proposals for a testing ground for innovative robo-advice providers and other similar services. It also highlights ASIC's views about some regulatory options already open to Fintechs under the current law.

The sandbox will allow new entrants to test a service for up to 100 retail clients for up to six months without holding an Australian Financial Services Licence (AFSL). The sandbox only relates to particular services and caters primarily to robo-advisers. Product issuers such as payment facility providers and marketplace lenders are excluded, as is advice about general and life insurance. Each client's exposure must be capped at AUD10,000 and total entrant exposure at AUD5 million.

Key consumer protections under Australia's financial services laws will continue to apply, such as external dispute resolution requirements, professional indemnity insurance, and the need for some form of disclosure. Startups will not need to apply to ASIC to be admitted to the sandbox (unlike comparable sandbox arrangements in the United Kingdom and other jurisdictions), but may need to be vetted by a "sponsor," such as a hub, co-working space, or venture capital firm.

ASIC is open to consulting on the details of the sandbox, and the proposal is likely to generate significant interest in the industry. Key areas for consultation are likely to be whether it is broad enough for Fintech innovators and whether it strikes the right consumer protection balance.

CROWDFUNDING LEGISLATION

In late 2015, the government introduced the Corporations Amendment (Crowd-sourced Funding) Bill 2015 (Cth), which would allow many more companies to crowd source equity funding through a new category of licensed intermediaries. The bill's passage through parliament has been interrupted by a general election, and it will need to be reintroduced after the election if it is to proceed. Both major political parties support moves to facilitate crowdfunding, so it is likely crowdfunding legislation will be pursued regardless of the election result.

The details of the proposed reforms were criticized for trailing similar crowdfunding measures in the United Kingdom, New Zealand, and the United States. In addition, the startup sector in Australia has complained about crowdfunding being limited only to public companies, which requires many startups to spend money to convert to public company status and to pay additional ongoing associated compliance costs for compulsory audits (subject to any relief from these requirements that may ultimately be available).

MARKETPLACE LENDING

Australia does not currently have a specific regulation tailored to marketplace lending. As a result, businesses wishing to provide a marketplace for retail borrowers and investors must fit within one of the existing regulated categories. To date, managed funds or pooled investment vehicles are the only means that ASIC has approved to provide

“The sandbox will allow new entrants to test a service for up to 100 retail clients for up to six months without holding an Australian Financial Services Licence (AFSL).”

marketplace lending to retail borrowers and investors. This involves interposing a unit trust between lenders and borrowers. As a result, marketplace providers have been forced to obtain both an AFSL and an Australian Credit Licence. They also have been required to comply with two regulatory regimes that do not neatly regulate this emerging business model.

The 2014 Australian Financial System Inquiry (FSI) Final Report recommended that once securities based crowdfunding legislation had been implemented, consistent policy settings should also apply to marketplace lending regulation. In addition, the FSI Final Report recommended graduating the current regulatory regime to accommodate different platforms, such as pooled investments and “bulletin board” models, and that attention should be paid to facilitating other mechanisms for direct lending.

In its response to the FSI Final Report, the government stated that it had plans to, “graduate fundraising regulation to facilitate crowd-funding for both debt and equity and over time other forms of financing.” After the general election, and in conjunction with continuing efforts on crowdfunding legislation, the government is expected to turn its attention to more efficient settings for marketplace lending regulation.

ROBO-ADVICE

The provision of automated financial product advice, also known as robo-advice, is regulated by the same provisions in the Corporations Act

2001 (Cth) that apply to advice which is provided by a natural person.

Simple forms of advice can be provided by robo-advisers within the current regulatory framework, but the regulation of more complex advice to retail clients is not always easily adapted to robo-advice. Current regulations are unclear as to how advice given without the involvement of a natural person can meet a number of complex advice-related obligations. A key issue of debate in the industry has been how a robo-adviser can discharge the fiduciary duty to act in the best

best interests of its clients and prefer their interests in the event of a conflict. ASIC expects robo-advisers to comply with this duty and anticipates that this will require, among other things:

- explaining to the client from the outset what advice is being offered and what is not being offered (i.e., the scope of the advice)
- at key points in the advising process, informing the client about the limitations and potential consequences of the scope of advice



interests of its clients. Traditional financial advisers and those in the legal industry have expressed doubts that they can. In an attempt to both address these concerns and provide greater protection to consumers, ASIC is proposing to issue specific guidance to the robo-advice sector. This guidance is likely to require robo-advice algorithms to be prepared by suitably qualified personnel and regularly audited. The tools will also need to clearly designate the scope they can cover and triage clients for whom robo-advice is not appropriate.

Despite these technical legal debates, the Corporations Act 2001 (Cth) imposes a statutory duty on advisers, including robo-advisers, to act in the

- throughout the advising process, informing the client about key concepts and the risks and benefits associated with the advice being provided
- filtering out clients for whom the advice being offered is not suitable, or who want advice on a topic outside the scope of advice being offered
- informing the client about the upfront and ongoing costs of the advice
- informing the client about how they can withdraw from the advice being provided, and any associated costs, before the advice is implemented;
- explaining applicable dispute resolution processes
- explaining why the client is likely to be in a better position if they follow the advice

The incidence of robo-advice models in Australia is growing rapidly. While ASIC has established a “robo task force” to look into these issues, the task force will need to respond quickly to ensure that Australian financial services participants can take advantage of available technology and compete with offshore models.

PAYMENTS

The FSI Final Report identified that the current regulation of payments in Australia is far too complex, with overlapping laws administered by a collection of regulators. The FSI made a number of recommendations for reform, including a recommendation that only service providers that provide access to large, widely used payment systems would need to meet the highest regulatory and prudential standards. The government's

response to the FSI Final Report was that the Australian Prudential Regulation Authority, ASIC, and the Reserve Bank of Australia (RBA) would work to review the framework of payments regulation and develop scalable regulatory outcomes. In addition, the government introduced a ban on excessive payment surcharges on 25 February 2016, while the RBA has proposed changes to card payment fees and system interchange fees. The aims are to ensure that merchants do not impose surcharges in excess of their actual costs and to improve competition and efficiency in the card payments market and in the broader payments system through fairer interchange fees.

The government also plans to clarify the powers of ASIC and the RBA to ensure that regulation can be applied to digital currencies. For example,

the government is currently exploring extending antimoney laundering laws to apply to digital currencies and other digital payment solutions.

CONCLUSION

Numerous regulatory challenges remain before Australia fully embraces and facilitates new Fintech technologies. However, the government seems to have recognized that regulations that encourage investment and growth of Fintech startups and innovation could attract significant investment in Australia and result in major growth in the financial sector. The recent responses by the government and regulators have been welcomed by the Fintech industry, and the outlook for a globally competitive regulatory environment into the future is positive.

“ [T]he government seems to have recognized that regulations that encourage investment and growth of Fintech startups and innovation could attract significant investment in Australia and result in major growth in the financial sector.”

AUTHORS

Jim Bulling
Melbourne
jim.bulling@klgates.com

Daniel Knight
Melbourne
daniel.knight@klgates.com

Turning the Trust Indenture Act of 1939 Upside Down?

PUBLICLY HELD DEBT HAS HISTORICALLY BEEN A GOOD SOURCE OF LIQUIDITY FOR MANY COMPANIES

To raise capital or liquidity, companies have frequently issued long-term senior unsecured debt instruments in public offerings. When this unsecured debt cannot be serviced by cash flows, this leads to bond payment defaults as well as nonpayment defaults and covenant breaches. As a result, a number of companies in this circumstance have chosen bankruptcy to obtain a court-supervised debt restructuring. Others, in an effort to avoid bankruptcy or to restructure existing debt to permit a new issuance of securities, have tried a variety of balance sheet restructurings involving consent solicitations and exchange offers or intercompany sales transactions. When these have involved publicly offered bonds, Section 316(b) of the Trust Indenture Act of 1939 has imposed requirements designed to protect minority bondholders in out-of-court restructurings that impair certain of their core rights. Section 316(b) of the Trust Indenture Act states in part that “the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture, on or after the respective due dates expressed in such indenture, shall not be impaired or affected without the consent of such holder.” Prior to 2015, established precedent generally interpreted Section 316(b) narrowly. However, two cases recently adopted a much broader interpretation of the scope of noteholders’ legal rights that are entitled to be protected under

Section 316 of the Trust Indenture Act. These two decisions have upset settled interpretations of Section 316 of the Trust Indenture Act and may materially affect the ability of issuers to restructure their debt and their balance sheets going forward into 2016 and beyond.

THE TWO CASES

The Marblegate Decision

The first decision came in *Marblegate Asset Mgmt. v. Education Mgmt. Corp.*, 111 F. Supp. 3d 542 (S.D.N.Y. 23 June

of two events: (i) by majority of a vote taken by the unsecured noteholders, or (ii) by a corresponding release of a separate guarantee given by the parent to the secured lenders. There was no value assigned to the parent guarantee when the original indenture was issued.

A committee consisting of holders of approximately 80 percent of the secured debt and holders of approximately 80 percent of the unsecured notes negotiated an out-of-court restructuring whereby the secured lenders received debt and equity providing for an approximately 55 percent



2015). In this case, a for-profit education company and its affiliated entities sought to restructure approximately US\$1.5 billion of debt out of court because the company effectively could not file bankruptcy without rendering it ineligible for federal funding, which accounted for 80 percent of its revenues. The company’s debt consisted of approximately US\$1.3 billion of secured debt in the form of a revolver and term-loan debt. The balance of approximately US\$200 million was in the form of unsecured notes issued by the subsidiary and guaranteed by the parent. The transaction contemplated in this case qualified under the Trust Indenture Act. The parent issued guarantees on both the secured and unsecured debt. The parent’s guarantee of the unsecured debt could be released by either one

recovery, and the unsecured noteholders received equity equal to an approximately 33 percent recovery. However, if 100 percent of the creditors did not consent to the negotiated agreement, the parent would proceed with an intercompany sale transaction that would release the parent guarantees; the secured lenders would foreclose on their collateral, which was virtually all the assets, and the dissenting unsecured noteholders would receive no distribution, while the consenting unsecured noteholders would receive the negotiated deal.

The dissenting, minority shareholders brought suit in the bankruptcy court and sought an injunction to stop the exchange. While the bankruptcy court denied the injunction sought by the dissenting

noteholders, in lengthy dicta, the court analyzed Section 316(b) of the Trust Indenture Act and concluded that the text and drafting history of Section 316(b) should be read expansively to protect nonconsenting minority bondholders from being forced to release claims outside of a court-supervised debt restructuring. Prior to this decision, Section 316(b) had been viewed narrowly to deny minority shareholders such relief.

The Caesars Decision

One month later, in *MeehanCombs Global Credit Opportunities Funds, LP v. Caesars Entertainment Corp.*, 2015 WL 9478240 (S.D.N.Y. December 29, 2015), the same court further developed its position on Section 316(b). In *Caesars*, in the initial indentures, the parent issued US\$1.5 billion in unsecured notes. One-half was due in 2016, and the remaining half was due in 2017. The parent issued unconditional guarantees and was prohibited from divesting its assets. In 2014, additional indentures were issued that arguably released the parent guarantees but were supported by a majority of the noteholders.

In January 2015, *Caesars'* wholly owned operating company filed Chapter 11 in Chicago. The indenture trustee for the unsecured notes issued in the original indentures asserted that the bankruptcy triggered the parent guarantees and demanded payment. The parent argued that the additional indentures issued in 2014, which were supported by a majority

of the noteholders, contained a release of the parent's guarantee obligation and when voting on the additional indentures in 2014, the noteholders knew that releasing the guarantees did not create any impairment to them.

The indenture trustee filed suit in the Southern District of New York seeking summary judgment that the release of the parent guarantees violated Section 316(b) of the Trust Indenture Act. The parent argued that the noteholders, when voting in favor of the additional indentures, knew that the guarantees were never intended to provide value but were a device created to comply with SEC regulations. Looking at the indentures' language, the court disagreed and concluded the parent guarantees were a meaningful provision of the original indentures. The indenture trustee then argued that any impairment affects a noteholder's right to payment, reasoning that all impairments are violations of the Trust Indenture Act. The court disagreed, stating that if the indenture trustee were correct, then courts would have to interfere with ordinary business practices and would then have to determine when impairment levels were impermissible. The court held that Section 316(b) bars an action that would impair a noteholder's right to sue for payment and a noteholder's substantive right to receive such payment. The court also concluded that there has to be a balance between corporate flexibility and protecting minority bondholders from being forced to release their claims outside of a formal court debt restructuring. The court did not explain what the balance should be.

THE TAKEAWAY


When a restructure is the only viable option, the dilemma is whether to do it in or out of court. Certainly, bankruptcy is a viable restructuring option supervised by a federal court with the power to bind any creditor or party in interest.

For out-of-court restructurings, the district court in the Southern District of New York has turned the Trust Indenture Act upside down. Despite the court's reasoning in *Marblegate* and then *Caesars* that it did not want to interfere with a company's ordinary business practices, the effect of the court's rulings did just that. The court interpreted the Trust Indenture Act so broadly in these two cases that minority bondholders can use the Trust Indenture Act not only as a shield from harm, the intended purpose of the statute, but also as an offensive weapon in a restructuring under which minority bondholders can impose a right to unanimous consent to matters that historically required only a majority vote. These two cases change what was understood to be authority that the Trust Indenture Act only protects noteholders' legal rights. Now a minority bondholders' practical right to payment of principal payment with interest under the original issuance is arguably protected.

This means that for out-of-court restructurings—at least those in the Southern District of New York—advisors need to be more creative when confronted with indentures qualifying under Section 316(b) of the Trust Indenture Act. There is often more than one method to restructure debt out of court, including mechanisms governed by state law that do not have the constraints imposed by the interpretations given Section 316(b) in *Marblegate* and *Caesars*.

AUTHOR

Trey A. Monsour
Houston and Dallas
trey.monsour@klgates.com



“ Since the 2008 financial crisis, global regulators have sought to heighten regulation of the asset management industry generally and the fund industry in particular, aiming to identify and regulate key players and financial instruments, products, and activities that may pose significant risks to investors and to the financial system as a whole.”

Brussels Policy Agenda for 2016

As it often happens, the agenda of the European Union (EU) for 2016 is influenced by major developments at the European and international level. Thus, it does not necessarily reflect what was foreseen (or foreseeable) in the previous year.

EU leaders are now intensively discussing how best to address the so-called refugee crisis. It is currently estimated that as many as 60 million people may be forced to leave their countries as a result of conflicts, violence, human rights violations, or persecution as well as natural disasters. By the end of February 2016, over 1.1 million people had arrived in the EU to escape conflicts or in search of better economic prospects.

This “unprecedented displacement crisis” has had a substantial impact on the EU political debate. Leaders of member states argue about how to best deal with the crisis and who should take responsibility for the large number of persons in need of assistance, protection, and shelter. Moreover, possible solutions to the crisis are directly linked to other sensitive issues, including the relationship of the EU with countries on the frontline of the European external border controls. This particularly relates to Greece, which is undergoing a series of structural reforms in the framework of its latest bailout, and Turkey, which is negotiating its accession to the EU. Both countries have been accused of using the refugee crisis to exert pressure on the EU in order to advance their own interests.

Another popular topic of formal and informal discussions in Brussels has been and will be Brexit, i.e. the United Kingdom’s (UK) decision to leave the European Union. A specific section of this publication deals with the main consequences of the vote in the UK, and how they may develop in the next few years. The victory of the “Leave” side at the referendum poses a huge challenge and great uncertainty for Europe which will last for years, given its numerous and intricate consequences. It is expected to have an enormous impact not only

in the UK-EU relations, but also in the EU itself. The vote in the UK has been a call for reform for the EU, as well. In other words, beyond the result of the negotiations with the UK, and the final content of the Withdrawal Agreement which will define them, the remaining 27 member states need to prepare for the future of a different EU. It will not be just business as usual but with one member less. An immediate change in the EU Treaties was excluded in the first approaches to this matter in 2016, but cannot be considered impossible.

Fundamentally, the referendum result raises several levels of questions about a post-Brexit Europe, including many issues with respect to the distribution of powers between the EU and its members, political accountability and transparency, and structural changes in the field of security and economic and fiscal policy. Besides, it must be underlined that the departure of the UK from the EU institutions represents as well a shift in the current power balance among member states. Seats in the European parliament are allocated in proportion to the total EU population. Voting rights in the Council result from a formula based on member states’ population as well. As soon as the UK population cannot be counted for these purposes, the other big countries in Europe will certainly gain influence in the decision making process in terms yet to be defined.

On the other side, it is difficult to anticipate the long term policy change in an EU where there will be no voice from the United Kingdom. But that change will be certain: UK voices (both in Parliament and in Council) had always carried a certain concept of capitalism and a specific approach to the markets and their regulation; they had their essential

leadership in the shaping of transatlantic business relations; and they counted enormously in the understanding of (and engagement with) business and politics in Far East Asia, or in the Middle East.

In other words, 2016 will see the start of a fundamental change in the EU as we know it and only time will allow a real assessment of this evolution. We will be following it all along, and in many aspects, we will also contribute to this transformation.

On other fronts, as discussed in a related article below, EU institutions are focused on digital-related issues within the wider framework of the so-called Digital Single Market (DSM). Data protection concerns—both within Europe and in the transatlantic relationship—may be expected to have a strong impact on EU policy in 2016.

This year could also be the year of the finalization of the Transatlantic Trade and Investment Partnership (TTIP), aimed at removing trade barriers between the EU and the United States in several economic sectors (including, for example, car safety, chemicals, and pharmaceuticals). The negotiations for the treaty (the largest trade deal of all time) started in July 2013 and have not always been easy. Several important sectors were excluded because of fierce opposition from one side or the other (e.g., financial services) and the prospect for eventual approval of any such partnership has been questioned several times. Despite all this, recent statements and reports seem to suggest that the TTIP could actually be signed this year.

Unfortunately, security has been made another important item on the EU agenda. The terrorist attacks in Paris in November 2015 and in Brussels in March 2016 highlighted the weaknesses and the lack of coordination of both domestic and international intelligence services. EU and national institutions are now called on to find a common approach to the security in the EU, the controls of its

borders, and the international crisis that seems to be connected to the terrorist threat. Questions remain with respect to how much of that enhanced security effort requires new legislation or just more serious implementation of existing tools.

The EU is still making wide use of restrictive measures against non-member countries. Some of these restrictions were lifted because they were deemed to have met the objective for which they were introduced. An example is the EU sanctions against Iran, which were lifted in January 2016, after an international nuclear watchdog (IAEA) certified that Iran had complied with a deal designed to prevent it from developing nuclear weapons. Following the lifting of this restriction, several activities are no longer prohibited for EU (and U.S.) companies and nationals in Iran, and this will likely open several business opportunities. The lifted restrictions only impact some of the sanctions imposed on Iran (i.e. those connected to the Iranian nuclear program); the eased restriction does not lift other sanctions connected to the violation of human rights.

In broader terms, it is possible to identify a general trend at the EU level.

The current European Commission seems to be substantially less prolific than previous Commissions, in terms of legislative activity. This is the result of a precise policy decision of President Juncker and of his team, who have decided to focus on “better regulation.” In EU jargon, this means that they have decided to focus on designing EU policies and laws so that they achieve their objectives at minimum cost, and on being “big on big things and small on small

things.” This approach has substantially reduced the volume of proposed legislation and therefore impacted the activity of the legislator of the EU (Parliament and Council), who formally lacks the power to propose new legislation.

As a consequence, the most visible policy actions from the EU with a direct impact on business do not seem to come from legislative initiatives but rather from antitrust enforcement by the Commission. Such enforcement can be more difficult to scrutinize or influence from outside. This applies in particular to potential changes

in the field of taxation and digital-related matter, which result not from legislative proposals, but from other initiatives led by Competition Commissioner Vestager, including investigations on national taxation systems, a sector inquiry on e-commerce, or a case involving the U.S. film studios and a large UK broadcaster where their whole current business model is at stake. This seemingly poor regulatory panorama may prove to be more an appearance than a reality; in any case, a series of legal initiatives are announced for the second half of the year.



AUTHORS

Philip Torbøl
Brussels
philip.torbol@klgates.com

Alessandro Di Mario
Brussels
alessandro.dimario@klgates.com

Ignasi Guardans
Brussels
ignasi.guardans@klgates.com

The Digital Single Market: An Updated Overview

On 6 May 2014, with a seriousness that corresponds to significant occasions, the European Commission (EC) unveiled its Digital Single Market (DSM) Strategy. It was a solemn moment, compared by some observers to the launching of the Single Market in 1992, as the objective was somehow similar: to promote, force, or impose the creation of a real single digital space across the internal European Union (EU) borders. Doing business online or being a digital consumer with full legal protection and full purchasing capacity was to be made possible in full across the continent. And to reach that goal, some regulatory barriers were to be removed by means of new legislation; in some other cases, self-regulation by the industry was expected to produce a similar effect.

This ambitious project, the DSM in the Brussels' jargon, was soon turned into a working program, with a potential impact in several different fields, and involving the work of many Directorates-General and nearly 10 different Commissioners. Predictably, this ambitious endeavor has hit practical and political roadblocks, which have necessitated some moderation relative to those initial ambitions and the proposed timeline for reform. Still, about two years after the initiation of this process, the DSM is undoubtedly on its way. A significant portion of the policy and regulatory initiatives being discussed in Council and in Parliament, or submitted for public consultation, is the result of the implementation of the DSM Strategy.

The original plan centered on three principal goals, also called “pillars.” The state of the effort in each of these areas can be summarized as follows:

I. TO PROMOTE BETTER ONLINE ACCESS FOR CONSUMERS AND BUSINESSES ACROSS EUROPE

The EC has proposed legislative initiatives intended to improve cross-border rules for consumers and businesses in their online trade. This includes a proposal on the harmonization of EU rules for online purchases of digital content (e.g., for defective content purchased online, like e-books). A review of the current EU-wide mechanisms to protect consumers is also on its way, but the implementation of uniform consumer protections is anticipated to be more difficult.

A main focus for the EC in this area has been to prevent unjustified geo-blocking

and “geo-filtering.” The EC wants to prevent the different mechanisms used by online traders to ban online cross-border access to products or services (geo-block) or even to discriminate or differentiate (geo-filter) their product offerings among their e-customers depending on the customer's country of residence. This essential policy objective is being pursued through different means (and by different EC services and units). An extensive competition sector inquiry focusing on the application of competition law in e-commerce was launched in 2015, and in early 2016, its preliminary results on geo-blocking were made public, with a clear distinction between the cross-border delivery of tangible products or services, and cross-border access to digital content, often protected by IP and related territorial rights. There is still a long way to go in this area, and several additional measures are expected to be adopted or implemented in 2016, including a possible clarification of the application of some EU rules on cross-border trade and services in a way that could have a possible impact in this matter (such as the Services Directive or the Unfair Commercial Practices Directive).

Digital content and its territorial copyright protection pose their own set of challenges to an ideal Digital Single Market. A full review of the EU-harmonized rules on copyright is still to be presented, although its main goals and principles were already announced. The only real legislative proposal related to this issue has been a draft regulation allowing full portability of legally acquired content (e.g., access to subscription services already acquired in the home country while staying in another member state). Its text is under discussion

in the normal legislative procedure, as the original proposal—generally well received in terms of its objectives—raised important issues regarding the need for legal clarity and certainty.

Other reforms, such as the reduction of VAT-related burdens and obstacles when selling across borders, are on their way but at a much slower speed than anticipated: a comprehensive action plan was presented in April 2016, but legislative proposals are only expected by the end of the year. The main intention is to include here a scheme simplifying the current VAT system for EU cross-border online sales of tangible goods, establishing a single interaction point for businesses and companies that otherwise may need to deal with VAT in more than one country.

II. TO CREATE THE RIGHT CONDITIONS AND A LEVEL PLAYING FIELD FOR ADVANCED DIGITAL NETWORKS AND INNOVATIVE SERVICES

This “pillar” of the original DSM Strategy included a new and ambitious overhaul of the telecom regulatory framework, to focus on a consistent single market approach to spectrum policy and management. There are many challenges related to this goal, particularly with respect to spectrum management harmonization. The Commission is facing clear resistance, as many member states still consider that the power to organize spectrum allocation is a prerogative directly related to national sovereignty. Thus, it remains to be seen how and when it can start delivering real reform.

Also included in this “pillar” was the important review of the Audiovisual Media Services Directive, which is the general legal framework covering all the do’s and don’ts of audiovisual services across the continent (children protection rules, advertisement and consumer protection, content-related rules, etc.). Today, traditional broadcasters and audiovisual service providers complain (with good reason) about being subject to a regulation that does not apply to “newcomers” such as YouTube, the so-called Over-The-Top (OTT) services such as Netflix, etc. The expected changes in the Directive are therefore mostly related to a change in its scope, and the creation of a more level playing field in regulatory terms for all those delivering images and sound anywhere in Europe, independently of the technology used, whatever the device, whatever the business model, and wherever that content is coming from. A proposal is expected for June 2016, and its real impact will only be analyzed in depth once the draft text has been released.



Another important—even if uncertain and not fully defined area—is the role of online platforms, as it is assumed that their market power in the digital economy raises a number of issues that warrant further analysis and potential measures. The debate has been ongoing for months, and a public consultation was launched on the matter related to the related subject of the so-called “sharing economy.” But it is still completely unclear what these exercises will produce in regulatory terms. In fact, preempting the Commission’s moves, an important group of EU governments sent a public letter requesting that no regulatory measures be imposed at all on online platforms. In short, a coherent leveling of the playing field with respect to new digital stakeholders continues to be an objective, but much dust remains to settle before the EC can push forward significantly.

III. TO MAXIMIZE THE GROWTH POTENTIAL OF THE DIGITAL ECONOMY

Several important topics were encompassed by this general objective in the original DSM Strategy. These included the construction of a framework for the so-called “data economy,” including the extent of necessary regulation of cloud computing and the free movement of data within the EU, as well as the emerging issues of ownership in big data, especially in the context of the Internet of Things. These remain significant issues with an undefined policy and regulatory outcome.

essential sectorial standardization needs in areas such as health (telemedicine, e-health), transport (interoperable transport plan, e-freight), mobile payments, and facilitating cross-border provision of services.

All told, the Digital Single Market, as a policy objective, is alive, and it is the construction of a framework for the so-called data economy. These remain significant issues with an undefined policy and regulatory outcome, keeping a large number of civil servants, lobbyists, and analysts busy in Brussels. The impact of Brexit in this matter remains to be seen, but cannot be neglected. Not only

A technical but important aspect here is ICT Standardization: The EC issued a communication on April 19, 2016, that identifies key priorities for ICT Standardization to leverage maximum impact as well as a limited number of standards that are considered essential to Europe, and addressing several

because the DSM may not include Great Britain anymore (subject to the terms of the final Withdrawal Agreement), but also as the whole Brexit issue may delay the legislative activity in Brussels.

AUTHORS

Philip Torbøl
Brussels
philip.torbol@klgates.com

Alessandro Di Mario
Brussels
alessandro.dimario@klgates.com

Ignasi Guardans
Brussels
ignasi.guardans@klgates.com

The EU-U.S. Privacy Shield More Than A Safe Harbor 2.0—But Will It Be Enough?

THE *SCHREMS* DECISION

On 6 October 2015, the European Court of Justice (ECJ) ruled in the *Schrems* case that the U.S.-EU Safe Harbor framework on the transfer of personal data from Europe to the United States was invalid. For 15 years, this Safe

Then, following the opinion of Yves Bot, the ECJ's Advocate General for the case, the ECJ also stated that "once personal data is transferred to the United States, the National Security Agency and other United States security agencies such as the Federal Bureau of Investigation are able to access it in the course of a mass

and indiscriminate surveillance and interception of such data."

As a result of the ECJ ruling, most transfers of European personal data to the United States done under that scheme became potentially illegal if not covered by other legal options (binding corporate rules or model

contracts). However, Europe's national DPAs, through the so-called Article 29 Working Group, subsequently declared their intention not to bring enforcement actions against such EU-U.S. data transfers before 1 February 2016, in order to give the United States and EU time to reach a new agreement that could meet the objections raised by the ECJ.

THE EU-U.S. PRIVACY SHIELD: A NEW DEAL ON PERSONAL DATA TRANSFERS

On 2 February 2016, two days after the deadline set by Europe for agreement on a new Safe Harbor governing U.S. access to the personal data of European citizens, U.S. and EU negotiators announced that they had agreed upon a framework for a new data sharing agreement, the EU-U.S. Privacy Shield. U.S. companies adhering to the EU-U.S. Privacy Shield will be able to receive, store, and use personal data from Europe according to its terms.

On 29 February, the U.S. Secretary of Commerce released letters to the European Commission setting forth

the EU-U.S. Privacy Shield Principles along with undertakings of different U.S. government agencies—the Departments of Commerce, Transportation (DOT), State, and Justice; the Federal Trade Commission (FTC); and the Office of the Director of National Intelligence—to enforce and implement them.

KEY ELEMENTS

First, the EU-U.S. Privacy Shield Principles set out the key requirements a company must meet in terms of assuring that U.S. protections of European personal data will be essentially equivalent to those provided in Europe. The Privacy Shield maintains the self-certification regime previously established for the Safe Harbor, but with clearer obligations on companies, annual recertification, and enhanced complaint resolution (enforcement). The key requirements are:

- Notice—disclosure of the types of data the company collects and the purpose for that collection, the third parties to which it may disclose that data, and how individuals can file complaints in the EU or United States;
- Choice—a requirement to afford clear, conspicuous, and readily available means to opt out or opt in, depending on the nature of the data involved;
- Accountability for onward transfer—i.e., the use of third-party processors;
- Security—the obligation to use reasonable and appropriate measures to protect data;
- Data integrity and purpose—the obligation to limit data collection to specified purposes;
- Access—an individual's right to access and correct, amend, or delete that data;
- Recourse—complaints must be investigated and expeditiously resolved at no cost to the individual;

“ U.S. companies adhering to the EU-U.S. Privacy Shield will be able to receive, store, and use personal data from Europe according to its terms. ”

Harbor framework gave privileged status to U.S. companies, allowing such entities to “self-certify” that they complied with privacy standards negotiated between the European Commission and the U.S. Department of Commerce under the Clinton Administration in 1999, which were viewed as “adequate” by the EU.

The ECJ ruling threw this out. The ECJ first ruled that each EU member state Data Protection Authority (DPA) has the authority to hear complaints about the level of protection for personal data that other countries offer and potentially to second-guess any determinations that the European Commission has made that those countries offer adequate protection.

Next, the ECJ stated that “legislation not providing for any possibility for an individual to pursue legal remedies in order to have access to personal data relating to him, or to obtain the rectification or erasure of such data, compromises the essence of the fundamental right to effective judicial protection, the existence of such a possibility being inherent in the existence of the rule of law.”

- Enforcement—government follow-up must occur to assure companies adhere to their assertions; and
- Liability—sufficiently rigorous sanctions must be administered to ensure compliance.

Second, letters from the federal agencies that will enforce Privacy Shield obligations on companies set out the means by which those agencies will administer the protections set forth in the Privacy Shield Principles. They include:

- Requirements that companies certifying under the Privacy Shield publish their privacy policies, establish independent recourse mechanisms, and respond promptly to individual complaints, at no cost to the individual;
- Regular channels of communication between EU DPAs and U.S. agencies to communicate individual complaints from the EU;
- Requirements that U.S. agencies, e.g., FTC and DOT, assert their enforcement jurisdiction and promptly resolve complaints that are not satisfied under the company process;
- Requirements for binding arbitration in the event that U.S. agency enforcement is not effective;
- Requirements for annual recertification by companies participating in the Privacy Shield;
- Requirements that U.S. agencies provide sufficient resources to promptly follow up on individual complaints, maintain accurate Privacy Shield lists, and ensure the certifying companies are, in fact, compliant; and

- Annual reviews by the EU and U.S. authorities to ensure effective enforcement of the Privacy Shield Principles.

Third, the Privacy Shield Principles also establish greater restraints on U.S. government access to information of EU individuals—directly addressing the complaint of the ECJ in the *Schrems* case about widespread and indiscriminate surveillance:

- Appointment of a Privacy Shield Ombudsman at the U.S. State Department to address requests from EU individuals relating to U.S. signals intelligence;



- A description of how the U.S. intelligence signals collection process works, including an explanation of why no non-U.S. person should be subjected to indiscriminate mass surveillance; and
- Detailed explanations and descriptions of additional legal remedies that EU individuals may exercise under U.S. law.

REPLACING SAFE HARBOR

To implement the Privacy Shield, the European Commission had to issue a so-called adequacy decision with respect to the Privacy Shield, i.e., formally

acknowledging that it provides an adequate level of protection to personal data of EU citizens by reason of U.S. law or commitments. The result of that determination will be that personal data can be transferred from the EU to the U.S. businesses adhering to the Privacy Shield principles. This determination replaces the previous one originally issued with respect to the EU-U.S. Safe Harbor declared void by the ECJ.

Before the European Commission could act, however, three bodies were called to opine on the merits of such an adequacy determination.

First, a group of national DPAs, the so-called Article 29 Working Party, was requested to issue an opinion. Although not legally binding, this opinion carries strong political and regulatory weight, since DPAs are tasked with investigating complaints and can potentially bring data transfers to the United States to a halt.

Second, the “Article 31 Committee,” made up of representatives of each EU member state, had to adopt a binding opinion by qualified majority, under a special procedure that limits the European Parliament’s intervention to a scrutiny role.

And finally, the European Parliament is also to be heard. Again, even

if its vote is not binding or strictly required, it does carry political weight, since Commissioners are politically responsible before the Parliament.

No frontal resistance to the agreement was expected in any of these fora, but the initial text was not received with general enthusiasm. During a parliamentary hearing held with experts on 17 March 2016, contrasting views emerged within the main political groups. While the center right (EPP) took the view that the Privacy Shield guarantees effective protection of the privacy rights of EU citizens, other voices (Liberal Democrats from ALDE, as well as Social Democrats from S&D) raised concerns regarding whether the agreement provides sufficient safeguards against mass surveillance and bulk collection of personal data. Furthermore, the Chair of the Article 29 Working Party and head of the French data protection authority (CNIL), Mrs. Isabelle Falque-Pierrotin, questioned the sufficiency of safeguards on data retention and emphasized that the ombudsperson should have concrete powers and be independent from the U.S. government. Likewise, the European Data Protection Supervisor, Mr. Giovanni Buttarelli, highlighted areas in need of further examination, such as the need to take a close look at the possible interaction between the Privacy Shield and the EU-U.S. Umbrella Agreement for the transfer of data for law enforcement purposes or the obligation on the European Commission to analyze the domestic law and international commitments of the United States before the adoption of its adequacy decision.

The first of the three opinions was approved by the Article 29 Working Party on 13 April 2016. The group's positive assessment of the deal was conditioned to clarification in three fields:

First, the EU DPAs demanded an assurance against massive and indiscriminate collection of data by the U.S. authorities. In their opinion, the six exceptions wanted by the U.S. intelligence agencies to collect data limited to national security purposes are not regulated enough, leaving the possibility for bulk collection.

Second, DPAs required a clarification on the powers and the independence of the Ombudsman from the U.S. intelligence services. This new redress mechanism will guarantee a follow-up of complaints from EU citizens and inform them whether the relevant laws have been respected.

Finally, the regulators asked for a review of the EU-U.S. agreement in two years in order to analyze whether it complies with the General Data Protection Regulation that should be implemented in 2018.

As a result of the opinions issued by these bodies, the European Commission took some time to ask its U.S. counterparts for some clarifications to prevent an immediate judicial challenge to the original proposal. Only once the U.S. provided such clarifications and assurances, could the Commission issue the adequacy decision to be approved by the College of Commissioners, i.e., all EU Commissioners.

This process took several months. Fortunately, the head of the Article 29 Working Party suggested that enforcement was to be effectively be suspended during this time.

In the United States, given the recent enactment of the Judicial Redress Act, implementation will require adoption of monitoring mechanisms, enforcement procedures, an arbitration process, and the organization of the

office of an ombudsman appointed within the U.S. State Department.

WILL THE PRIVACY SHIELD STAND?

We expect that the adequacy determination will be made by the European Commission. At that point, U.S. companies willing to abide by the new EU-U.S. Privacy Shield will need to make any necessary adjustments in order to adhere to it.

It is worth noting that the digital technology industry collectively and warmly welcomed the new arrangement as an important step in restoring trust between the EU and the United States. Yet representatives from academia and civil society in both the EU and the United States have expressed doubts on whether the agreement meets the requirements set by the ECJ and would withstand a legal challenge. A number of privacy advocates are already discussing potential challenges to the Privacy Shield before the ECJ. They are collecting each reservation expressed by any of the stakeholders described above in order to bolster a future offensive before the ECJ.

Perfecting a legal strategy and getting to the ECJ could take several years. In the meantime, it could also be challenged by EU DPAs, which retain the power to investigate EU data controllers sharing data with U.S. companies that accede to the EU-U.S. Privacy Shield. Also, the Privacy Shield must undergo annual reviews during that time and could be modified or even cancelled if the European Commission is unhappy with its implementation and enforcement.

The strong uncertainty created by the decision in *Schrems* and the cancellation of the Safe Harbor framework will be replaced by a mechanism that should provide a solid legal method for the transfer of data between the EU and the United States for several years. But this new scheme will most probably have a much shorter life than its predecessor. Time will tell.

AUTHORS

Etienne Drouard
Paris
etienne.drouard@klgates.com

Bruce J. Heiman
Washington, D.C.
bruce.heiman@klgates.com

Ignasi Guardans
Brussels
ignasi.guardans@klgates.com

Michael J. O'Neil
Washington, D.C.
mike.oneil@klgates.com

Evolving Regulatory Structures Governing Nanomaterials in the United States and Europe

Nanotechnology is synonymous with new technology. However, few individuals actually know what “nano” means, or whether there are any regulations governing the manufacture and use of nanomaterials. Simply stated, nanotechnology refers to the creation, control, and use of materials at roughly the 1 to 100 nanometer scale, in order to create and use structures, devices, and systems that have novel physical, chemical, mechanical, and optical properties and functions because of their size. The use of nanoparticles can lead to changes in strength, durability, flexibility, and toxicity. Nanomaterials are used in a broad variety of products. Examples include clothing, paint, drug delivery mechanisms, and sunscreen.

In Europe, by contrast, the regulatory framework is varied. While there are some existing statutory or regulatory regimes that govern nanoscale materials and that do not mention them explicitly, other regulations specifically cover nanoscale materials. Thus, European regulators have commenced a process whereby regulation is tailored, in part, to nanomaterials. It remains to be seen whether and when the United States will follow this lead and also start enacting nano-specific regulations.

The primary U.S. federal regulatory agencies that have jurisdiction over nanoscale materials are the Environmental Protection Agency (EPA), the Food & Drug Administration (FDA), and the Occupational Health and Safety Administration. Interestingly, while all of these agencies have attempted to understand the role of nanomaterials within the context of their regulatory authority, they have reached different conclusions. For example, in 2008, the EPA launched a two-year voluntary program to have companies report on the nanomaterials they use and any related toxicity data. Due to the inherent shortcomings of voluntary disclosure,

the agency proposed a reporting rule in 2015 under the Toxic Substances Control Act that would be mandatory on industry and that would require,

indicating that the agency would continue to use its existing regulations and examine nanomaterials, on a product-by-product basis, in the context of those regulations.



among other things, manufacturers using nanomaterials to provide a one-time report on production volume, uses in commerce, and toxicity data. The proposed rule also would require manufacturers and processors to provide this information 135 days before commencement of manufacturing or processing. EPA has not indicated when the proposed rule will be finalized even though the comment period expired last year.

The FDA has also been investigating ways it should regulate nanomaterials. In August 2006, the FDA formed an internal task force to examine regulation of the use of these materials in food, drugs, and cosmetics. However, in June 2014 (nearly eight years later), the FDA issued a guidance document to the industry

The most significant European Union regulations regarding nanomaterials are the Registration, Evaluation, Authorisation, and Restriction of Chemicals Regulation (REACH) and the Classification, Labeling, and Packaging Regulation. Neither of these regulations was, however, designed to address nanomaterials specifically. But like the 2014 FDA guidance, the European Commission noted that all REACH provisions apply to nanomaterials—including the mechanisms put in place by REACH that allow for controlling risks (including registration, evaluation, authorization, and restrictions).

As noted, other regulations in the European Union explicitly govern the use of nanomaterials. These regulations pertain to cosmetic products, biocides,

foods, and food contact materials. With respect to these products, either REACH does not apply to such specific products or the regulating body has chosen more stringent measures than those provided in REACH. In particular:

“ European regulators have commenced a process whereby regulation is tailored, in part, to nanomaterials. It remains to be seen whether and when the United States will follow.”

Regulation (EC) 1223/2009 requires that cosmetic products must be safe for human health when used under normal or reasonably foreseeable conditions of use taking into account the presentation and appearance of the product, labeling, instructions for use and disposal, and any other indication or information provided. This regulation requires that the European Commission be notified of any cosmetic item containing nanomaterials six months prior to it being put on the market, and any such notification must include safety data and a toxicological profile.

Regulation (EC) No. 528/2012 concerns the marketing and use of biocidal products that are used to, among other things, protect humans and animals from harmful organisms, like pests or bacteria, through the action of the active substances contained in the biocidal product. Biocidal products cannot be marketed or used unless authorized. This regulation also imposes post-authorization

obligations on manufacturers such as advertising, packaging, and labeling obligations. However, for products or substances that meet the definition of nanomaterials (i.e., particles in the number size distribution, one or

more external dimensions is in the size range 1–100 nm), there are specific requirements.

Regulation (EC) No. 1333/2008 on food additives requires a list of authorized substances. Given the heightened safety concerns attached to such products, this regulation

requires nanomaterials to be placed on the list of authorized substances separately even if their conventionally sized counterpart is already present on that list. Also, Regulation (EC) No. 1169/2011 on food labeling stipulates specific labeling requirements for engineered nanomaterials.

One area in which the Europeans are currently moving forward is in developing a harmonized definition of nanomaterials across various laws. Nanomaterials are currently regulated by, and defined within, each separate piece of legislation, and these definitions are not entirely consistent. In 2015, the European Commission began a review of all European Union legislation on nanomaterials with the aim of developing a consistent approach for addressing nanomaterials, recognizing that, in certain instances, specific definitions will be needed. Consequently, it is likely that the current discrepancies between the different regulatory regimes largely will be eliminated.

The use of nanomaterials in both the United States and Europe continues to evolve and become further embedded in different products. The relevant regulatory structures are also undergoing an evolution, albeit slowly, but it appears that regulators are moving toward regulating specific nanomaterials. There has been further progress in Europe in this direction than in the United States. This wave of more particularized or specific regulation of nanomaterials can be expected to continue in Europe and the United States. We may also expect regulators in the United States and Europe to start to emulate aspects of nanomaterial regulation that appear to work in other jurisdictions. For example, if finalized, EPA's 2015 proposed rule will require manufacturers and processors to submit information about uses, physical and chemical properties, production volume, and environmental and health effects. In addition, “discrete forms” of the same nanoscale chemical substance will be required to be reported separately.

For companies, the concern is that EPA will use the information discovered through these disclosures to shift from its current position on premanufacture notices. Currently, EPA holds that premanufacture notices are not necessary for nanoscale materials that have the same molecular identity as their conventionally sized counterparts. If premanufacture notices are required, this would mean a substantial increase in the regulatory burden. Specifically, manufacturers, processors, and importers would need submit documentation, including scientific data, 90 days in advance of their respective activity and then await EPA's response. There are costs associated with developing such data, and this would be particularly taxing on small- and medium-sized companies that have limited resources and are uncertain about the prospects of their technology or product. However, regardless of company size, changes that bring about more nano-specific regulations need to be followed closely because they can have significant bottom-line implications.

AUTHOR

B. David Naidu
New York
david.naidu@klgates.com

How Can Smart Companies Manage Global Government Risk and Opportunities?

Where can businesses invest to get some of the best returns on investment? The answer may surprise you. It is Washington, D.C., according to a recent Bloomberg Government analysis of shareholder return on lobbying spending, “Stakeholder Return on Lobbying Spending: Omnibus Tax Provisions,” which found that effective lobbying can generate returns ranging from 61 percent to an astounding 57,820 percent.

At the same time, the Association of Corporate Counsel’s “ACC Chief Legal Officers 2016 Survey” found that nearly one-third of global general counsels and chief legal officers say “their company has been targeted by a regulator or other government entity for an enforcement action” in the past two years. Bloomberg Government published a report, “D.C. Disconnect: Business Insights Into the Future of Lobbying,” in January 2016 finding “the effects of government on business have grown over time.” A 2011 McKinsey & Co. survey, “Managing Government Relations for the Future: McKinsey Global Survey Results,” also found that “[g]overnments and regulators are second only to customers in their ability to affect companies’ economic value.”

So how can smart companies manage these government risks and create opportunities to increase shareholder value in light of the ratchet-like effects of government intervention? Executive officers and boards can more effectively manage their government risks and opportunities by considering the four questions outlined below.

What government risks are we trying to avoid, and what opportunities can be enhanced through effective public policy?

The first step to managing risks and opportunities is to understand them. Consider this: In 2014, federal

departments, agencies, and commissions issued 3,554 rules and, as of 16 October 2015, another 2,674 rules had been issued, according to the Competitive Enterprise Institute’s “Mapping Washington’s Lawlessness 2016: A Preliminary Inventory of ‘Regulatory Dark Matter.’” Congress enacted 296 laws in the 113th Congress (2013–2014) and has enacted another 183 so far during

despite the fact that government actions pose some of the biggest risks to, and create some of the most significant opportunities for, companies, a McKinsey & Company study (discussed in “D.C. Disconnect: Business Insights Into the Future of Lobbying” McKinsey Quarterly (November 2013)) found that “fewer than 30 percent of the executives responding [to a February 2013 survey]



this 114th Congress, based on GovTrack.us statistics. Hundreds if not thousands more policy decisions—letter rulings, policy directives, etc.—were handed down by federal agencies. These laws, regulations, and policies can impose significant costs and burdens, produce competitive advantages or disadvantages, and create entirely new business opportunities while eliminating others.

Is our government relations team structured effectively to meet corporate goals and objectives?

Company executives and boards establish objectives that align with the corporate vision and mission statement. They determine the goals in each area of the objectives and establish execution plans to meet those objectives. Yet,

said that their external-affairs groups had the organizational setup and talent necessary to succeed.” The best teams will be in a position not only to develop comprehensive strategies but also to drive and focus government affairs efforts.

Are we dedicating the resources commensurate with the risk or opportunity that are necessary to succeed?

A vision without resources is an hallucination. Corporations that fail to allocate sufficient resources to government affairs, despite recognizing that government actions represent both risks and opportunities to their businesses, undermine shareholder value. Risk-based resource allocation is an appropriate way to determine

the level of resources to dedicate to government affairs. As Bloomberg noted in “D.C. Disconnect: Business Insights Into the Future of Lobbying”:

“Forward-thinking Washington offices that use quantitative, systematic frameworks to inform engagement decisions, adopt new data-driven tools that provide deeper insights into the nuances of government action, and objectively measure engagement outcomes will develop a competitive advantage that translates directly into shareholder value.”

Smart companies will not only assess their government relations risks and opportunities but also systematically review corporate resource allocation to maximize their ability to achieve their objectives in the area of government relations. Are you spending adequately to ensure your corporate interests are effectively represented

in Washington, D.C.? Is that spending being allocated between in-house counsel, outside consultants, and trade associations to effectively protect your interests and succeed?

Are we quantifying and measuring our government relations activities?

You cannot manage what you cannot measure. Government relations is perceived to be difficult to measure. Not long ago, companies found it difficult to quantify how marketing investments were contributing to real business outcomes. Now, however, it has become the norm to measure marketing return on investment. As stated in the *Harvard Business Review* article, “Quantifying the Impact of Marketing Analytics,” “Marketing analytics can have substantial impact on a company’s growth. But if companies cannot figure out how to make the best use of it, in the end, it’s just another expense.” Government

relations is similar to the marketing function—with the right analytics, it can be measured; it can have a substantial impact on corporate success; and it can deliver significant returns on investment. Do you apply the same metrics and analytics to government relations that you apply to other sectors of the company?

CONCLUSION

Companies that are effectively engaged in government relations can not only manage risks but also create opportunities, and, by doing so, they will be better positioned to create shareholder value. The answers to these four questions can help better position companies to evaluate and take action to improve their government relations activities and, ultimately, their corporate performance.



AUTHORS

Emanuel L. Rouvelas
Washington, D.C.
emanuel.rouvelas@klgates.com

Darrell L. Conner
Washington, D.C.
darrell.conner@klgates.com

Internationalizing the Internet—U.S. Government is Likely but Not Certain to Relinquish Remaining Control Over the Domain Name System

THE DOMAIN NAME SYSTEM AND HISTORY OF INTERNET GOVERNANCE

The Domain Name System (DNS) is a distributed set of databases residing in computers around the world that contains all domain name addresses and ensures interoperability across the Internet. The DNS is one of the most critical components of the global Internet. It matches URLs (i.e., klgates.com) with the actual numerical Internet Protocol (IP) addresses of computers and was initially managed by the U.S. government.

Although the U.S. government had a historical role in developing the Internet, the Clinton Administration decided in 1998 to transition most governance authority over the DNS to the Internet Corporation for Assigned Names and

Numbers (ICANN). ICANN is a private, not-for-profit organization based in Los Angeles, California, and represents a multistakeholder model of Internet governance that develops its policies through Supporting Organizations and Advisory Committees in a consensus-based “bottom-up” process.

Two years ago, the Obama Administration announced its intention to relinquish its remaining control to ICANN after an extensive multistakeholder certification process. While the proposal has generated considerable controversy, it is likely to occur in late 2016—but not without a likely fight.

CURRENT INTERNET GOVERNANCE

The Department of Commerce (DOC), through the National Telecommunications and Information Administration (NTIA), contracted with ICANN to manage and oversee the DNS and IP addressing in 2000. This contract is referred to as the Internet Assigned Numbers Authority (IANA) contract. The current contract was set to expire in September 2015 but was extended until September 2016.



In 2009, ICANN and the DOC signed an Affirmation of Commitments (AoC), which gives DOC the authority to improve mechanisms for public input, accountability, and transparency with regard to DNS management and oversight. There is no expiration date for the AoC, but it can be terminated unilaterally by either party with 120 days’ written notice.

The DOC also has a Cooperative Agreement with the authoritative registrar of all .com and .net (among others) domains, Verisign, to manage and maintain the official root zone file of the DNS. The root zone file determines which DNS domains are available on the Internet. The agreement expires in November 2018.

The combination of the IANA contract and the Cooperative Agreement gives the DOC

the ability to specifically authorize or deny any change or modification to the root zone file and, more broadly, to steer the direction of ICANN and DNS oversight.

PROPOSED IANA TRANSITION

In March 2014, in response to the Edward Snowden disclosures and international concern over U.S. government control of the Internet, NTIA announced its intention to turn over its remaining oversight of the

management of the DNS to ICANN. NTIA stated, however, that it will not accept a transition that would result in other governments or an intergovernmental organization controlling the Internet. Instead, NTIA specified that the transition must have broad Internet community support and must achieve the following goals: support and enhance the multistakeholder model; maintain the security, stability, and resiliency of the Internet DNS; meet the needs and expectation of the global customers and partners of the IANA services; and maintain the openness of the Internet.

Since that time, the Multistakeholder Community convened the IANA Stewardship Transition Coordination Group and the Cross Community Working Group on Enhancing ICANN Accountability

(CCWG-Accountability) to ensure that the IANA transition would proceed according to NTIA's requirements and be fully supported by a broad community consensus. The recommendations of those groups reflected input from a wide variety of stakeholders in the global Internet community.

The CCWG-Accountability report recommends several important new specific powers for the ICANN community to ensure that consensus building continues in the same "bottom-up" manner that exists under the current regime. The powers listed below will be supported by an Empowered Community that is granted the status of designator (a recognized role in law) and has the standing to enforce the powers if needed. The Empowered Community would be able to:

1. Reject ICANN budgets, IANA budgets, or strategic/operating plans.
2. Reject changes to ICANN's standard bylaws.
3. Approve changes to new fundamental bylaws, articles of incorporation, and ICANN's sale or other disposition of all or substantially all of ICANN's assets.
4. Remove an individual ICANN Board Director.
5. Recall the entire ICANN Board.
6. Initiate a binding independent review process (where a panel decision is enforceable in any court recognizing international arbitration results).

7. Reject ICANN Board decisions relating to reviews of the IANA functions, including the triggering of post-transition IANA separation.

8. Have the rights of inspection and investigation.

All chartering organizations of CCWG-Accountability approved the plan, which was then sent to the ICANN Board for review during its 55th public meeting in Marrakesh, Morocco, where it was approved. After approval, the ICANN Board submitted the transition plan to the NTIA for a final 90-day review. NTIA approved the plan on 9 June 2016.

CONGRESS' RESPONSE

Congress responded cautiously to the administration's 2014 announcement and sought to limit NTIA's abilities regarding the transition. The DOTCOM Act, introduced by Rep. John Shimkus (R-IL), passed the House in 2015 and prevents NTIA from relinquishing authority over the DNS until 30 legislative days after it submits a report to Congress certifying that the above goals are achieved in the transition proposal. A companion bill to the DOTCOM Act, introduced by Sen. John Thune (R-SD), was also approved in 2015 by the Senate Committee on Commerce, Science, and Transportation. Senator Ted Cruz (R-TX) attempted to amend the bill in Committee to require an affirmative congressional vote on the matter before the IANA transition could be approved. However, it only received five out of 24 votes. Full Senate approval has since been blocked because Sen. Cruz has placed a hold on the bill preventing full Senate consideration.

Additionally, the FY2016 Commerce, Justice, Science (CJS) Appropriations Act prohibited NTIA from using any of its FY2016 funds to relinquish authority over the IANA function before 1 October 2016. This prohibition was included in the FY2016 Omnibus Appropriations bill, which became law on 18 December 2015.

This year the legislative restriction was again included in the House committee version of the CJS Appropriations Act, but not in the Senate committee version. However, the Senate Appropriations Committee report expresses concern over the transition and the ultimate security of the .gov and .mil domains. The report directs the NTIA to continue quarterly reports to the Committee on the transition process and further directs the NTIA to inform the Senate Commerce, Science, and Transportation Committee at least 45 days before it makes a decision on a successor contract.

Senators Cruz and others have also proposed amendments to include a prohibition or, alternatively, at least require an affirmative congressional vote before the transition can continue.

THE UNITED STATES WILL LIKELY RELINQUISH CONTROL OVER THE DNS

The next few months will be critical. Although the Obama Administration is committed to the transfer, and Democratic presidential candidate Clinton has announced her support, continued opposition by influential members of Congress and perhaps Republican presidential candidate Trump could still derail that from happening or at least delay any final actions until after a new president is elected.

AUTHORS

Bruce J. Heiman
Washington, D.C.
bruce.heiman@klgates.com

Emily F. Trapani
Washington, D.C.
emily.trapani@klgates.com

R. Paul Stimers
Washington, D.C.
paul.stimers@klgates.com

It's 2:00 a.m. Do You Know Where Your Trade Secrets Are?

OVERVIEW OF THE U.S. GOVERNMENT'S EFFORTS TO PROSECUTE FOREIGN TRADE SECRET THEFT AND A NEW TOOL FOR VICTIMIZED COMPANIES

The Economic Espionage Act (EEA)—a U.S. federal statute that criminalizes trade secret theft—has made many headlines in recent years as the U.S. Department of Justice and Federal Bureau of Investigation (FBI) have stepped up EEA enforcement efforts.

In 2015, the Department of Justice charged six Chinese citizens under the EEA for allegedly stealing trade secrets from two U.S. companies. The year prior, the Department of Justice charged five Chinese officials under the EEA for allegedly hacking five U.S. companies and a labor union, the first charge of its kind against employees of a foreign state. That same year also marked the first federal jury conviction under the EEA in a case already notable for being the first brought against a foreign state-owned company.

All of those recent “firsts” are consistent with the Department of Justice’s current strategic plan, which by 2018 seeks to “[i]ncrease to 15 percent counterespionage actions... that result from FBI outreach initiatives.” In fact, economic espionage is the FBI’s top investigative priority after terrorism.

LIMITS ON U.S. GOVERNMENT ENFORCEMENT EFFORTS UNDER THE EEA

The vast majority of companies victimized by economic espionage will not directly benefit from these stepped-up enforcement efforts. The primary reason is the increasing number of trade secret

FBI simply “does not have the resources and necessary bandwidth to bring prosecution of all trade secret cases.”

Another reason for minimal direct benefit is that the Department of Justice approaches trade secret theft as a matter of national security and thus is more likely to prosecute cases in which the



thefts that the FBI cannot investigate, or that the Department of Justice cannot prosecute, given the government’s finite resources. In 2015, a U.S. Senator explained the problem as one of “soar[ing]” caseload, concluding that the

perpetrator seeks to benefit a foreign government. In contrast, over 90 percent of trade secret cases litigated by private parties in U.S. state courts concern domestic offenders, typically an employee or business partner. Said differently, the fact pattern of a typical trade secret theft case is unlikely to warrant expenditure of the FBI’s finite resources.

What, then, is a trade secret victim to do if it cannot be certain that a U.S. agency will pick up its case? The answer may lie in a new law amending the EEA.



*As companies increasingly utilize trade secrets and as trade secret theft has soared, the FBI reports that their caseload for economic espionage and **trade secret theft cases increased more than 60% from 2009 to 2013.** In fact, some commentators point out that in the face of what the FBI has described as an “immense threat,” the Bureau’s Counterintelligence Division’s Economic Espionage Unit, which is tasked with investigating offenses under the EEA, does not have the resources and necessary bandwidth to bring prosecution of all trade secret cases.*



A PRIVATE FEDERAL CAUSE OF ACTION IS NOW AVAILABLE: THE DTSA

On 11 May 2016, President Barack Obama signed the Defend Trade Secrets Act (DTSA) into law with overwhelming support from both the Senate and House of Representatives. The DTSA amends the EEA to add a civil counterpart to the EEA's existing criminal provisions, 18 U.S.C. §§ 1831–32. More specifically, the DTSA adds a *private* federal cause of action, and accompanying federal jurisdiction, for trade secret theft. Such a private cause of action allows trade secret victims to seek relief in federal court even without a U.S. agency's involvement.

Prior to the DTSA, private causes of action for trade secret theft were limited to those under state law. There is variability in state statutes and common law, with even the Uniform Trade Secrets Act (UTSA) varying from state to state if it is in force at all. The DTSA does not preempt state law, but rather co-exists as an alternate cause of action that, over

time, will give rise to a more uniform and predictable body of caselaw.

In view of uniformity and predictability, the DTSA aligns with the UTSA in several important respects, including in their respective definitions of a trade secret. Additionally, like the UTSA, the DTSA provides for a three-year statute of limitations and the potential for enhanced damages of twice the damages amount actually proved. The DTSA, however, shows a relatively heightened respect for employee mobility by limiting application of the so-called “inevitable disclosure” doctrine, under which persons with knowledge of a trade secret may be enjoined from future employment. Under the DTSA, plaintiffs seeking to enjoin such a person's future employment have to produce evidence of threatened misappropriation—not merely evidence of knowledge of the trade secret.

In addition to creating a private federal cause of action, the DTSA also contemplates roles for federal law enforcement. For instance, the DTSA

authorizes federal law enforcement to carry out *ex parte* seizure orders in “extraordinary circumstances.” The DTSA also provides a safe harbor for whistleblowers who, in the course of reporting illegal activity, disclose trade secrets in confidence to a lawyer or government official.

Trade secret theft is a crime. But unless that crime rises to the point of affecting national security, victimized companies cannot reasonably rely on the Department of Justice to punish the perpetrator. The DTSA provides a new, reliable route to federal court and relief for the victims.

“There is variability in state statutes and common law, with even the Uniform Trade Secrets Act (UTSA) varying from state to state if it is in force at all.”

AUTHORS

John J. Cotter
Boston
john.cotter@klgates.com

Andrea B. Reed
Boston
andrea.reed@klgates.com

New Outer Space Laws Set the Stage for Future Growth

Space: the final frontier (or, at least, the next one). In the previous edition of *Global Government Solutions*[®], we noted that 2015 was poised to be a big year for the commercial spaceflight industry and for commercial spaceflight policy. Looking back, we can safely say that it did not disappoint. The industry notched several important achievements. Perhaps the most far-reaching were the first demonstrations of fully reusable rockets by Blue Origin and SpaceX. Both companies launched payloads into space and then landed their rockets in usable condition (unlike the Space Shuttle, which was only partially reusable, and then only after significant refurbishment). Blue Origin actually reused its rocket a few weeks later.

Reusability will fundamentally transform the spaceflight market. To get a sense of just how game-changing this will be, imagine throwing away a car or airplane after every use. This is how we currently go to space. The savings from reusing rockets will make a wide variety of space missions economical, opening up new possibilities for a wider variety of players. 2015 also saw a major development in commercial spaceflight policy: in November 2015, President Obama signed into law the U.S. Commercial

Space Launch Competitiveness Act (CSLCA). CSLCA is a comprehensive update of the Commercial Space Launch Act, which governs commercial spaceflight in the United States. This update was the industry's top priority in 2015. It promises to help make 2016 another banner year in the commercialization of space.

CSLCA preserves the FAA's ability to regulate commercial human spaceflight in order to protect the uninjured public, as well as participant and crew safety in response to an accident or other unplanned event. However, CSLCA extends a regulatory learning period into 2023 in order to allow the FAA to gather data from commercial spaceflight operations, which will enable the agency to develop guidance governing the safety of those involved in space

flight. In the meantime, CSLCA allows the industry to develop consensus standards in coordination with the FAA. The extension of this learning period provides much-needed regulatory stability for the industry, which had

CSLCA also closes a gap in existing law, which saw indemnification coverage extended to the launch provider's contractors and subcontractors but left spaceflight participants out of indemnification coverage. Now,



been concerned that major regulatory changes could occur just as companies were beginning commercial operations.

CSLCA also extends into 2025 an indemnification risk-sharing structure that exists between the U.S. government and launch providers. Under international law, the nation from which a rocket is launched is liable for space accidents, and all such "launching states" require launch providers to have third-party liability insurance. In the United States, that insurance covers both the launch provider and the government. CSLCA extends this risk-sharing regime and requires the FAA to update the manner in which it calculates the maximum probable loss associated with launches, which forms the basis for the required amount of insurance.

spaceflight participants are no longer exposed to potential liability above insurance limits and are included in the third-party liability risk-sharing regime. Similarly, CSLCA includes spaceflight participants in the requirement that all parties to a launch sign cross-waivers, while allowing spaceflight participants to file claims in the event of gross negligence or willful misconduct.

Because the federal government is liable for spaceflight-related accidents, CSLCA requires that federal courts, not state courts, have jurisdiction over lawsuits resulting from such accidents, but still allows for the application of state tort law in cases filed in federal court.

To streamline the transition between experimental and commercial uses

of new space vehicles, CSLCA allows for flexibility by correcting a statutory provision that would have voided an experimental permit once a launch license was issued for the same vehicle design. Under CSLCA, a launch provider will be able to conduct commercial operations with one or more vehicles while testing other vehicles of the same design under an experimental permit.

CSLCA's final provision may well represent the most sweeping legislative recognition of property rights in history. The CSLCA permits U.S. citizens "engaged in commercial recovery of an asteroid resource or a space resource"

CSLCA was the result of a great deal of careful negotiation—especially within the Senate, which passed it unanimously. Given that the bill was introduced in the Senate by one presidential candidate, Ted Cruz (R-TX), and contained language from another then-candidate, Marco Rubio (R-FL), it was by no means a foregone conclusion that the other 98 senators would support it, especially since at the time, two others were also presidential candidates. In the House, the vote was not unanimous, but with the strong support of Majority Leader Kevin McCarthy (R-CA), Science, Space, and Technology Committee Chairman Lamar

objects in orbit around the Earth, with the objective of avoiding collisions), orbital debris, and federal oversight of spaceflight activities. The question of how the United States should fulfill its obligations under the Outer Space Treaty to authorize and continuously supervise private-sector spaceflight activities is still on the agenda, as is NASA reauthorization.

Meanwhile, other countries are beginning to react to the United States' recognition of space resource property rights. For example, in February 2016, Luxembourg announced plans to set up a regulatory and legal framework in preparation for accelerated space exploitation.

Luxembourg's Vice Prime Minister, Etienne Schneider, stated that Luxembourg's announcement and the CSLCA reflect positions similar to fishing rights in international waters, whereby fishermen can harvest resources of the oceans without laying claim to ownership.

As the U.S. presidential campaign progresses, the space policy positions of the leading candidates will likely come into clearer focus. Legislators, lawyers, and scholars are increasingly recognizing that space promises rewards that are simply too great to ignore. The 2008 campaign led to policy shifts that greatly benefited the commercial spaceflight industry. The industry may see similar benefits in 2016.

“The U.S. Commercial Space Launch Competitiveness Act was the industry's top priority in 2015. It promises to help make 2016 another banner year in the commercialization of space.”

to extract, "possess, own, transport, and sell [such resource] according to applicable law, including U.S. international obligations." It states that the United States recognizes the right of U.S. citizens to any resource obtained in outer space, and affords U.S. citizens the maximum property rights available within the Outer Space Treaty regime. For the growing space mining industry, which includes players such as asteroid mining company Planetary Resources, this legal certainty is critically important.

Smith (R-TX), and Space Subcommittee Chairman Brian Babin (R-TX), as well as nearly 50 Democrats, the bill passed with more than a two-thirds majority.

The next steps in commercial spaceflight policy include the U.S. government's completion of a number of reports and studies mandated by CSLCA, on topics related to orbital traffic management, space situational awareness (namely, understanding and predicting the physical location of natural and man-made

AUTHORS

R. Paul Stimers
Washington, D.C.
paul.stimers@klgates.com

Clay LaPoint
Palo Alto
clay.lapoint@klgates.com

Ranjini Acharya
Palo Alto
ranjini.acharya@klgates.com

Europe's New Aviation Strategy: EU to Hit Back Against Unfair Benefits for Foreign Airlines

NEW AVIATION STRATEGY

Few companies directly or indirectly involved in aviation will be unaffected by the new European Union (EU) aviation strategy. This ambitious package of initiatives was presented by the European Commission (EC) last December and includes a review over the next few years of each and every aviation regulation of the EU. The objective is to ensure that *"the European aviation sector remains competitive and reaps the benefits of a fast-changing and developing global economy."*

While some of the initiatives remain in line with classic EU themes, such as environmental protection, safety, security, single European Sky, and passenger rights, new tones have emerged in relation to international aviation: the EU can no longer be expected to open its market to foreign operators without reciprocity. In other words, as discussed below, the objective of achieving a level playing field in international aviation now takes precedence over market opening.

CONTROVERSIAL TOPICS

Security, environmental issues, and passenger rights undoubtedly will trigger large and fierce discussions when those topics come under the magnifying glass of the legislature, with the European Parliament pushing for ever-stronger protection of citizens' rights, the environment, and consumers. However, the three topics that seem certain to trigger the largest policy battles are:

1. Airport capacity and charges.

"Tackling limits to growth" is one of the pillars of the new aviation strategy. In relation to that objective, the EC is examining issues affecting capacity, such as slot allocation and infrastructure (i.e., new airports and/or terminals). It also is examining the question of efficiency of airport services and ground handling, which lead to one of the major issues of concern for Europe's largest airlines: airport charges. The groundwork is laid for



a major battle between airlines and airports, and the mere inclusion of airport charges as a topic of discussion might suggest the airlines have won the preliminary skirmishes in the battle.

2. The relationship to third countries.

Probably the most remarkable, even if expected, element of the aviation package concerns the warning addressed to non-EU countries and their carriers. The EU has stated that it will continue to promote an ever more open international aviation market, but foreign participants should not expect the European block to seek market opening at any price. More specifically, those countries who refuse to enter into

bilateral aviation agreements with the EU (e.g., the Gulf States, Russia, China) should not expect the EU necessarily to grant equal rights to their airlines. In particular, Gulf airlines have long been accused by their European (and U.S.) competitors of benefiting from overly generous treatment by their national states and state-controlled airports (financial support, cheap fuel, artificially low airport charges). These benefits allegedly distort the competitive landscape unfairly. The tone of the new

aviation strategy clearly suggests that the EC has listened to those complaints and is prepared to tackle the issues, if need be, by regulatory means. One of the specific measures that can be expected as a topic of debate is the restriction of foreign investment in EU air carriers. At the moment, no more than 49 percent of an EU carrier may be owned by foreign capital. This rule may be modified in the future, but exceptions seem likely to be considered only on a case-by-case basis and where reciprocity is the key factor. As a first step in the execution of the strategy, in June 2016, the member states of the EU gave the green light for the EC to start negotiations or renegotiations of aviation agreements with Turkey, the Gulf States, and the ASEAN countries.

3. Distribution and transparency.

Finally, *travel distribution and transparency* seems likely to remain a contentious topic for EU institutions and stakeholders. The Internet and easy access to travel options for travelers has created opportunities for new airlines to reach customers and make an impact on the market even without a strong brand. These market developments have been supported by regulatory tools (price transparency obligations and the code of conduct for computer reservation systems), which are intended to promote transparency, particularly in relation to price. This has produced benefits for consumers—but may have been seen less favorably by large legacy carriers with historically heavy cost structures and collective labor agreements belonging to a time that involved less competition.

The discussions related to the new EU aviation strategy could well develop into a battleground between, on the one hand, strong airline brands that will argue for their rights to limit access to their prices and content (travel options) in an attempt to restrict competition and, on the other hand, consumers who will argue for their right to transparency and choice, supported by travel intermediaries (agents and global reservations systems). The EU has generally vowed to help promote European aviation's competitiveness, but it would be highly surprising to see this happen at the expense of consumers or transparency. Much remains to be decided. We will continue to monitor closely this dialogue and related regulatory developments.

IT'S DINNER TIME

The discussions on a new EU aviation strategy are just beginning, yet it seems that already certain key topics are emerging and the debate is raging. Knives are sharpened by all those who will take a stake in the festivities and they are many, for everyone knows in Brussels that if you are not at the table, you are likely to be on the menu—and it's dinner time.

“ Few companies directly or indirectly involved in aviation will be unaffected by the new EU aviation strategy. ”

AUTHORS

Philip Torbøl
Brussels
philip.torbol@klgates.com

Alessandro Di Mario
Brussels
alessandro.dimario@klgates.com

Ignasi Guardans
Brussels
ignasi.guardans@klgates.com

Unmanned Aircraft Systems in 2016: Change is in the Air

Federal Aviation Administration (FAA) Administrator Michael Huerta revealed this past February in remarks at K&L Gates' Unmanned Aircraft Systems (UAS) Conference, "Aviation's Next Frontier: UAS Outlook for 2016," that the number of UAS in the FAA's registry now exceeds the number of conventional manned aircraft. A similar trend is unfolding in countries around the world. Thus, 2016 promises to be a pivotal year in the development of the burgeoning UAS industry.

The immense growth of the UAS industry has accelerated the momentum of efforts to develop regulatory frameworks for their use. Unmanned aircraft have presented a distinct disruption to the existing aviation regulatory paradigm. Unlike manned aircraft, unmanned aircraft can be purchased inexpensively at retail stores and flown by almost anyone with little formal training. At the same time, their seemingly limitless capabilities raise numerous policy and regulatory questions, many of which have yet to be answered.

As is often the case in the early stages of a new technology, policymakers are working aggressively in an effort to keep pace with the blistering pace of innovation in the UAS industry. Many consumers expect that unmanned aircraft will be able to deliver packages to their doors within the next few years, and commercial operators are eager to unleash the potential of UAS for industries as diverse as agriculture, filmmaking, oil and gas, and construction. Before these ambitions can be realized, policymakers must come to grips with the legislation and regulations that will define the terms that will guide potential applications for UAS. Key developments in the regulatory landscape over the next year in key countries and regions will likely include the following:

United States

The FAA unveiled its long-awaited regulations for the commercial operation of small UAS in June 2016. The new rules emerge in the midst of a dynamic



period for UAS regulation in the United States. In April, a panel of industry and government experts recommended that the FAA develop a framework for the operation of small UAS directly over bystanders, a possible first step toward expanded UAS integration in urban environments. Meanwhile, UAS have also attracted the attention of lawmakers on Capitol Hill, who are considering various legislative proposals in the context of reauthorization of the FAA.

Efforts at the federal level will intersect with a growing body of UAS regulations at the state and local levels. A recent study by *The New York Times* found that 20 states and several major cities enacted new restrictions on drones in 2015 alone. The FAA has warned that

this "patchwork quilt" of regulations raises substantial safety concerns by providing an array of rules that are inconsistent with both each other and with the FAA's broader policy. Action by Congress or the FAA may be needed to clarify the regulatory regime that takes precedence in a given jurisdiction.

Europe

Just before the end of last year, the European Aviation Safety Agency (EASA) released its technical framework for UAS regulation across the member states of the European Union (EU). The framework will

serve as the basis for rulemaking activities at the EU and member-state levels in 2016 and 2017. The proposed European model is grounded in the concept of proportionality. EASA would take a largely hands-off approach with respect to low-risk UAS operations conducted with lightweight, low-powered UAS flying within the line of sight of the operator. Larger UAS and those operating in shared airspace or overflying crowded areas would require regulatory authorizations and specialized certifications and training.

Australia

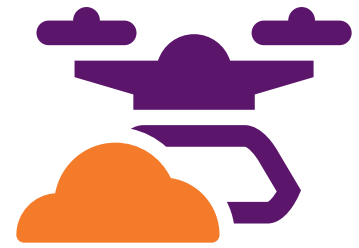
Responding to the growing number of requests for UAS operator certificates, Australia's Civil Aviation Safety Authority (CASA) announced that effective September 2016, it will authorize

commercial operations of UAS weighing 4.4 pounds or less without an operator's certificate or prior authorization provided that such aircraft are flown within the line of sight of the operator, no higher than 400 feet, and at least five kilometers from airports, among other requirements. CASA will continue to require an operator's certificate for flights involving larger UAS.

The Global View

Even as UAS regulations take shape in individual countries and regions, efforts by the International Civil Aviation Organization and other groups are underway to foster greater international coordination concerning UAS. If they come to pass, harmonized standards and regulations would help streamline compliance for the industry and set common safety guidelines for UAS operations. Together with the regulatory initiatives outlined above, these efforts will aim the UAS industry toward a future regulatory framework that strikes the appropriate balance between safety and innovation.

The projected value of
the drone industry will be
\$90 BILLION
BY 2025¹



Drone Sales
have increased
by 63% from
2014-2015.²



**SALES
UP 63%**

AUTHORS

Stephen A. Martinko
Washington, D.C. and Pittsburgh
stephen.martinko@klgates.com

Ignasi Guardans
Brussels
ignasi.guardans@klgates.com

Roderick D. Hall
Washington, D.C.
rod.hall@klgates.com

Peter V. Nelson
Washington, D.C.
peter.nelson@klgates.com

Steven Wulff
Melbourne
steven.wulff@klgates.com

¹(<http://www.inc.com/will-yakowicz/1-million-drones-to-take-to-skies-after-holidays.html>)

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Vehicle Technology in the Fast Lane

In January 2016, the annual Consumer Electronics Show (CES) in Las Vegas, Nevada, showcased the latest technological advances in the marketplace. Surprisingly, some of the biggest names at CES were not your traditional electronics companies. They were from the automotive sector—companies like General Motors, Ford, Toyota, and other vehicle manufacturers. These automotive companies were barely a presence at CES 10 years ago but with the growing intersection between consumer technologies and the car, executives now view it as important as any domestic or international auto show.

As the pace of new vehicle technology options increases, the legal and policy implications of these developments are significant, bringing into play a host of new issues—e.g., protection of intellectual property, privacy, insurance coverage, and new legislative and regulatory regimes.

Vehicle-to-vehicle and vehicle-to-infrastructure communication systems (also known as the “connected car”) have been a focus of the automotive industry and related businesses in recent years. Also referred to as the Intelligent Transportation System, this effort uses a dedicated spectrum, electronics, and an advanced communication-based safety system to seamlessly deliver messages between cars and infrastructure. Eventually, the Intelligent Transportation System is expected to provide a seamless interface between drivers and their environment to enhance vehicle safety and mobility.

Self-driving cars, or autonomous vehicles, also are being tested for eventual use on public roads and highways. In fact, four states have moved forward with legalization of self-driving cars. Generally, there are two different types: semi-autonomous and fully autonomous. A

fully autonomous vehicle can drive from point A to point B and successfully handle a range of on-road scenarios without



needing any interaction from the driver. Fully autonomous vehicles are not yet commercially available. However, there are vehicles on dealer lots today that offer some semi-autonomous features, including self-parking, automatic braking systems, or sensors that alert a driver to obstacles on the roadway.

As consumers demand more features in their vehicles, car companies have accelerated the pace of research and development. Non-automotive companies are also making significant investments in new automotive technologies. For instance, Google has been developing an artificial intelligence system for autonomous vehicles. There have been numerous reports that Apple is working on an “Apple Car” and that the

company has engaged in preliminary discussions with regulatory agencies.

Federal policymakers are also making significant investments in this new segment of the automotive sector. A major transportation bill enacted late in 2015 established grants for “advanced transportation and congestion management technologies deployment.” In this category, the law specifically mentions autonomous vehicles, as well as “technologies associated with autonomous vehicles, and other collision avoidance technologies,” as eligible for the grant

funding. A new initiative announced in early 2016 by the Obama administration also would allocate \$4 billion to accelerate the development and adoption of safe vehicle automation through real-world pilot projects. Additionally, the Department of Transportation is working to remove potential roadblocks to the integration of cutting-edge automotive technology, which can significantly improve safety, mobility, and sustainability.

These technologies hold the promise of revolutionizing the automobile industry and the way people drive and communicate. Regulatory agencies like the National Highway Traffic Safety Administration and the Federal Motor Carrier Administration, which set motor vehicle safety regulations, are also

struggling to adjust to the rapid pace of development and are considering a host of new regulations to address their evolution from agencies historically focused on mechanical engineering to agencies increasingly focused on software engineering. The Federal Highway Administration is conducting research on sensor technologies, the adoption of standardized communication protocol, and other intersection controls that may be needed with autonomous vehicles.

But the advent of new automotive technologies also raises a number of policy, regulatory, and legal challenges ranging from privacy and security to product liability and insurance claims. For instance, there is no legal precedent for a self-driving car involved in an accident. Who bears responsibility from an insurance perspective or from a product liability perspective? Is it the automobile manufacturer? The software developer? The computer chip designer? The passenger responsible for the vehicle?

Privacy is also a concern. According to a recent poll by an automobile trade association, 75 percent of respondents said they were concerned that companies would use the software that controls a self-driving car to collect personal data, and 70 percent were worried that data would be shared with the government. What kind of regulations might be developed to protect consumer privacy while also allowing the vehicle and related software to operate at an optimum level? In light of recent battles between Apple and the Federal Bureau of Investigation regarding access to certain mobile telephone data and relatively recent case law concerning tracking devices on cars, will the technology on vehicles concerning location be “locked” or made available to law enforcement?

In addition to the many federal issues, there will need to be wholesale changes and updates to state and local traffic laws to accommodate the full implementation of the technology.

Automobile insurance policies are regulated at the state level, and there may be substantial discrepancies in how the states respectively address “smart vehicles” and related technology.

In the years ahead, automakers and nontraditional automotive competitors such as Google will continue to push the high-tech envelope in designing, testing, and producing the next generation of cars and light trucks. Not only will policymakers and regulators in the United States and around the world be important players in this process, but the legal system will also evolve to address the rapidly changing landscape in the automotive sector.

We are not yet at the point of seeing the Jetsons’ flying car in our neighborhoods, but it may not be that far off either.



GLOBAL ANNUAL INDUSTRY REVENUES FROM CONNECTIVITY
are expected to increase sixfold from approximately €30 billion
in 2014 to approximately €170-180 billion in 2020.¹

AUTHORS

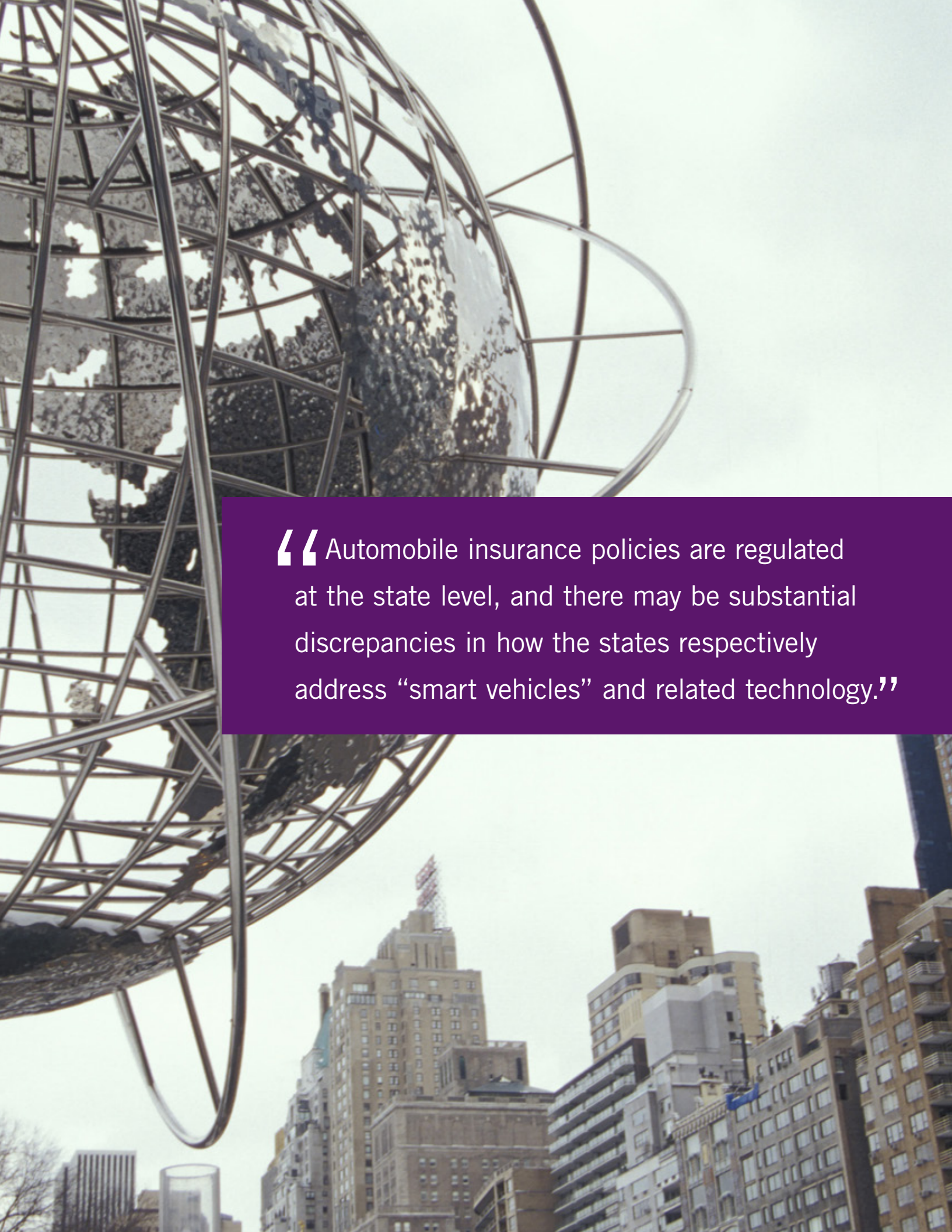
Cliff L. Rothenstein
Washington, D.C.
cliff.rothenstein@klgates.com

Scott Aliferis
Washington, D.C.
scott.aliferis@klgates.com

Darrell L. Conner
Washington, D.C.
darrell.conner@klgates.com

Russell S. Abrams
Charleston
russ.abrams@klgates.com

¹ McKinsey, “How carmakers can compete for the connected consumer”



“Automobile insurance policies are regulated at the state level, and there may be substantial discrepancies in how the states respectively address “smart vehicles” and related technology.”

Expanded Demand for U.S. Oil and Natural Gas: Infrastructure Impacts From Shifts in Environmental Policy

Hydrocarbon exports from the United States have experienced a renaissance in recent months. In December 2015, Congress ended its multi-decade broad prohibition on crude oil exports. Since then, several cargoes have been exported to Asian markets. In February 2016, the first large-scale cargo of liquefied natural gas (LNG) to be exported from the lower-48 U.S. states left Cheniere's Sabine Pass LNG export facility in southwestern Louisiana. And in early March 2016, global chemical company INEOS exported ethane from the U.S. Marcellus Shale basin to Norway, marking the first time that U.S. shale gas has been exported to Europe. In addition, U.S. demand for natural gas as a cleaner alternative relative to other fossil fuels is being spurred by domestic initiatives like the Clean Power Plan, which inevitably will encourage the continued deployment of natural gas power plants, and by compliance with the December 2015 Paris Agreement on climate change. These developments ought to integrate global energy markets, which should create efficiencies that will boost both domestic and international economic growth.

Despite these positive developments, emerging environmental policy trends may limit the economic benefits of expanded natural gas demand. In particular, environmental groups and some government agencies have taken

the position that permitting agencies must consider the potential environmental impacts of upstream natural gas production and downstream combustion and end-use of energy commodities when analyzing a midstream transportation project like a natural gas pipeline or LNG export facility. This position runs counter to federal regulators' traditional, narrower approach to analyzing environmental impacts, which recognizes the difficulty in tracing a particular natural gas molecule in a pipeline gas stream back across the vast integrated pipeline grid to its production well. With two federal appeals courts currently examining whether federal agencies have improperly excluded the impacts of natural gas production when performing environmental reviews of interstate natural gas pipelines and LNG export terminals, and with permitting timelines slowing down, project developers and investors should recognize and plan for uncertainties in the regulatory process that are emerging as a result of the shifting environmental policy landscape.

BACKGROUND

Section 3 of the U.S. Natural Gas Act (NGA) splits authority over natural gas imports and exports between the Department of Energy (DOE) and the Federal Energy Regulatory Commission (FERC). DOE has jurisdiction over the

import and export of the natural gas commodity, while FERC has authority over the siting, construction, and operation of LNG import or export facilities. In addition, FERC has authority over the siting, construction, and operation of interstate natural gas pipelines under Section 7 of the NGA. In contrast, state authorities have jurisdiction over the siting, construction, and operation of oil and natural gas liquids (NGL) pipelines and refineries, with input from federal regulators.

Congress passed the National Environmental Policy Act (NEPA) in 1969 to standardize federal agencies' review of environmental impacts of their actions. NEPA mandates a process through which agencies consider the direct, indirect, and cumulative impacts of their actions, including actions such as granting federal permits. Both FERC and DOE must comply with NEPA when exercising their respective authority under the NGA. In addition, some states have analogous NEPA-like statutes that require similar reviews of potential environmental impacts.

For LNG import and export facilities, as well as for interstate natural gas pipelines, FERC acts as the lead NEPA agency. However, several other agencies provide environmental oversight within their areas of expertise and act as cooperating agencies in the NEPA process: the U.S. Environmental Protection Agency (EPA), the U.S. Army Corps of Engineers, and state environmental agencies. In the federal context, all of these agencies work together within the NEPA framework to assess the potential environmental impacts of a major federal action. The NEPA process also provides the mechanism for nongovernmental organizations and private citizens to offer input regarding the proposed federal action.

Congress passed the National Environmental Policy Act (NEPA) in 1969 to standardize federal agencies' review of environmental impacts of their actions.



ENVIRONMENTAL POLICY SHIFTS MAY CREATE OBSTACLES FOR INFRASTRUCTURE PERMITTING

Over the past several years, environmental groups opposed to hydraulic fracturing and the development of hydrocarbon infrastructure have attempted to use the NEPA process to create additional obstacles for infrastructure permitting, particularly for natural gas and LNG projects. Several environmental groups, led by the Sierra Club and Delaware Riverkeeper, consistently have argued that NEPA requires federal permitting agencies to consider both the potential environmental impacts from upstream natural gas production as well as the downstream (possibly overseas) consumption or combustion of natural gas when authorizing an interstate gas pipeline or LNG project. These groups argue that the federal permitting agencies should use existing studies of aggregated upstream production activities and similarly general downstream consumption data to inform the agencies' review of the midstream natural gas projects.

Both FERC and DOE have resisted arguments to expand the scope of the NEPA review in this way. Responses from both agencies have found that the analysis the environmental groups demand would not provide meaningful additional insight because the evaluations requested are nebulous or inapposite to the analysis requested. FERC has consistently refused to link natural gas production with the permitting process for specific pipeline projects so as to consider natural gas production as an indirect effect of a natural gas pipeline or LNG project. FERC

often notes that natural gas production is likely to continue regardless of whether a specific midstream project goes forward. In FERC's opinion, the potential upstream and downstream impacts would not be "reasonably foreseeable" and therefore need not be considered in a NEPA analysis. One federal court upheld FERC's approach on this issue in 2012. As explained in greater detail below, several cases on this issue are currently pending in federal appeals courts.



OTHER FEDERAL AGENCIES SUGGEST FERC SHOULD EXPAND ITS NEPA ANALYSIS FOR INFRASTRUCTURE PROJECTS

Despite FERC and DOE's position, other parts of the federal government may be open to the environmental groups' arguments. The Council on Environmental Quality (CEQ), the White House office that oversees government-wide implementation of NEPA, issued revised draft guidance in December 2014 offering guidelines for the consideration by federal agencies of greenhouse gas (GHG) emissions and climate change issues in the context of NEPA reviews. The CEQ draft guidance contemplates expanding the NEPA analysis to encompass downstream impacts by including impacts associated

with consumption of the resource and provides as an example a hypothetical NEPA analysis for an open-pit mining project. In its comments in response to the CEQ draft guidance, FERC focused on the CEQ's use of the phrase "reasonably close causal connection" to describe when GHG emissions upstream or downstream from the contemplated project should be included in the federal agency's review. FERC emphasized that absent a close causal connection between the midstream infrastructure project and the

alleged upstream or downstream impact, those potential impacts would not be "reasonably foreseeable." CEQ's guidance is still in draft form and, if the agency ever finalizes the document, it is likely that the guidance will not require that other federal agencies like FERC adopt CEQ's approach in its entirety. Regardless, the draft guidance signals that at least a section of the executive branch is open to the environmental groups' arguments.

Another federal agency, EPA, also has aligned itself with and adopted the environmental opponents' arguments on potential upstream and downstream impacts. Commenting on FERC's recent updates to its Guidance Manual on natural gas and LNG infrastructure application requirements, EPA Headquarters asked

FERC to require project applicants to provide information on the potential for increased natural gas production as the result of the proposed project and an analysis of GHG emissions from the “production, transport, and combustion” of the natural gas associated with the project. EPA’s regional offices have offered similar comments on several LNG import and natural gas pipeline projects over the last several years, which FERC has rebuffed to date. These comments on the FERC Guidance Manual represent the first time in this context that EPA Headquarters formally adopted the regional offices’ position. With EPA’s chief policymakers now raising similar issues, FERC may face more difficulty pushing back on what now appears to be EPA’s approach to include upstream and downstream impacts in a NEPA review of an interstate natural gas pipeline or LNG import or export facility.

In addition, project opponents hope to use the courts to compel FERC to adopt a more expansive approach under NEPA. Currently, there are multiple cases pending before two separate U.S. Courts of Appeal challenging FERC and DOE’s approach to upstream and downstream impacts.

At least two of these cases involve LNG terminals and two involve interstate natural gas pipelines. The project opponents have pointed to both CEQ’s draft guidance and EPA’s comments on GHG emissions to support their arguments in court. In late June 2016, the D.C. Circuit rejected the environmentalists’

claims in two of the pending cases that FERC should examine upstream impacts from hydraulic fracturing when performing its environmental and safety review of LNG export terminals finding that the requisite causal relationship does not exist.

However, the court also suggested that environmentalists’ claims may be better lodged against DOE’s authorization of the LNG commodity exports, likely leading to additional litigation and uncertainty. The ramifications of these and future decisions may extend throughout the midstream natural gas sector and beyond—if a court requires FERC or DOE to engage in significant new analysis regarding alleged upstream or downstream impacts, such a requirement will add time, cost, and complexity to the permitting process for all federally regulated natural gas and LNG infrastructure projects. Furthermore, other agencies at the state level could follow a similar approach to require upstream and downstream impacts analyses for oil and NGL pipeline projects, as well as intrastate natural gas projects.

PROJECT DEVELOPERS AND INVESTORS CAN MANAGE THESE RISKS PROACTIVELY

Project developers and investors can take proactive steps to manage the risks that environmental policy shifts may place on the midstream energy sector.

First, project developers and investors should monitor the evolving policy landscape closely. If a court expands

the scope of the NEPA review, these requirements could have the immediate effect of slowing down permitting for projects across the board while regulators attempt to address the court’s requirements.

Second, project developers should avoid designing projects that tie an infrastructure project that is subject to a NEPA review to any single source of supply unless absolutely necessary. Creating such a direct link simplifies the project opponent’s argument that the infrastructure project is connected directly to a single source of production, potentially leading to the more extensive NEPA analysis discussed above. Project developers should consider interconnecting their projects with the broader natural gas grid, not only for improved market access and efficiencies but also to make clear that the gas transportation or LNG projects in question are not associated with any single production area, thereby limiting the ability of regulators to find a causal relationship between upstream production and a specific infrastructure project.

Finally, project developers and investors can anticipate that these policy shifts will increase costs and lengthen permitting timelines. Even though domestic policy choices such as the Clean Power Plan and opening export markets for U.S. oil and natural gas should encourage infrastructure development, expanded NEPA analysis will add time, cost, and complexity to project permitting. These obstacles could limit the economic benefits that energy exports create and the environmental benefits that policies like the Clean Power Plan and the Paris Agreement encourage.

AUTHORS

David L. Wochner
Washington, D.C.
david.wochner@klgates.com

Michael L. O’Neill
Washington, D.C.
mike.oneill@klgates.com

Sandra E. Safo
Washington, D.C.
sandra.safo@klgates.com

John L. Longstreth
Washington, D.C.
john.longstreth@klgates.com

Gillian R. Giannetti
Washington, D.C.
gillian.giannetti@klgates.com

Navigating the Rapids of Superfund Sediment Sites

On 11 December 1980, President Jimmy Carter signed into law the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), better known as Superfund. With the stroke of the pen, the president gave the Environmental Protection Agency (EPA) unprecedented authority to hold parties strictly, jointly, severally, and retroactively liable to clean up the nation's most toxic waste sites. Thirty-five years and over 1,300 sites later, Superfund is still going strong. Early on, much of the focus was on cleaning up smaller sites, measured in acres not miles. Today, much of the focus is on cleaning up contaminated sediments in waterways, from the Lower Passaic River in New Jersey to Portland Harbor in Oregon, and many sites in between.

Contaminated sediment sites are among the toughest remaining Superfund sites in the United States. There are hundreds, if not thousands, of contaminated urban waterbodies in the United States with impacts from a century or more of industrial development.

However, the Superfund program was not designed to address contaminated sediment sites.

Applying its framework to such sites is like trying to put a square peg in a round hole.

CERCLA's remedy selection structure and criteria are set

forth in the National Oil and Hazardous Substances Pollution Contingency Plan (NCP). However, sediment sites strain the application of the NCP because of the degree of complexity and uncertainty at those sites compared to more "typical" sites. Contaminated sediment sites are more complex than early Superfund sites as a result of a number of things, including these factors:

- the large geographic extent of the sites
- the large number of potentially responsible parties (PRPs), including both private and public entities and defunct parties
- legacy and ongoing sources of contamination
- the urban context and economic importance of the areas where these sites are located
- high costs and lengthy time frames, including 10+ year studies that may exceed US\$100 million and 20+ year remedy implementations that may exceed US\$1 billion
- contribution actions against other PRPs, and powerful enforcement tools available to EPA that incentivize compliance, as well as issues of political complexity. Given the relationships between and among different EPA programs, EPA and the states, EPA and the Natural Resource Trustees, numerous PRPs, public entities, Native American tribes, and local communities, remedy selection and implementation is often fraught with political tension. Furthermore, there are significant political pressures to move sites toward cleanup, as the waterbodies often run through the heart of urban cities.



EPA has recognized that contaminated sediment sites are different from typical Superfund sites. Intending to promote scientifically sound and nationally consistent risk management decisions at sediment sites, it published *Principles for Managing Contaminated Sediment Risks at Hazardous Waste Sites* (OSWER Dir

“...the Superfund program was not designed to address contaminated sediment sites. Applying its framework to such sites is like trying to put a square peg in a round hole.”

9285.6-08, 2/12/02) and *Contaminated Sediment Remediation Guidance for Hazardous Waste Sites* (OSWER Dir 9355.0-85, 12/2005). In addition, EPA established a protocol involving two levels of review with respect to sediment sites: a review by the Contaminated Sediments Technical Advisory Group (CSTAG) (a technical advisory group established to monitor and provide advice at contaminated sediment sites) and a review by the National Remedy Review Board (NRRB) (a peer review group that reviews certain proposed cleanup decisions to ensure they are consistent with Superfund law, regulations, and guidance).

However, EPA's guidance documents for sediment sites and the provisions of the NCP are applied inconsistently by EPA regions at sediment sites, both procedurally and substantively. Further, in 2011, EPA eliminated the second round of independent CSTAG review, instead providing that a subset of CSTAG members would participate in the NRRB review at the proposed plan stage. As a result, there is even more uncertainty and less EPA headquarters' oversight of these sites for the regulated community.

The lack of consistent or predictable treatment of sediment site remediation has attracted attention. In May 2015, concern “that EPA Regions may no longer be complying with policies, guidance

and procedures that were intended to improve the timeliness, cost-effectiveness, consistency, and quality of sediment cleanup sites,” prompted Sens. Inhofe and Rounds of the Committee on Environment and Public Works to request that the U.S. Government Accountability Office (GAO) review EPA's efforts to clean up “mega” contaminated sediment sites where the expected cleanup costs will exceed US\$50 million. The GAO's review is under way, and a report is anticipated to be issued this year.

The results of the GAO study may propel Congress into a more active oversight of EPA's implementation of Superfund to ensure that remedies are nationally consistent and compliant with the NCP and guidance by directing EPA to:

- require greater involvement by EPA headquarters, including that the EPA administrator sign all Records of Decision for “mega sites” to ensure national leadership and uniformity of policy
- reestablish an independent CSTAG review of all proposed remedies meeting the criteria for NRRB review
- require an independent, third-party study for all mega sites

Congress may also want to consider whether there is a different, more streamlined mechanism to address contaminated mega sites than the current NCP paradigm. For example, rather than focusing efforts to improve waterways on the use of separate and independent actions under Superfund and the Clean Water Act, the U.S. government may conclude that a holistic watershed approach that aligns decision-making on surface water discharges, Total Maximum Daily Load requirements, National Pollution Discharge Elimination System permits, and sediment cleanups can more cost-effectively reduce recontamination potential and improve watershed restoration. And by taking a holistic approach, more economic and recreational opportunities may be provided for the communities who live and work along these urban waterbodies. There is no simple solution, but achievement of a holistic approach to Superfund leading to more cost-effective remediations would be beneficial to all stakeholders involved.

It's been 30 years since Congress last reformed Superfund. But with a new GAO study in the wings, the prospect of greater congressional oversight, and a presidential election just around the corner, there is once again an opportunity for stakeholders to seek legislative and administrative Superfund reforms that provide a holistic and cost-effective approach to cleaning up our urban waterways.

AUTHORS

William H. Hyatt
Newark
william.hyatt@klgates.com

Cliff L. Rothenstein
Washington, D.C.
cliff.rothenstein@klgates.com

Dawn Monsen Lamparello
Newark
dawn.lamparello@klgates.com

Ankur K. Tohan
Seattle
ankur.tohan@klgates.com

The Endangered Species Act and Regulatory Tools for a Climate Change Era

Climate change is a topic of active discussion, evaluation, and debate. The effects of a changing climate are impacting the regulatory landscape, including the regulation of business activities and other conduct that may affect endangered or threatened species. In the United States, the Endangered Species Act (ESA) is designed to “provide a means whereby the ecosystems upon which endangered and threatened species depend may be conserved.” Under the ESA, however, designating a species as “endangered” or “threatened” due to climate change raises challenges because the statute was not written with climate change in mind. Its species-specific approach, which works to address singular human-induced threats, like clearing a habitat or damming a river, is unwieldy and potentially unworkable when used to address the effects of a multifaceted and global phenomenon like climate change.

ESA PROTECTIONS— THE FRAMEWORK

The United States Fish and Wildlife Service (FWS) or the National Marine Fisheries Service evaluates a species for listing. Under the ESA, differing types and levels of protection are afforded to a listed species and its habitat, depending on whether it is listed as endangered or threatened.



An endangered listing triggers the most stringent protections. It makes it unlawful for any person to “take” the species without a permit— i.e., to kill or harm the species, including through habitat modification, which impairs essential behavioral patterns. The Services may issue permits to authorize an “incidental take,” provided there is a Habitat Conservation Plan (HCP) that sufficiently addresses the impacts of taking the species and the steps to minimize and mitigate such impacts.

A threatened listing does not trigger the same protections. The “incidental take” prohibitions do not apply automatically to a threatened species, and actions

that may incidentally take a threatened species may not require a permit. It is within the discretion of the Services to

are met, allows citizens to bring suit to stop any person or governmental agency from violating the statute.

determine which actions are necessary and advisable to promote the conservation of a threatened species. The Services may therefore determine that only certain activities require “take” authorization.

If a species is designated as endangered or threatened, the Services must designate its critical habitat, which may include areas that the species does not occupy but are essential to its conservation.

Failure to comply with the ESA may lead to civil or criminal liability. In addition, the ESA includes a citizen suit provision, which, if certain prerequisites

ESA LISTING LINKED TO CLIMATE CHANGE

In 2008, the FWS listed the polar bear as threatened because of future threats to its habitat attributed to climate change. Given the FWS’ findings regarding the impact of climate change on the polar bear, many observers anticipate that it will list other species as endangered or threatened due to climate change.

The prospect of listing a species as endangered or threatened due to climate change raises questions about how the Services can create permit conditions

that would prevent or minimize the “taking” of a species when a take—e.g., from adverse modification of critical habitat—may result from worldwide greenhouse gas (GHG) emissions.

For example, the Services would confront difficult issues of causation when attempting to prosecute an entity or individual for effectuating a take by emitting GHGs. The ESA requires a showing of a causal link between the action and the take and, unlike hunting a species or modifying its critical habitat, a take that stems from climate change could be the result of numerous natural and anthropogenic global GHG sources. It is, in fact, currently impossible to link a new or existing project that emits GHGs directly to a decline in a particular species or its habitat. Therefore, it is unclear how affected businesses or individuals would seek to create GHG-related HCPs or how the Services could issue corresponding incidental take permits.

The causation issue, in turn, gives rise to thorny implementation questions. For instance, when federal agencies propose actions that might cause, fund, or authorize GHG emissions, how would the Services consult with them to determine whether the actions would jeopardize a species or adversely modify critical habitat? Or what would be the mitigation terms in a HCP for a project with GHG emissions? Moreover, even if a species is listed due to climate change, would actions that do not result in increased GHG emissions, but

nevertheless harm or harass a species, be considered a take under the ESA?

TRENDS

The Services have recently used ESA provisions that reduce burdens on land-use and development. One of those provisions is section 4(d), which enables the Services to tailor prohibitions to incentivize conservation activities for a threatened species and streamline regulatory requirements for activities that have only minor effects on the species. One purpose of section 4(d) is to reduce conflicts between relevant business, or other activities, and the protection of a threatened species, by relaxing the restrictions that would pertain to the species, if listed as endangered.

The FWS developed section 4(d) rules when it listed the polar bear as threatened. Because the polar bear was not listed as endangered, the agency was not forced to grapple with all the activities that might be considered to “take” it, including the emission of GHGs. The agency explained that the section 4(d) rules did not require the Services to approve development permits for projects that would emit GHGs because the emission of those gases cannot be tied directly to the effects on specific polar bears or bear populations.

In an age of climate change-related listings, listing a species as threatened and then using section 4(d) to create specific rules for its protection may be the way the

Services balance development interests with their mandate to protect species.

In addition, the FWS may rely on other approaches to avoid listings altogether. For example, the agency recently decided against listing the greater sage-grouse because it concluded that a landscape-scale conservation plan, involving federal, state, and private landowners, would provide adequate protection for the species and its habitat.

WHAT TO EXPECT

As the Services continue to consider climate change as a basis for listing different species, advocacy groups and Congress may seek to constrain the Services’ efforts—for example, by requiring federal agencies to consult with the Services for all projects that will emit large amounts of GHGs or limiting the Services’ ability to use ESA listings to indirectly regulate GHG emissions.

Short of these efforts, however, existing provisions of the ESA provide mechanisms for citizens to require the Services to contend with climate change. For instance, the ESA establishes a petition procedure that enables citizens to prompt the Services to consider species for protection. In addition, as noted above, the ESA has a citizen suit provision that allows for “private attorney general” actions to enforce the statute. As a result, even if the Services limit their use of regulatory tools to address climate change

The effects of a changing climate are impacting the regulatory landscape, including the regulation of business activities and other conduct that may affect endangered or threatened species.



impacts on a given species, the citizen suit provision will likely be used to force the issue and demand that the Services integrate the effects of climate change into the administration of the statute and their listing decisions. As such, the Services will increasingly be required to apply the statute to address climate change-related impacts to a species. In addition, they may seek to protect critical habitats where listed species may migrate as a result of climate change. As the Services are more frequently asked to make listing decisions, there likely will be an increase in litigation, regulations, and policy changes affecting all industries and many landowners.

The Services have shown a willingness to use the provisions of the ESA in a way that balances their statutory mandate to protect species and critical habitats with the interests of land-use and development. As they continue to wrestle with whether and how to list species due to climate change, we expect them to expand their use of listings that rely on section 4(d). In addition to listings, there may be an increase in cooperative conservation plans, like the one that was created for the sage-grouse, to address the complex species and habitat effects of climate change. The FWS' acceptance of such plans creates an opportunity for stakeholders, such as project developers, agencies, and conservation groups, to preemptively develop conservation plans for species and habitats affected by climate change.

STAY AHEAD OF THE CURVE

Listings determinations for species and critical habitat occur regularly. To stay ahead of the curve, landowners and industry participants should be aware of determinations that may impact their land or operations. While the ESA imposes significant obligations on the regulated community, there is also significant flexibility in how that community may

comply with the ESA. However, the range and degree of flexibility changes as a species changes in status under the ESA (i.e., from unlisted, to candidate, to listed). As such, awareness of what the Services are considering, along with early engagement with them, provides the regulated community the greatest range of options to avoid running afoul of the ESA.



AUTHORS

Ankur K. Tohan
Seattle
ankur.tohan@klgates.com

Anthony R. Holtzman
Harrisburg
anthony.holtzman@klgates.com

James M. Lynch
Seattle
jim.lynch@klgates.com

Alyssa M. Fritz
Seattle
alyssa.fritz@klgates.com

21st Century Infrastructure in Mining and Other Natural Resources Projects—the Search for a Shared-use Solution

The steady decline in natural resource prices over the last five years has meant not only a severe reduction in capital available for mining and other natural resources projects, but has inevitably turned attention to the measures available to substantially decrease individual project costs. Of crucial importance is the need to reduce the burden within project budgets of developing supporting infrastructure. In this context, the development of shared-use infrastructure, whether for multiple users or multiple purposes in defined geographical areas, is an obvious choice. The challenge is to develop a regulatory framework that will facilitate open third-party access in an equitable and transparent way, without compromising the return on investment required by public/private partnerships or foundation projects to make an investment decision to develop this shared-use infrastructure.

K&L Gates is contributing to an initiative being undertaken by the Milken Institute (www.milkeninstitute.org) to establish a set of principles for shared use of mining infrastructure. The project follows a body of work undertaken by other agencies (including the World Bank and Columbia University's Center on Sustainable Investment) that has similarly been aimed at analyzing the best means of developing nonrenewable resources in developing countries in a way that provides long-term benefits and supports sustainable growth.

The creation of infrastructure that can be shared as either multiuser or multipurpose is an obvious starting point in countries where national infrastructure is lacking. However, the options for achieving that objective need to be carefully weighed. The higher capital costs, efficiency

loss, increased project complexity, and financing challenges that flow from a requirement that companies provide excess infrastructure capacity should be balanced against other more traditional mechanisms that are available, such as taxation or tariffs. This is especially important where the regulatory structures for overseeing the efficient use of excess infrastructure capacity are either not in place or are insufficiently developed, and the ability to regulate properly shared use, including access conditions and access charges, may be lacking.

Increasingly, the costs involved in developing infrastructure to support mining projects, declining commodity prices, and related profit pressures, as well as the emergence of resource for infrastructure schemes in Africa,

are shifting the momentum toward a shared-use approach. In this context, the Milken Institute's project to develop shared access principles that will form a standardized and pre-established platform in which negotiations can take place is very timely. It is also consistent with the previous successful adoption of established principles for project development, such as the Equator Principles, which provide a blueprint for environmental and social best practices.

Shared-use principles connected to the delivery of mining or energy resources infrastructure must necessarily be broad. Questions to be considered are: (1) the categories of infrastructure (railways, port, power, water, and communications and technology) that lend themselves to a shared-use solution; (2) whether shared use means multipurpose or multiuser; (3) whether shared use is applicable to both brownfield and greenfield projects; (4) whether there is an optimum model of ownership, operatorship, integration, and regulation; and (5) how principles regarding access pricing, capital cost recovery, and access conditions will apply.

There are a number of existing international models that may inform future approaches to these issues. For decades, Australia has had a regulated environment for third-party access to infrastructure under the *Competition and Consumer Act, 2010* (Cth) and state-based legislation. The Australian Competition and Consumer Commission has a range of regulatory functions in relation to national infrastructure industries as well as an oversight role with respect to prices in some markets where competition is limited. Its functions include determining the prices, access terms, and conditions for some nationally significant infrastructure services. However, the regulatory

“ The creation of infrastructure that can be shared as either multiuser or multipurpose is an obvious starting point in countries where national infrastructure is lacking.”

framework has not been successful in delivering a broad, open-access regime, due to the limitations of the legislation (which is restricted to declared facilities that meet defined criteria) combined with a history of lengthy and expensive legal challenges that have turned on the legal interpretation of economic objectives in the legislation. For instance, an attempt to secure access to four private rail lines in the Pilbara region of Western Australia ran for nine years, including an appeal to the High Court of Australia, and was largely unsuccessful. This means that there has been limited success in securing third-party access to expensive infrastructure using the regulatory route. In Australia, the opportunity to achieve an open-access environment is better addressed not through the regulatory environment, but through agreements struck as part of the development approval process. This

approach was adopted when our Perth office assisted the Western Australian government to develop the multiuser infrastructure solution for the Wheatstone LNG project in Western Australia, which has included the project operator as part of the development approval process and permitted the development of facilities that, when completed, will be owned and administered by the Pilbara Ports Authority and are subject to a third-party access regime. We also advised the Western Australian government on the broader strategy for the Ashburton North Strategic Industrial Area (ANSIA), which is being implemented with the cooperation of several statutory authorities and the local government, and the agreement of the founding private-sector proponents. That plan provides an 8,000 hectare site for major gas-processing proponents;

secondary processing sites for the establishment of hydrocarbon-processing industries, including downstream processing and incidental uses; a port with common user facilities (being built as part of the Wheatstone project, but to be managed on completion by the Pilbara Ports Authority); and common user access and infrastructure corridors to provide unimpeded use of common user infrastructure, access, and transport corridors. The development approval process has been used to establish the ANSIA and create a hydrocarbon



hub, directed at maximizing the opportunities afforded by the substantial gas discoveries that have occurred off the Pilbara coast by providing a shared-use precinct aimed at facilitating and attracting ongoing investment.

The urgent need to create a model for developing infrastructure and essential services required for mining and resources projects, which can be accessed by multiple users, is a particular priority in developing countries. The advisability of a set of shared-use principles related to

those projects is increasingly becoming a focus for governments and industry. Lessons learned from existing multiuser infrastructure settings provide important considerations with respect to shared-use principles that may be applied in other circumstances in the future. The goal is to find a balance between the competing interests of mining and resources companies, governments, and communities within an economic model that can compete successfully for increasingly competitive global capital.

AUTHORS

Simon Salter
Perth
simon.salter@klgates.com

Clare Power
Perth
clare.power@klgates.com

Development of Energy, Infrastructure, and Resources in Indonesia: Another Step Toward an Open Economy

Although Indonesia is making progress with respect to private sector involvement and economic growth in the energy, infrastructure, and resources space, more is still needed and it may take some time before it sees significant improvement.

Indonesia has taken additional steps to attract foreign capital to meet its infrastructure and energy demand (including a program promoted by Joko “Jokowi” Widodo, the president of Indonesia, to provide an additional 35 GW of power capacity by 2019 (25 GW of which is to be developed by the private sector)). Such steps include committing US\$672 million to the recently established, China-led Asian Infrastructure Investment Bank (AIIB) and partnering with Turkey and the Jeddah-based Islamic Development Bank to form the World Islamic Infrastructure Bank, a multilateral agency that will promote infrastructure development in Muslim-majority countries using sharia-compliant financing. In addition, the “I Love Sharia Finance Program” announced by President Widodo in June 2015, is intended to ease restrictions on foreign ownership in Islamic banks (which are currently limited to 40 percent) in order to attract foreign financial institutions from the Middle East. In February 2016, the Indonesian government announced plans for its tenth economic policy package (EP 10), which aims to stimulate growth and investment in Indonesia. EP 10 is expected to include revisions to the Daftar Negatif Investasi or “negative list,” which specifies the business activities and operations that are either closed or restricted with respect to foreign investment and shareholding. Expected to be implemented via a presidential regulation in the coming months, it appears that EP 10 will further reduce current restrictions on foreign investment in business activities and sectors in Indonesia. As the largest liberalization of Indonesia’s economy in a decade, EP 10 would represent a

major step in Indonesia’s commitment to private sector growth, which many see as necessary given Indonesia’s desire to improve its total investment and gross domestic product, which remain low. The introduction of EP 10 has been viewed as an effort by President Widodo to achieve the 7 percent annual growth rate that he promised during his campaign (a rate that Indonesia’s economy has not seen since the Asian financial crisis during the late 1990s). Between 2010 and 2014, Indonesia’s growth rate fell from 6.2 percent to 5 percent.

The negative list to be formulated pursuant to EP 10 may not materially alter the restrictions on foreign ownership in the energy and resource sectors except in relation to geothermal plants of 10 MW or more, for which 100 percent foreign ownership may soon be permitted. Such revised ownership restrictions for geothermal power projects appear to be intended to further the objective of the Indonesian government to increase the use of renewable energy to 23 percent of all energy production by 2025. Expanded ownership and foreign investments in geothermal power also could have a significant impact given the 29,000 MWe of geothermal resources Indonesia is speculated to have (considered to be the highest in the world).

The Asian Development Bank recently committed **US\$10 billion** over the next five years to finance infrastructure projects in Indonesia and AIIB may provide an additional **US\$2 billion**.



EP 10 appears to be part of an overall trend to move away from Indonesia's characteristic protectionist measures. Indeed, foreign investment in the Indonesian economy rose to IDR 365.9 trillion (~US\$27.5 billion) in 2015 (an increase of 19.2 percent from 2014) and is expected to climb further under the new measures prescribed by EP 10. The latest data from BKPM (the Investment Coordinating Board of the Republic of Indonesia) shows that Indonesia has IDR 355 trillion of investment commitment in February 2016 or a 167 percent increase relative to the same period in the previous year. In addition, with an aim to increase such investments, the Indonesian government in August 2015 made it easier for "tax holidays" (reduced or eliminated tax liabilities for a period of years) to be available to pioneer industries, which include basic metals, petroleum refining, and organic basic chemicals derived from petroleum and natural gas.

Furthermore, the Asian Development Bank recently committed US\$10 billion over the next five years to finance infrastructure projects in Indonesia and AIIB may provide an additional US\$2 billion. In addition, the World Bank has stated that it will lend Indonesia up to US\$11 billion over the next three to four years for infrastructure development and improving the quality of its workforce. Finally, last year China pledged to lend US\$50 billion to facilitate the building of toll roads, seaports, airports, and power plants throughout Indonesia.

The Indonesian government is cognizant of the need to cut down bureaucratic red tape and has in recent months enacted a slew of legislation designed to promote and expedite foreign investment, including the introduction of a three-hour investment licensing service and certain industry specific changes (e.g., on 8 January 2016, the Indonesian government issued regulations intended to accelerate development of power projects by introducing a new

refining or processing of mineral ore before export (although there are recent reports that Indonesia may lift or modify the mineral ores export ban). It also asserts or implicates enhanced national interests when extending an expiring oil and gas production sharing contract.

In all, Indonesia seems to be headed in the right direction with respect to private sector involvement and economic growth in the energy, infrastructure, and resources space. Nonetheless,



government guarantee and a shorter time period to obtain necessary permits).

Despite these signs of progress, meaningful hurdles remain, including a complex land acquisition process, a lack of legal certainty and enforceability, flip flops in policy and regulations, and the mandated use of the Indonesian language in agreements and Indonesian Rupiah in local transactions. Furthermore, consistent with the global trend and notwithstanding a plain desire to attract foreign investment, Indonesia continues to take a nationalistic approach toward the energy and natural resource sectors. Indonesia has imposed local content requirements and regulations requiring

further efforts are still needed. While initiatives like EP 10 and others outlined in this article should lend some comfort to potential investors, change will not happen overnight and it may take some time before we see significant improvements in the related Indonesian regulatory and political landscape.

AUTHOR

Lian Yok Tan
Singapore
lian.tan@klgates.com





“The urgent need to create a model for developing infrastructure and essential services required for mining and resources projects, which can be accessed by multiple users, is a particular priority in developing countries.”

Introduction of Trade Restrictions by the EU on the Horizon?

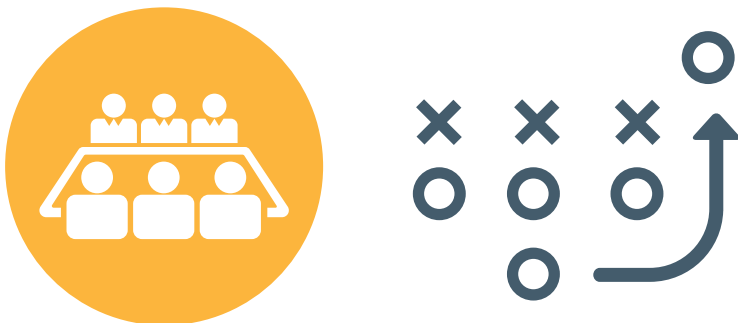
In the last few decades, it has been a key priority for the European (commission), the executive body of the European Union, to open up market opportunities for European (EU) businesses outside the EU. One of the most recent legislative proposals by the commission in that area aims to further open foreign public procurement markets for companies from the EU. At the same time, however, this proposal increases the risks that additional trade restrictions will be imposed by the commission on outside countries seeking access to the EU public procurement market.

At the end of January 2016, the Commission introduced a revised proposal into the legislative process for a regulation, entitled *“On The Access Of Third-Country Goods And Services To The Union’s Internal Market In Public Procurement And Procedures Supporting Negotiations On Access Of Union Goods And Services To The Public Procurement Markets Of Third Countries.”* The long title reflects the two aspects of the regulation, which will—if adopted—enable the EU to restrict the access of companies from outside the EU to the EU public procurement market,

which comprises all procurements by public contracting entities in the EU, and promote open access for EU companies to public procurement markets in other countries around the world. The commission considers such a regulation necessary because in many non-EU countries, EU companies still encounter restrictions when trying to access the public procurement market. In contrast, the EU public procurement market is generally open to all bidders from third countries. To introduce a higher degree of reciprocity, the commission now aims to provide

for the opportunity of countermeasures vis-à-vis countries that restrict access of EU companies to their procurement procedures. Therefore, the commission revised its original proposal and reintroduced it into the legislative process.

The commission’s first attempt to introduce a similar regulation in 2012 failed. The original 2012 proposal allowed for closing the entire EU public procurement market to specifically sanctioned non-EU countries. The prospect of total closure of the EU public procurement market to companies from such countries, as well as the complicated mechanism for imposing and implementing such restrictions, led to the opposition of several member states in the Council of the EU. Since then, the commission has relied on bilateral and multilateral trade negotiations with other countries to further open foreign public procurement markets to EU companies. Most importantly, the talks between the EU and the United States under the framework of TTIP (Transatlantic Trade and Investment Partnership Agreement on free trade between the EU and the United States) involve the commission’s request for unconditional opening of the U.S. public procurement markets to bidders from the EU. The EU has also initiated talks on a free trade agreement with Japan. On a multilateral level, the EU’s talks with several countries—most importantly China—on their accession to the worldwide Government Procurement Agreement (GPA) under the World Trade Organization (WTO), which contains multilateral commitments to mutually open



“After the Brexit, bilateral negotiations will also have to be started with the UK in order to avoid difficulties for UK companies when accessing the EU market and vice versa.”

the public procurement markets, have continued. Considering the fact that these negotiations have only achieved limited results and many third countries have not yet fully opened their public procurement markets for companies from the EU, the commission has introduced the revised proposal for an EU regulation, no doubt hoping to increase the political pressure for successfully closing these negotiations.

After the Brexit, bilateral negotiations will also have to be started with the United Kingdom (UK) in order to avoid difficulties for UK companies when accessing the EU market and vice versa.

Contrary to the commission's original proposal, the newly revised proposal is not designed to completely close EU public procurement markets for bidders from third countries, but rather provides for a *simplified mechanism* to restrict the access

to the EU public procurement market for goods and services that originate in a third country. On its own initiative, or in case it receives a complaint regarding a possible discrimination against EU companies in foreign public procurement markets, the commission may initiate an investigation into the alleged restrictive or discriminatory measures. If it concludes that access to the foreign public procurement market for EU companies is restricted, the commission may initiate political consultations with the respective third country on lifting the restrictions. These consultations may lead to a conclusion of a bilateral or a multilateral agreement (e.g., accession to the GPA under the WTO). If the consultations do not reach a satisfactory result, the commission may impose price

adjustment measures that would apply to all bidders from the respective third country and to all bids containing goods or services from the respective third country (provided these account for more than 50 percent of the value of the offer). In case the commission imposes a price adjustment, all procuring entities in the EU would generally be required to calculate a penalty of up to 20 percent on the price offered by the respective bidders.

The proposal does contain several exemptions. For example, it will not apply to

for the EU to parallelly increase its political efforts to promote the effectiveness of the GPA as well as bring the ongoing negotiations on bilateral and multilateral trade agreements to a successful close. Discussions are still in the early stages, so all potential stakeholders still have the chance of contributing to the conclusion of an agreement that promotes, rather than restricts, global trade.



suppliers from least-developed countries or developing countries. It also exempts offers from EU small and medium-sized enterprises that offer goods or services from the respective third country, and its application will be limited to contracts above a certain threshold. Additionally, it allows limiting its application to certain suppliers from the third country concerned and its implementation to a select group of contracting authorities in each EU member state.

While this proposal is less restrictive and more balanced than the original 2012 proposal, it could still trigger countermeasures by third countries against the EU, leading to further trade restrictions. To reduce these risks, it would seem wise

AUTHORS

Dr. Dorian Dorschfeldt
Berlin
dorian.dorschfeldt@kligates.com

Dr. Annette Mutschler-Siebert,
M.Jur (Oxon)
Berlin
annette.mutschler-siebert@kligates.com

Committee on Foreign Investment in the United States (CFIUS): Do its National Security Reviews Chill Chinese Investment?

Chinese outbound foreign direct investment (FDI) is increasing and the number of Chinese companies looking to buy U.S. companies also is increasing. The number of completed Chinese acquisitions in the United States has increased from seven transactions in 2006 to 103 transactions in 2015. At the same time, Chinese companies have submitted the most notices to CFIUS in each of the past three years, including 24 of the 147 notices submitted to CFIUS in 2014.

Chinese companies have also been involved in several recent high profile proposed acquisitions, including Chongqing Casin Enterprise Group's purchase of the Chicago Stock Exchange, ChemChina's acquisition of Syngenta, a large pesticide company, and Haier's acquisition of GE's appliance business. Each of those transactions is expected to involve a CFIUS notice. At the same time, CFIUS' assessment of national security risks can too often be opaque. In particular, it is sometimes hard to identify the specific national security issues that CFIUS is concerned about during the confidential review process. That uncertainty can limit the time and increase the difficulty in adequately presenting facts and information to address those concerns. It is increasingly becoming a risk factor affecting Chinese acquisitions of U.S. businesses to the disadvantage of both U.S. sellers and Chinese buyers.

CFIUS is an interagency committee of the U.S. government that is authorized to review and investigate any transaction that could result in the control of a U.S. business by a foreign person that may raise national security concerns. The first step in an acquisition is to determine whether a particular foreign investment is a "covered transaction." A "covered transaction" is any transaction where a foreign person will acquire control of a U.S. business. If the answer is yes, the next step is to consider voluntarily submitting a detailed notice to CFIUS so that it can determine

whether the covered transaction poses a threat to U.S. national security.

If CFIUS determines that a transaction may pose a threat to U.S. national security, it has the power to require that the parties to the transaction take steps to mitigate the risk to national security, or it can recommend that the president block the transaction in whole or in part. If a transaction that CFIUS believes is a covered transaction is completed without submitting a notice to CFIUS, CFIUS has the power to require the submission of a notice and, if it determines that the transaction raises national security risks, recommend that the president order the unwinding of the completed transaction, as was the case in an acquisition by a Chinese company (Ralls) of U.S. wind farms in 2013.

While the role of CFIUS is to protect U.S. national security, it is sometimes hard to predict which transactions will require CFIUS review because "national security" is undefined. In place of a statutory definition, the government has published Guidance Concerning the National Security Review Conducted by CFIUS, which lists certain factors that may be taken into account, including the effects of the transaction on, *inter alia*, the capability and capacity of domestic industries to meet national defense requirements; U.S. international technological leadership in areas affecting U.S. national security; and U.S. critical infrastructure, including major energy assets or critical technologies.

Additional factors include whether the transaction could result in control of a U.S. business by a foreign government or by an entity controlled by or acting on behalf of a foreign government.

In addition to being nontransparent, based on limited public guidance and implemented with broad authority, the CFIUS process is confidential and has been the subject of very little judicial interpretation. CFIUS regulations state that any information or documentary material filed with CFIUS, including any information filed pursuant to a prenotice consultation, shall not be made public and shall be exempt from disclosure under the Freedom of Information Act. The regulations also clearly state that the confidentiality provisions apply even when the transaction is no longer before CFIUS (e.g., the parties withdrew the notice or CFIUS concluded its review or investigation). This is important to protect business secrets, but even those directly involved in the process can be left partially in the dark. CFIUS often does not communicate to the parties the reasons for its questions or the gravamen or nature of any potential concerns. This lack of communication creates challenges for parties seeking to understand, anticipate, and respond appropriately to concerns of CFIUS.

Both the United States and China recognized the issue when on 25 September 2015, the countries announced, in a White House press release following a summit meeting between President Obama and Premier Xi Jinping, a commitment (i) to address national security risks through targeted mitigation rather than prohibition whenever reasonably possible and (ii) to limit the scope of their respective national security reviews of foreign investments solely to issues that constitute national

security concerns and not to generalize the scope of such reviews to include other broader public interest or economic issues. Both countries also committed to use only information provided by parties to the investment and not to use information provided by competitors seeking to influence the CFIUS process for their commercial interests.

When it comes to the CFIUS reviews, there are steps the U.S. government can take to provide greater clarity, certainty, and transparency. Even modest enhancements in the CFIUS process will assist the United States to attract more investments from China. To be sure, national security processes require confidential reviews and responsible governments will seek properly to maintain flexibility in such sensitive areas. However, thoughtful and measured approaches to these issues can improve the CFIUS review process without harming national security.

As Chinese companies increasingly look to invest in U.S. companies, the current opaque CFIUS process is affecting deals between U.S. and Chinese companies in ways that do little to increase understanding by investors. Recently, a Chinese firm, Unisplendour Corp, rescinded its US\$3.8 billion dollar offer to purchase a controlling interest in California-based Western Digital after CFIUS announced that it would review the acquisition. Additionally, Fairchild Semiconductor International, a U.S. company, rejected an offer from China Resources

Microelectronics Ltd and Hua Capital Management Co. Ltd, citing concerns over the CFIUS approval process.

Perhaps these transactions would have failed on substantive grounds. Only CFIUS—and possibly the parties—know for sure. What is clear is that other potential investors have little ability to understand these results or anticipate how the process might affect them. As a consequence, U.S. companies seeking investors may shy away from some

Chinese investors and Chinese interest in investing in U.S. companies may be chilled. This confusion is avoidable and likely unintended. It flows from a failure by CFIUS to explain better how it scrutinizes foreign investments, what standards it applies, and how it communicates with parties. Changes to the process and enhancements regarding the manner and clarity with which CFIUS communicates may prevent such confusion without adversely impacting the mission or objective of CFIUS.



AUTHORS

Michael J. O'Neil
Washington, D.C.
mike.oneil@klgates.com

Grace Parke Fremlin
Washington, D.C.
grace.fremlin@klgates.com

The Positional Game: Anticipating Uncertainty in the Age of the Trans-Pacific Partnership

In chess, one can plan specific moves only so far into the future as one can anticipate the state of play; even grandmasters have their limits in overcoming future uncertainty. So how does one plan strategically when one cannot anticipate the state of play? One must play a positional game. That is, one's moves must be designed to improve one's position on the board in absolute terms rather than in tactical anticipation of an opponent's moves. Just as in chess, strategic businesses in today's global marketplace must position themselves to succeed in the new regulatory landscape likely to come into force with ratification of the Trans-Pacific Partnership (TPP).

If ratified by all of the state parties that signed the agreement in February, the TPP would be the largest free trade agreement of our generation, regulating trade relations among Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the United States, and Vietnam. Such ratification would affect fully 40 percent of global trade, with far-reaching implications for a host of regulatory compliance regimes, ranging from the implementation of minimum requirements for local sourcing of materials to potential shifts in production, such as the expected move of many factories to Vietnam (which has been projected to result in as much as an 11 percent boost in economic growth over the next decade). Proponents welcome the potential of the TPP to reduce barriers to doing business abroad, including the elimination of 18,000 tariffs on American exports according to White House reports, viewing the TPP as a positive step in the ongoing quest for seamless global trade and investment, which may help to unlock a vast untapped economic potential for the states that are party to the agreement.

Critics, however, decry potential negative impacts of the agreement, such as the potential loss of jobs in countries like the United States or perceived failures

of the agreement to go far enough to address important concerns, such as currency manipulation. Regardless of the outcome of this debate, for many businesses, and especially for small and medium enterprises entering international competition for the first time, the TPP may hold a vast potential for global business development. What many businesses entering or retooling within the TPP regulatory space may not realize, however, is that the TPP will also usher in a new—and as yet undefined—regulatory environment for anticorruption and transparency laws determined on a state-by-state basis that may directly affect their operations.

While a great deal of uncertainty remains regarding the specific changes the TPP may bring to current regulatory and compliance environments, businesses can wisely position themselves competitively by implementing best practices for entering or remaining in the TPP regulatory environment. Such practices include not only ensuring proactive compliance with existing legislation that may be applicable to international business, such as the U.S. Foreign Corrupt Practices Act (FCPA) and the UK Bribery Act (UKBA), but also the proactive development of trade

compliance plans that are socially responsible and that implement “end-to-end” global value chain transparency to prepare such businesses for the range of potential regulatory moves among states implementing the requirements of the TPP in domestic contexts. Touching on a few points in the agreed text of the TPP well illustrates this point. Article 26.7(1) of the agreed TPP text, for example, requires TPP states to undertake an obligation that “[e]ach Party shall adopt or maintain legislative and other measures as may be necessary to establish as criminal offences under its law, in matters that affect international trade or investment, when committed intentionally, by any person subject to its jurisdiction” acts such as direct or indirect bribery of an official, “solicitation” of public officials, and “aiding or abetting, or conspiracy in the commission” of such offenses. Article 26.7(5) goes on to require that TPP states adopt further related measures “regarding the maintenance of books and records, financial statement disclosures, and accounting and auditing standards” in order to support deterrence efforts, including prohibiting “the establishment of off-the-books accounts,” “the entry of liabilities with incorrect identification of their objects,” and “the intentional destruction of bookkeeping documents earlier than foreseen by the law.” Article 26.7(2) further attempts to make the above provisions more effective by mandating that “[e]ach Party shall make the commission of an offence described in paragraph 1 or 5 liable to sanctions that take into account the gravity of that offence.”

Interestingly, while the TPP provides the ultimate ends of such legislation, it leaves the means to obtaining such ends in the hands of the parties' domestic laws.

Article 26.7(3) requires that “[e]ach Party shall adopt or maintain measures as may be necessary, consistent with its legal principles, to establish the liability of legal persons for offences described in paragraph 1 or 5,” although it does require that states “include monetary sanctions” that are not tax-deductible. As such, implementation of the TPP is likely to inspire a range of domestic regulatory responses that, while similar in ultimate intent, may differ widely in practical requirements for compliance and enforcement. Businesses that proactively implement compliance regimes based on best practices such as those above are likely not only to reduce compliance costs in the longer term but also enable themselves to more fully realize the potential benefit of the TPP by easing transitions across TPP jurisdictions.

While it seems certain that ratification of the TPP will give rise to substantial regulatory uncertainty across the TPP region as states make their own moves to pursue the TPP strategy, in the process, there will likely be both potential peril for risk management as well as strategic potential for new business opportunity. Playing a positional game of strategic business development may be the difference between success and failure in managing the risk and maximizing

the potential of an enforced TPP. While such an approach must be tailored to the needs of each individual business, it will likely include the incorporation of best practices for compliance with such existing laws as the FCPA and the UKBA, as well as the proactive development of trade compliance plans that are socially responsible and implement “end-to-end” global value chain transparency to minimize compliance and opportunity costs in preparation for the coming wave of regulatory change in TPP states.



Just as in chess, where even the most seasoned players must look to sound positioning to hedge against risk inherent to an uncertain state of play, global businesses must use sound positioning to hedge against risk inherent within the uncertain environment of regulatory change and enforcement under the TPP. With proper positioning, potential liability can become opportunity at the dawn of the new Pacific age.

AUTHORS

Andre Jumabhoy
Singapore
andre.jumabhoy@klgates.com

Robert Houston
Singapore
robert.houston@klgates.com

Investment in America's Port Infrastructure: A Critical National Policy Priority

The ability of U.S. ports to handle growing demand, increasing ship sizes, and larger cargo volumes and manage contentious labor contract negotiations is vital to the nation's economic growth, employment, international competitiveness, and national and homeland security. Yet long-term, systemic port congestion issues threaten the nation's economic prosperity with port disruptions costing the economy up to US\$2 billion each day.

Maintaining and modernizing America's ports and intermodal connections requires significant investments to meet the transportation needs of the 21st century. In 2016, federal agencies, Congress, and interested stakeholders—carriers, terminal operators, logistics providers, rail and trucking industries, labor, port

a comprehensive strategy on 21st century ports. The Commerce Department's Advisory Committee on Supply Chain Competitiveness recently provided recommendations to the Secretary of Commerce concerning port congestion and operational and infrastructure factors impacting the flow of cargo. Further, the

U.S. Maritime Administration is in the final stages of proposing a National Maritime Strategy that will address growing the U.S. maritime industry, including port infrastructure

Engineers' (USACE) priority infrastructure improvement projects, such as deepening vital harbors and increasing needed investments in America's ports through the Harbor Maintenance Trust Fund (HMTF) and the Inland Waterways Trust Fund (IWTF). Collectively, these efforts could transform U.S. ports going forward.

“Labor is a significant stakeholder in port policy discussions as well as a major concern for many port users.”

authorities, importers, and exporters—are discussing policies to promote efficient, competitive, and safe ports and related logistics through a number of federal initiatives and legislative proposals. Stakeholders have a great deal riding on these ongoing policy discussions.

THE PORT DEBATE HAS STARTED

A wide variety of federal agencies and Congress are focused on improving port infrastructure investments and addressing challenges facing ports and port users throughout the nation.

The National Economic Council, the U.S. Department of Commerce (Commerce Department), the U.S. Department of Labor, and the U.S. Department of Transportation (DOT) are conducting a series of roundtable discussions with stakeholders to solicit input and develop

needs to improve U.S. port operations and related businesses.

Additionally, the DOT's Bureau of Transportation Statistics (BTS) is bringing together representatives from the rail, trucking, maritime, and marine terminal industries; labor; port authorities; and the Transportation Research Board to establish a Port Performance Freight Statistics Working Group (Working Group) as required by the Fixing America's Surface Transportation Act (FAST Act). The Working Group will make recommendations to the BTS Director no later than 4 December 2016, on port capacity and throughput statistics and data collection and reporting standards. Congress is also working on legislation to authorize and prioritize port infrastructure projects. The Water Resources Development Act (WRDA) of 2016 will authorize the U.S. Army Corps of

POLICY CONSIDERATIONS FOR PORTS

As part of these efforts, policymakers are considering a wide range of policy initiatives to improve ports' efficiency, productivity, and reliability. Beyond upgrading port capabilities by dredging channels and installing larger cranes, for example, broader policy measures will focus on funding and financing opportunities, project delivery, labor, and connectivity and master planning.

The American Association of Port Authorities' 2015 “The State of Freight” report found that significant additional investment in port infrastructure is required to keep pace with increasing demands on America's ports. Diversified funding and financing options, including local, state, regional, and federal funds and grants; bonds; commercial loans; and public-private partnerships (P3s), are necessary for port infrastructure investments. To encourage and facilitate private investment in ports and port connectivity infrastructure, the DOT is collaborating with state and local governments and the private sector to incentivize P3s. Importantly, both chambers of Congress have advanced appropriations bills that would provide additional funding for port infrastructure, appropriating nearly US\$6 billion to

the USACE for port and freight projects authorized by previous WRDAs and the FAST Act. The House and Senate bills would provide project funding through the HMTF (with the House bill identifying over US\$1.2 billion in such funds) and the use of all estimated annual revenues from the IWTF, which the Senate bill estimates at US\$106 million for FY 2017.

Congress has prioritized improving project delivery, environmental review streamlining, and internal process reform for transportation infrastructure projects under recent transportation-related laws, including the Moving Ahead for Progress in the 21st Century Act (MAP-21), the Water Resources Reform and Development Act of 2014, and the FAST Act. These reforms could benefit port infrastructure projects by reducing regulatory burdens, expediting projects, and streamlining planning and permitting processes.

Labor is a significant stakeholder in port policy discussions as well as a major concern for many port users, as labor issues can adversely impact port operations. In response to major backlogs at West Coast ports last year amid a management-labor contract dispute, national roundtables involving shippers, carriers, port authorities, labor, and various federal agencies are already addressing the need to avoid disruptions to the supply chain and considering how to provide more certainty against unexpected walkouts, long-lasting strikes, and port shutdowns.

Ports are only as strong as their ability to connect to related land-side logistics, including inland and coastal waterways, railroads, and highways. As part of the

National Freight Policy established by MAP-21, the DOT last month released a Draft National Freight Strategic Plan (Draft NFSP) that addresses highways, railways, waterways, ports, airports, and intermodal facilities. Better master planning for ports could improve productivity and efficiency in the supply chain, as well as provide cost savings. The Draft NFSP recommends establishing best practices to integrate planning and investment decisions and coordinating at the national, state, regional, and local levels to efficiently move the nation's goods and avoid harmful disruptions.



GOING FORWARD

Recognizing the importance of strengthening America's port infrastructure, federal agencies and Congress can be expected to take significant steps in 2016 toward addressing port infrastructure and productivity policies through national roundtables, working groups, regulations, and legislation. Stakeholders should stay tuned as these initiatives come on line.

AUTHORS

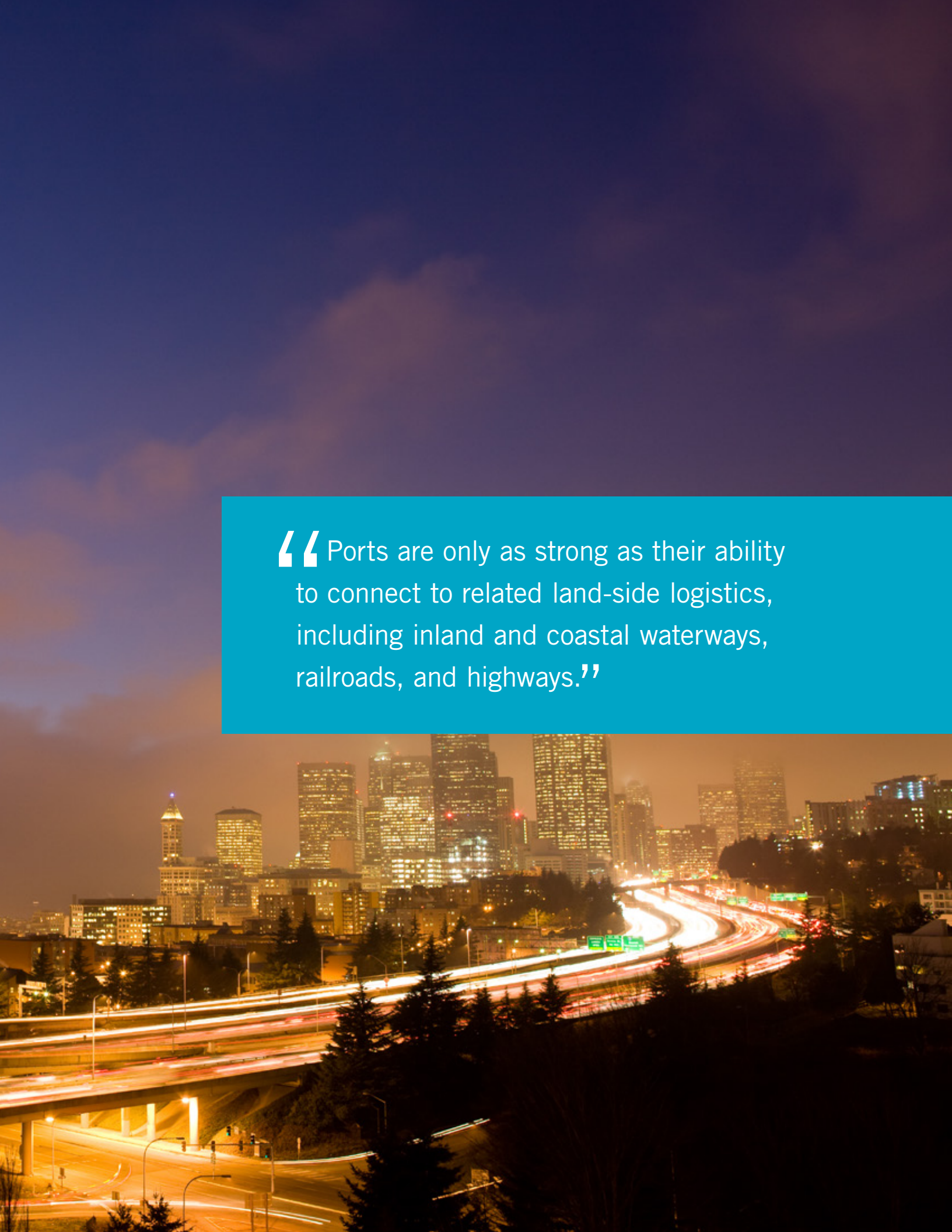
Darrell L. Conner
Washington, D.C.
darrell.conner@klgates.com

Michael F. Scanlon
Washington, D.C.
michael.scanlon@klgates.com

Stephen A. Martinko
Washington, D.C. and Pittsburgh
stephen.martinko@klgates.com

Sarah M. Beason
Washington, D.C.
sarah.beason@klgates.com



A nighttime photograph of a city skyline with a multi-lane highway in the foreground. The highway shows long-exposure light trails from cars, and the city buildings are illuminated against a dark sky. A teal text box is overlaid on the upper portion of the image.

“ Ports are only as strong as their ability to connect to related land-side logistics, including inland and coastal waterways, railroads, and highways.”

LABOR AND EMPLOYMENT

UK Employment Law for 2016

Several aspects of the United Kingdom (UK) employment law will see changes in 2016, including new gender pay reporting obligations, a new national living wage, and the exit of the UK from the European Union, which is likely to have an impact on the employment law system in the UK.

“BREXIT”

On 23 June 2016, the people of the UK voted to leave the EU. There now begins a long process of extrication, a process which has not yet officially begun and will not begin until the UK government serves its “Article 50” notice on the EU. Once it does so, negotiations will take place between the UK and the EU to agree the basis of their future relationship. This will include the extent to which the UK is required to allow free movement of workers from the EU into the UK and vice versa and to observe EU-originated employment laws.

Although in theory there will no longer be the immediate right for UK nationals to live and work in other EU countries or for nationals of other EU member states to work in the UK, at the time of writing it appears that some kind of agreement is likely to be reached to allow current migrants to remain in their host country. Further, although it is currently unknown what type of relationship the UK will have with the EU, early indications from the EU leaders suggest that accepting free movement of workers is an absolute condition to allowing the UK to continue to have access to the single market.

At the time of writing, our view is that it is unlikely that Brexit will have much impact on existing employment rights in the UK.

This is true for various reasons. Some UK laws, such as provisions governing discrimination and equal pay, actually pre-dated equivalent EU employment laws. Other laws, such as family friendly rights, actually go further than what is required by EU law, and any repeal or cutting back of these rights would constitute a significant change in policy for the UK government. Some rights, such as the right to paid holiday, are now enshrined in individual contracts of employment, meaning that those rights will survive, even if the legislation which first gave employees those rights is subsequently repealed.

If it is unlikely that employment laws will be repealed incident to a Brexit, various modifications of existing employment laws are a meaningful possibility. It has been suggested, for example, that a cap could be put on damages for discrimination claims or that it might become easier to harmonize terms following transfers under the Transfer of Undertakings (Protection of Employment) Regulations 2006.

In any event, negotiations between the UK and the EU will occur over a number of years. It seems unlikely that we will see any major changes in the near future.

REQUIREMENT TO PREPARE AN ANNUAL SLAVERY AND HUMAN TRAFFICKING STATEMENT UNDER THE MODERN SLAVERY ACT

From 31 March 2016, certain businesses whose financial years end on or after that date have been required to publish an annual slavery and human trafficking statement. This requirement was introduced by the Modern Slavery Act 2015 and applies to commercial organizations that supply goods or services in the UK and have an annual global turnover of more than £36 million.

The statement should include information on the steps the business has taken over the year to ensure that there is no slavery or human trafficking taking place in its business or supply chains. It is possible for businesses to state simply that they have taken no steps during the financial year, but it is unlikely that many businesses will choose this option from a public relations point of view.

Businesses are required to publish the statement on their website, with a prominent link to the statement on their homepage. If a business does not have a website, then it must provide a copy of the statement within 30

“From 31 March 2016, certain businesses whose financial years end on or after that date have been required to publish an annual slavery and human trafficking statement.”

days to anyone who requests it in writing. Failure to comply with these requirements could lead to an injunction from the Home Secretary to enforce the requirement to prepare the statement.

It is estimated that this new disclosure requirement will affect more than 10,000 companies. It is hoped that if businesses undertake the necessary due diligence, they will have sufficient power to influence a change within the supply chain and to tackle the global problem of slavery and human trafficking.

GENDER PAY GAP REPORTING

The British government has published the draft Equality Act (Gender Pay Gap Information) Regulations 2016, which requires private and voluntary UK employers with 250 or more employees working in the UK to report gender pay gap information.

More specifically, employers need to report the mean and median pay of men and women, the difference between the mean of any bonus payments made to men and women, and the number of men and women in each salary quartile of the employer's pay scale. The draft regulations include information on what "pay" should include and not include. Overtime, expenses and benefits in kind, for example, should not be included in the calculation.

The gender pay gap information should be published on a UK website as well

as uploaded on a government website. There are no penalties for not complying with the obligation, but the government will publish details of the companies that comply and potentially name and shame those that do not comply.

The new obligation will become effective on 1 October 2016, but employers will have until 30 April 2018, to publish responsive information. Employers are advised, however, to start the calculation process now to identify any gender pay gap and to attempt to address the issue.

A survey of more than 400 employers found that just under half had employees who would qualify for the national living wage and are currently paid less than £7.20 an hour with the annual cost to employers being an average of £592.89 per affected employee. The Resolution Foundation expects 2.8 million workers will get a direct pay raise, but it seems clear that the new national living wage will affect some sectors, such as the retail and hospitality sectors, more than others.

In sum, 2016 has introduced various changes to employment laws in the UK,



NATIONAL LIVING WAGE

On 1 April 2016, a new national living wage was introduced for workers age 25 and over. The national living wage starts at £7.20 an hour with the intention that it will rise to over £9 an hour by 2020.

Some employers may try to include certain benefits into the basic pay to absorb the cost to the business of having to pay the national living wage, but they would need to carefully consider the legal challenges attached to changing existing employment terms.

including new reporting or disclosure requirements for employers and a higher national living wage. Brexit carries the possibility of other changes. It remains to be seen whether such changes will occur and whether any of them will be deemed transformative for employers or workers.

AUTHOR

Paul Callegari
London
paul.callegari@klgates.com

The Blurred Line Between Independent Contractors and Employees: Facing the Challenges of the Modern On-Demand Economy

The growing on-demand or “gig” economy involves a business model in which workers contract for the opportunity to provide services directly to customers as independent contractors, as opposed to employees, through various technology platforms. While this business model facilitates greater innovation for companies and provides flexibility for workers, it has faced challenges from government agencies and some workers seeking to apply longstanding workplace protections to these arrangements. In particular, businesses like Uber have received significant attention as a result of class action lawsuits in the United States challenging the classification of workers as independent contractors.

RELEVANT LAW

In the United States, labor and employment laws apply to individuals with whom there is an employment relationship (i.e., employees) as defined under each applicable law, and not to independent contractors. Some of these laws were enacted many years ago and reflect a desire to address workplace and economic issues present at the time. For example, the Fair Labor Standards Act (FLSA), one of the earliest federal efforts to regulate the work environment, was enacted in 1938 as part of President Franklin D. Roosevelt’s New Deal legislation and established requirements for minimum wages, overtime pay, and recordkeeping that are still in effect today. The FLSA’s rigid requirements and punch-clock mentality were easier to apply in a factory of the 1900s than in many of the modern, nontraditional workplaces encountered today.

Under the FLSA, the determination of whether someone is an employee or an independent contractor is based on an

assessment of various factors known as the “economic realities test.” Recently, the U.S. Department of Labor’s Wage and Hour Division set forth its interpretation of that test, describing the standard in a way that favors finding an employment relationship and expressly stating the agency’s view that “most workers are employees.” This interpretation and the agency’s related enforcement efforts have generated a lot of discussion (and criticism) in the U.S. and have cast a spotlight on the issue of independent contractor classification. In addition, government agencies, such as the U.S. Equal Employment Opportunity Commission, National Labor Relations Board, IRS, and a variety of state agencies also monitor independent contractor relationships. For purposes of different laws enforced by various agencies, there are different tests that place different emphasis on the concepts of control, economic dependence, and the relationship between the parties.

Similar issues arise in the European Union (EU), where only employees benefit from

the full range of employment protection rights offered by law. Although some EU countries provide more limited protection to other categories of,

for example, “workers” or “agency workers,” independent contractors receive very little in the way of employment rights or protection. The determination of employment status in the EU is not an area of the law where harmonized EU-wide legislation exists, and so each member state is left to determine what constitutes an employee. National tax authorities in the EU, like in the U.S., take an active role in ensuring that self-employed contractors are appropriately designated, especially in those industries where the use of contractors is widespread. Enforcement and reclassification actions are common. However, if used correctly, the self-employment model continues to carry financial and administrative benefits for both the individual and end-user recipient of services, and so it remains commonly used.

IMPLICATIONS AND OPTIONS FOR BUSINESSES

Challenges to the independent contractor arrangements that underlie the on-demand economy can arise from private lawsuits or agency enforcement actions. The U.S. Department of Labor’s Wage and Hour Division has embarked on a nationwide initiative aimed at eliminating the misclassification of workers as independent contractors when they should be classified and treated as employees. As part of that initiative, the U.S. Department of Labor has entered

“...companies that try new business models face significant risk of challenge to their independent contractor classifications...”

into memoranda of understanding with the IRS and about half of the states, to share information and work together toward a common goal of identifying and eliminating purported misclassification.

Businesses that use independent contractors in the U.S. have several options to address the increasing challenges and potential liability associated with independent contractors. The first is to take the conservative approach and treat any questionable independent contractors as employees; the second is to build in protections to decrease the likelihood that independent contractors will be determined to be employees; and the third involves political action urging that archaic legislation and regulations be revised to allow for modern business models that use independent contractors.

Relaxed regulation and portable health benefits could be part of a legislative solution for independent contractors in the U.S. United States Senator Mark Warner, a former technology industry executive, has spoken out on this issue, urging lawmakers to think about the issue in ways that do not inhibit flexibility and innovation, but that provide a safety net for workers who do not have access to employee-based government programs. He has suggested further data collection and discussed ideas like a joint health and welfare fund model, similar to the system used by some building trades, where many

employers can pay employees' health and retirement benefits into a joint fund.

Many of the "protections" put in place for employees (and government efforts to shoehorn independent contractors into an employment relationship to apply those protections) do not necessarily reflect what modern workers want. In the end, this paternalistic approach may stifle new, innovative business models and work opportunities that technology has made possible.

agencies. Rigid, one-size-fits-all labor and employment laws, in particular wage and hour requirements, were not designed to address the nature of today's workplaces or the desires of today's workers. Nevertheless, companies that try new business models face significant risk of challenge to their independent contractor classifications, especially with the increased government attention now placed on this issue. Businesses should be aware of these issues, assess,



CONCLUSION

The classification of a worker as an independent contractor, as opposed to an employee, has never been a black-and-white determination, and the distinctions are becoming more blurred by changes in the type of work contractors perform and the interpretations of government

and recast as appropriate the materials and policies by which they administer their dealings with workers and consider lobbying for updated legislation that meets the needs of the modern workforce.

AUTHORS

Paul Callegari
London
paul.callegari@klgates.com

Patrick M. Madden
Seattle
patrick.madden@klgates.com

Amy L. Groff
Harrisburg
amy.groff@klgates.com





“Relaxed regulation and portable health benefits could be part of a legislative solution for independent contractors in the U.S.”

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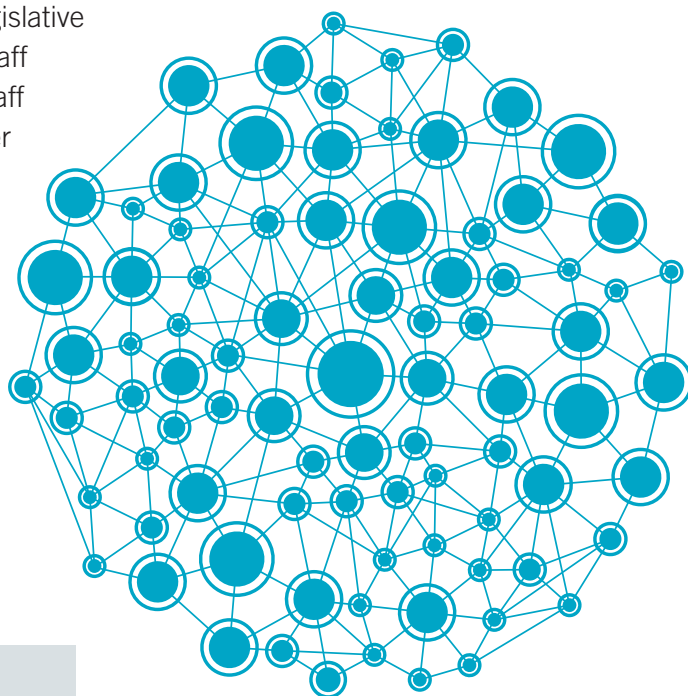
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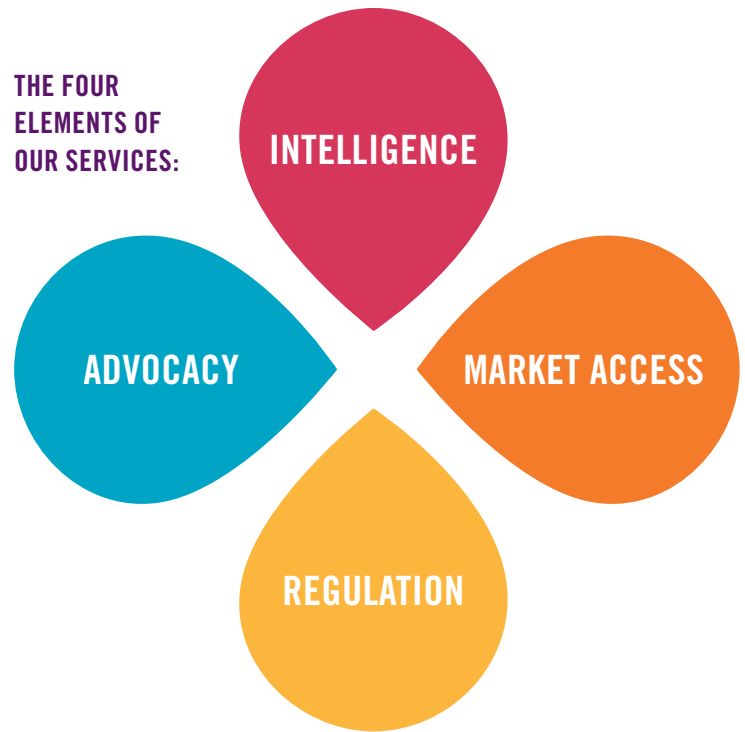
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We understand both the political processes and the need for politically sensitive advocacy, but we also provide guidance on the decision-making rules. We are able to assess the consequences of proposed regulatory changes compared to the current legal framework.



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We assist our clients in strategic issues involving securing market access and protecting free trade for investments into the EU and from the EU to third countries. To do so, we use a combination of EU and domestic laws, international agreements, and public policy instruments. This innovative service was specifically created to deal with strategic projects (often commercial) that depend on or could benefit from government intervention.



EU AND NATIONAL REGULATORY ADVICE: YOUR SUPPORT IN THE INTERPRETATION OF EU LEGISLATION AND ITS IMPLEMENTATION AT A NATIONAL LEVEL

Our aim is to help our clients navigate the regulatory maze by identifying risks and opportunities in order to facilitate their commercial operations. We work with our clients on any issue related to the interpretation, implementation, and enforcement of a regulation or a decision related to EU law—whether this happens at EU or national levels.

OUR BRUSSELS CONTACTS

Ignasi Guardans
Partner
+32.(0)2.336.1949
ignasi.guardans@klgates.com

Philip Torbøl
Partner
+32.(0)2.535.7853
philip.torbol@klgates.com

Most of our Brussels lawyers have previously worked in one or more of the EU institutions, and have first hand experience with the regulatory and policy procedures of the EU. Our experience and network enables us to facilitate access to decision makers, not only in Brussels, but equally in European capitals.

EUROPEAN REGULATORY PRACTICE DIRECTORY

The breadth of the K&L Gates European regulatory group reflects the fact that EU law is not only Brussels-focused. It also has a significant impact on most of the national legislation and regulation which derive directly from EU law. Our European regulatory group combines the knowledge, skills, and resources of our firm's European offices in Berlin, Brussels, Frankfurt, London, Milan, Munich, Paris, and Warsaw.

This directory of our European regulatory capabilities provides a concise overview of the K&L Gates regulatory lawyers located throughout Europe.

The directory is structured by regulatory practice area and provides essential information on each lawyer's proven experience within that sector. The objective of the directory is to assist clients looking for a specific capability and to facilitate efficient contact between those clients and the appropriate member(s) of our European regulatory group.

To download a copy of the directory, please visit our website at klgates.com/euregulatorydirectory.



AREAS OF FOCUS

Agriculture and Fisheries
Competition
Data Protection and Privacy
Distribution and e-Commerce
Energy and Climate Change
Environment, Chemicals, and Natural Resources
Food and Nutrition
Financial Services
Gambling
Health and Life Sciences
Intellectual Property and Technology Licensing
International Trade and Export Control
Media and Sports
Product Regulations and Marketing
Public Procurement
Subsidies and Grants
Tax and Customs Law
Telecoms
Transport
White Collar Crime

ASIA PACIFIC REGULATORY PRACTICE DIRECTORY

Regulations governing commercial transactions and operations in Asia Pacific are developing at a rapid pace. Most will usually require some form of official approval, potentially involving local and/or national government agencies. K&L Gates' Asia Pacific regulatory group combines the knowledge, skills, languages, and resources of our firm's Asia Pacific offices in Australia, China, Hong Kong, Japan, Korea, Singapore, Taiwan, and our India practice. Not only do we help clients navigate these systems, but we have developed strong working relationships with central and local government authorities across the region, enabling us to bring their attention to operating facts and circumstances which are also taken into account as new regulations are developed.



JURISDICTION OF FOCUS

Australia

China

Hong Kong

Japan

Korea

Singapore

Taiwan

This directory of our Asia Pacific regulatory capabilities provides a concise overview of K&L Gates' regulatory lawyers located throughout the Asia Pacific region. The directory is structured by jurisdiction and provides essential information on key areas of our regulatory practice along with details of key lawyers in each office. The objective of the directory is to assist clients looking for a specific capability and to facilitate efficient contact between those clients and the appropriate member(s) of our Asia Pacific regulatory group.

To download a copy of the directory, please visit our website at klgates.com/asiapacificregulatorydirectory.

GLOBAL LEGAL COUNSEL ACROSS FIVE CONTINENTS



K&L GATES OFFICES

Anchorage +1.907.276.1969	Dubai +971.4.427.2700	Newark +1.973.848.4000	Seattle +1.206.623.7580
Austin +1.512.482.6800	Fort Worth +1.817.347.5270	New York +1.212.536.3900	Seoul +82.0.2.2198.8700
Beijing +86.10.5817.6000	Frankfurt +49.(0)69.945.196.0	Orange County +1.949.253.0900	Shanghai +86.21.2211.2000
Berlin +49.(0)30.220.029.0	Harrisburg +1.717.231.4500	Palo Alto +1.650.798.6700	Singapore +65.6507.8100
Boston +1.617.261.3100	Hong Kong +852.2230.3500	Paris +33.(0)1.58.44.15.00	Sydney +61.2.9513.2300
Brisbane +61.7.3233.1233	Houston +1.713.815.7300	Perth +61.8.9216.0900	Taipei +886.2.2326.5188
Brussels +32.(0)2.336.1900	London +44.(0)20.7648.9000	Pittsburgh +1.412.355.6500	Tokyo +81.3.6205.3600
Charleston +1.843.579.5600	Los Angeles +1.310.552.5000	Portland +1.503.228.3200	Warsaw +48.22.653.4200
Charlotte +1.704.331.7400	Melbourne +61.3.9205.2000	Raleigh +1.919.743.7300	Washington, D.C. +1.202.778.9000
Chicago +1.312.372.1121	Miami +1.305.539.3300	Research Triangle Park +1.919.466.1190	Wilmington +1.302.416.7000
Dallas +1.214.939.5500	Milan +39.02.3030.291	San Francisco +1.415.882.8200	
Doha +974.4424.6100	Munich +49.89.321.215.0	São Paulo +55.(0)11.3704.5700	klgates.com

K&L GATES

AUTHOR LIST

EDITORS

Michael D. Ricciuti
Boston
michael.ricciuti@klgates.com

Stephen G. Topetzes
Washington, D.C.
stephen.topetzes@klgates.com

AUTHORS

Russel S. Abrams
Charleston
russ.abrams@klgates.com

Ranjini Acharya
Palo Alto
ranjini.acharya@klgates.com

Scott Aliferis
Washington, D.C.
scott.aliferis@klgates.com

Mark C. Amorosi
Washington, D.C.
mark.amorosi@klgates.com

Juliana Araujo
São Paulo
juliana.araujo@klgates.com

Nicole A. Baker
Washington, D.C.
nicole.baker@klgates.com

Marion Baumann
Berlin
marion.baumann@klgates.com

Sarah M. Beason
Washington, D.C.
sarah.beason@klgates.com

Christine Braamskamp
London
christine.braamskamp@klgates.com

Dr. Christian Büche
Frankfurt
christian.bueche@klgates.com

Jim Bulling
Melbourne
jim.bulling@klgates.com

Luke T. Cadigan
Boston
luke.cadigan@klgates.com

Paul Callegari
London
paul.callegari@klgates.com

Giovanni Campi
Brussels
giovanni.campi@klgates.com

Stephen H. Cooper
Washington, D.C.
stephen.cooper@klgates.com

Amy M. Conant
Washington, D.C.
amy.conant@klgates.com

Darrell L. Conner
Washington, D.C.
darrell.conner@klgates.com

John J. Cotter
Boston
john.cotter@klgates.com

Daniel F. C. Crowley
Washington, D.C.
dan.crowley@klgates.com

Alessandro Di Mario
Brussels
alessandro.dimario@klgates.com

Dr. Dorian Dorschfeldt
Berlin
dorian.dorschfeldt@klgates.com

Etienne Drouard
Paris
etienne.drouard@klgates.com

Jon Eisenberg
Washington, D.C.
jon.eisenberg@klgates.com

Grace Parke Fremlin
Washington, D.C.
grace.fremlin@klgates.com

Alyssa M. Fritz
Seattle
alyssa.fritz@klgates.com

Gillian R. Giannetti
Washington, D.C.
gillian.giannetti@klgates.com

Jonathan A. Graham
London
jonathan.graham@klgates.com

Amy L. Groff
Harrisburg
amy.groff@klgates.com

Ignasi Guardans
Brussels
ignasi.guardans@klgates.com

Roderick D. Hall
Washington, D.C.
rod.hall@klgates.com

Victoria Hamscho
Washington, D.C.
victoria.hamscho@klgates.com

Liz Hastilow
Sydney
elizabeth.hastilow@klgates.com

Bruce J. Heiman
Washington, D.C.
bruce.heiman@klgates.com

Clifford C. Histed
Chicago
clifford.histed@klgates.com

Anthony R. Holtzman
Harrisburg
anthony.holtzman@klgates.com

Robert Houston
Singapore
robert.houston@klgates.com

William H. Hyatt
Newark
william.hyatt@klgates.com

Andre Jumabhoy
Singapore
andre.jumabhoy@klgates.com

Erin Ardale Koepfel
Washington, D.C.
erin.koepfel@klgates.com

Shehram A. Khattak
London
shehram.khattak@klgates.com

Daniel Knight
Melbourne
daniel.knight@klgates.com

Dawn Monsen Lamparello
Newark
dawn.lamparello@klgates.com

Clay LaPoint
Palo Alto
clay.lapoint@klgates.com

Jonathan Lawrence
London
jonathan.lawrence@klgates.com

John L. Longstreth
Washington, D.C.
john.longstreth@klgates.com

James M. Lynch
Seattle
jim.lynch@klgates.com

Patrick M. Madden
Seattle
patrick.madden@klgates.com

Stephen A. Martinko
Washington, D.C. and Pittsburgh
stephen.martinko@klgates.com

Sasi-Kanth Mallela
London
sasi-kanth.mallela@klgates.com

Patrick C. McCooe
Boston
patrick.mccooe@klgates.com

James G. Millward
London
james.millward@klgates.com

Dr. Annette Mutschler-Siebert, M.Jur (Oxon)
Berlin
annette.mutschler-siebert@klgates.com

Trey A. Monsour
Houston and Dallas
trey.monsour@klgates.com

B. David Naidu
New York
david.naidu@klgates.com

Ayuko Nemoto
Tokyo
ayuko.nemoto@klgates.com

Peter V. Nelson
Washington, D.C.
peter.nelson@klgates.com

Stuart B. Nibley
Washington, D.C.
stu.nibley@klgates.com

Tsuguhito Omagari
Tokyo
tsuguhito.omagari@klgates.com

Michael J. O'Neil
Washington, D.C.
mike.oneil@klgates.com

Michael L. O'Neill
Washington, D.C.
mike.oneill@klgates.com

C. Dirk Peterson
Washington, D.C.
dirk.peterson@klgates.com

Clare Power
Perth
clare.power@klgates.com

Michael J. Quinn
Los Angeles
michael.quinn@klgates.com

Andrea B. Reed
Boston
andrea.reed@klgates.com

Michael D. Ricciuti
Boston
michael.ricciuti@klgates.com

Mark Roszak
Washington, D.C.
mark.roszak@klgates.com

Cliff L. Rothenstein
Washington, D.C.
cliff.rothenstein@klgates.com

Emanuel L. Rouvelas
Washington, D.C.
emanuel.rouvelas@klgates.com

Mark A. Rush
Pittsburgh
mark.rush@klgates.com

Thomas Ryan
Pittsburgh
thomas.ryan@klgates.com

Sandra E. Safro
Washington, D.C.
sandra.safro@klgates.com

Simon Salter
Perth
simon.salter@klgates.com

Yuki Sako
Tokyo
yuki.sako@klgates.com

Brian F. Saulnier
Pittsburgh and Dubai
brian.saulnier@klgates.com

David A. Savell
London
david.savell@klgates.com

Michael F. Scanlon
Washington, D.C.
michael.scanlon@klgates.com

Bill Semins
Pittsburgh and Dubai
william.semins@klgates.com

R. Paul Stimers
Washington, D.C.
paul.stimers@klgates.com

Fatima S. Sulaiman
Washington, D.C.
fatima.sulaiman@klgates.com

Lian Yok Tan
Singapore
lian.tan@klgates.com

Choo Lye Tan
Hong Kong
choolye.tan@klgates.com

Ankur K. Tohan
Seattle
ankur.tohan@klgates.com

Stephen G. Topetzes
Washington, D.C.
stephen.topetzes@klgates.com

Philip Torbøl
Brussels
philip.torbol@klgates.com

Anne Thümmel
Frankfurt
anne.thuemmel@klgates.com

Emily F. Trapani
Washington, D.C.
emily.trapani@klgates.com

Ed Vassie
Sydney
edward.vassie@klgates.com

Marc Veilleux
São Paulo
marc.veilleux@klgates.com

David L. Wochner
Washington, D.C.
david.wochner@klgates.com

Steven Wulff
Melbourne
steven.wulff@klgates.com

Dr. Ronnie R. Yearwood
London
ronnie.yearwood@klgates.com

K&L GATES

Anchorage Austin Beijing Berlin Boston Brisbane Brussels Charleston Charlotte Chicago Dallas Doha
Dubai Fort Worth Frankfurt Harrisburg Hong Kong Houston London Los Angeles Melbourne Miami Milan Munich
Newark New York Orange County Palo Alto Paris Perth Pittsburgh Portland Raleigh Research Triangle Park San Francisco
São Paulo Seattle Seoul Shanghai Singapore Sydney Taipei Tokyo Warsaw Washington, D.C. Wilmington

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Anchorage Austin Beijing Berlin
Boston Brisbane Brussels Charleston
Charlotte Chicago Dallas Doha
Dubai Fort Worth Frankfurt Harrisburg
Hong Kong Houston London Los Angeles
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K&L GATES

New York Orange County Palo Alto Paris
Perth Pittsburgh Portland Raleigh
Research Triangle Park San Francisco
São Paulo Seattle Seoul Shanghai
Singapore Sydney Taipei Tokyo
Warsaw Washington, D.C. Wilmington

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