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LEGAL ALERT

April 15, 2011

Summary of Selected Programs from SIFMA Compliance & Legal Division's 2011 Annual Seminar

On March 20-23, 2011, the Securities Industry and Financial Markets Association (SIFMA) Compliance & Legal Society hosted its annual seminar. Drawing some 1,700 securities industry participants and observers, the seminar constitutes one of the leading educational seminars of its kind.

Understanding that not all of our clients and friends attend the seminar, and even those who do cannot take part in every program and workshop, we are sending a summary of certain selected seminars and workshops to our clients and others. The topics discussed are listed below:

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

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

I. General Regulatory and Compliance Issues

The Current Economic Environment and Its Impact on Retail Investors

This panel primarily focused on new products and the likely rise in interest rates. The panelists noted that some clients have a fear of equities and are "chasing yields." Firms and advisers, therefore, must be careful about accurately assessing and describing safety and performance. Panelists stated that they believed firms are good at launching new products, but some are not as good at monitoring how the products are performing once they are sold. In addition, firms should focus on how performance changes as, for example, interest rates increase or market volatility increases.

The Financial Industry Regulatory Authority (FINRA) panel member made the following points:

- Review FINRA's annual letter on its priorities. Click here to access FINRA's letter;
- Don't sell what you don't know;
- Don't put profits ahead of compliance;
- Train brokers about products;
- Spend technology on new products, rather than, for example, relying on manual surveillance;
- Be aware of potential conflicts such as manufacturing and selling the same product; and

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- Don't compromise when supervising (violations often come about from inadequate procedures, training and supervision).

Key Legal Issues – Retail Firms

A panel consisting of General Counsel from Edward Jones, Morgan Stanley, Bank of America Merrill Lynch, UBS, and Wells Fargo, as well as outside counsel, discussed a number of key legal issues facing firms in 2011. The panel first discussed the potential impact of (1) the U.S. Securities and Exchange Commission (SEC) Study on Investment Advisers and Broker-Dealers required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act and (2) the proposal by the Department of Labor (DOL) concerning the definition of a fiduciary under the Employee Retirement Income Security Act (ERISA). Because no rules have been finalized, the panel expressed discomfort with the uncertainty, especially with respect to the rules proposed by the DOL. These rules, as conceived, include prohibitions on engaging in principal transactions in IRA and ERISA accounts, as well as restrictions on receiving fees or commissions in such accounts. Given that approximately 40% of accounts at firms (representing nearly 33% of total assets under management) are IRA accounts, the impact on firms is likely to be significant. Notably, unlike the SEC proposal, the DOL fiduciary standard does not permit disclosure to cure conflicts of interest and, thus, creates an absolute ban on principal transactions in IRA and ERISA accounts, potentially restricting the types of trades available in such accounts.

The panel also discussed the new FINRA Rules on suitability (Rule 2111) and "Know Your Customer" (Rule 2090). [*Ed. note*: Although, at the time of the seminar, these rules were to become effective on October 7, 2011, FINRA has subsequently filed a proposed rule change to push back the implementation date to July 9, 2012. Click here for the Legal Alert.] The panel noted that firms must decide how to go back to all of their customers and gather the new categories of information required by the new Rule 2111 (*i.e.*, age, other investments, financial situation and needs, investment experience, investment time horizon, liquidity needs, and risk tolerance). The new suitability rule requires firms to gather this information prior to making recommendations. Firms will need to determine, at likely great cost, how to gather the information and whether to restrict trading for accounts that do not have this new information on file.

Moreover, the panel discussed issues related to the supervision and document retention of registered representatives' use of social media and text messaging. The panel observed that most firms still do not permit registered representatives to use social media and text messaging given the large cost of document retention and potential costs involved in reviewing and producing these documents in litigation. Due to the popularity of social media and text messaging, however, some firms have begun pilot programs giving certain representatives limited access to social media for business purposes. The panel noted that the costs of supervision in these pilot programs have been high.

The panel also discussed the legal and regulatory issues presented by new, complex, and non-traditional products. Particularly, the discussion focused on the regulatory scrutiny of these products during a review of recent regulatory actions against firms and registered representatives selling these products, including life settlements, fully paid lending programs, private placements, variable annuities, reverse convertible notes, and collateralized mortgage obligations. Regulators have focused on fraud at the point of sale as well as the supervisory issues involved with these products.

Finally, the panel engaged in a robust discussion of the *Urban* decision and its impact on the role of firm management. *In the Matter of Theodore W. Urban*, SEC Admin. Proc. Initial Dec. No. 402, 2010 SEC LEXIS 2941 (Sept. 8, 2010) (Click here for the decision). In that case, the SEC brought an enforcement action against Theodore Urban, General Counsel of Ferris, Baker Watts, for an alleged failure to supervise despite the fact that Urban was not the direct supervisor for the registered representative at

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issue and despite the fact that Urban, among other things, recommended that the firm terminate the representative's employment. The Administrative Law Judge ruled that Urban was a supervisor for purposes of his role with the particular registered representative at issue but was not liable for failure to supervise. The panel discussed the implication of *Urban* and its potential chilling effect on lawyers within firms, given that the decision could be read to create a supervisory relationship for all lawyers who are asked to review a particular registered representative's situation and asked to render an opinion, binding or not, about whether and how to discipline the representative. The panel cautioned in-house counsel to ensure that they are aware of the potential ramifications of rendering advice on particular registered representatives and to ensure that their roles are clearly defined in internal documents to protect from potential *Urban* liability.

Dodd-Frank: Important Structural Issues

This panel discussed the work that lies ahead for the SEC, the Commodity Futures Trading Commission (CFTC), banking regulators, and the industry in trying to create a regulatory model for the swaps market. Panel members noted differences in jurisdiction between the SEC and CFTC and commented that, thus far, proposed regulations by these agencies are largely uniform. SEC staff on the panel stated that there is harmonization between the agencies but both agencies must also coordinate with banking regulators; staff also noted that it expects most entities in this market to register with both the SEC and the CFTC. The panel noted that the most important issues right now are margin and capital requirements and noted that differences of opinion exist between the CFTC and the Federal Reserve Board with regard to margin requirements for end-users; the CFTC appears willing to create an exception for end-users, but the Fed may have different views. SEC staff stated that it could not make any predictions regarding when to expect SEC proposals with respect to margin and capital requirements. SEC staff also stated that it has struggled with defining what constitutes a "block" trade in this market.

2011 State Regulatory Update

A panel including regulators as well as attorneys from the private sector discussed recent developments in state regulation of broker-dealers and investment advisers.

First, a representative from the North American Securities Administrators Association (NASAA) noted a rise in state investigations, enforcement proceedings and penalties over the prior year. NASAA's regulatory priorities for the upcoming year include: undisclosed conflicts of interest, "off the books" deals, online pitches and affinity fraud. With respect to specific products, the NASAA representative indicated a focus on foreign exchange traded funds, gold and precious metals, "green schemes" (which involve "investments" in environmental endeavors), and oil and gas deals. In the next year, state regulators intend to focus on Dodd-Frank implementation at the state level, collaborative efforts with federal regulators, and the creation of a uniform fiduciary standard for the industry.

The panel discussed at length "The Switch" from SEC to state investment adviser registration, affecting approximately 4,000 firms. Under the Dodd-Frank Act, investment advisory firms with less than $100 million of assets under management will switch from federal to state regulation by July 21, 2011. The panel encouraged affected investment advisers to affirmatively contact the states in which they will register for guidance about the process as well as to consult the NASAA Web site for additional information. The panel reminded the affected firms to review carefully all of its customer contracts, advertising and marketing materials, as well as other documents for registration references. The panel also reminded the firms that "The Switch" impacts individual registration and that all places of business for the affected individual should be considered for registration purposes.

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Compliance Issues for Large Retail Firms

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

The FINRA panel member stressed that firms need to comply with new rules by the effective dates. During exams, FINRA is primarily focused on what firms are doing to comply and is less focused on looking for enforcement actions unless firms completely ignore the rules.

Among the new compliance issues facing large firms is the use of social media. While many firms prohibit or restrict it, the panel agreed that firms are going to need to address the use of social media because clients are demanding the financial advisers use these new communication technologies. One interesting point that a panelist made was that because of the use of abbreviations, acronyms and writing words without vowels (*e.g.*, "cn u rd ths?"), lexicon searches will need to be adjusted and compliance review tightened.

Conflicts Management

This panel focused on recent developments impacting conflicts management at broker-dealer firms. Understandably, considerable attention was focused on provisions of the Dodd-Frank Act pertinent to conflicts for larger firms, such as the so-called "Volcker Rule" and conflicts relating to proprietary trading. In this regard, the panelists encouraged attendees to review the report issued in January by the Financial Stability Oversight Council, particularly on its study and recommendations on prohibitions on proprietary trading and certain relationships with hedge funds and private equity funds. This panel also referenced the rules proposed by the CFTC pursuant to the mandate under the Dodd-Frank Act that would require certain entities to adopt conflict of interest policies and procedures applicable to research activities relating to swaps.

The panelists also discussed different approaches for identifying and managing conflicts that can arise, including the use of commitment committees and other mechanisms. One panelist outlined a threefold framework for identifying conflicts between clients, conflicts between the firm and its clients (such as in the case of proprietary trades and valuation), and conflicts between the firm and its employees. To illustrate the conflict identification process, the panelists used a series of hypotheticals involving a complex trade proposal, structured product, research report and potential acquisition.

II. Regulatory Issues with Particular Products

Hedge Fund Challenges – The Hedge Fund Perspective

This panel began with registration-related issues for hedge funds. Dodd-Frank eliminates the private adviser exemption for investment advisers with less than 15 advisers. As a result, many hedge fund advisers are required to register no later than July 21, 2011. The threshold for SEC registration, however, has been raised from $50 million in assets under management to $100 million. Advisers with assets under management of less than $100 million must withdraw their SEC registration and register with their respective states. Advisers register with the SEC by filing Form ADV Parts 1 and 2, and they should pay careful attention to make sure the Part 2 narrative description does not constitute a "general solicitation" and thus compromise a private placement exemption.

The SEC also has proposed a Form PF for disclosure of holdings and leverage. In addition, proposed Rule 13H-1 would assign high volume traders a unique tracking number and require them to disclose to the SEC basic business information, as well as identification of any accounts over which these "large traders" exercise discretion. A "large trader" is defined as a person or entity that exercises discretion and trades (A) more than 2 million shares or $20 million in a day or (B) 20 million shares or $200 million in a month. A large trader must file the Form 13H after meeting the trading threshold and annually thereafter. The information on a Form 13H is deemed confidential and may not be released absent a request by Congress or by court order in an action brought by the SEC or a governmental agency. Broker-dealers will be required to monitor and report any "large traders" who do not have a unique tracking number.

Hedge Fund Challenges – The Broker-Dealer Perspective

This panel focused on hedge funds from the perspective of broker-dealers providing services to the hedge funds. In particular, the panel examined the duties, obligations and considerations for broker-dealers when their hedge fund clients encounter an "event," such as an indictment or subpoena. The panelists outlined first steps, such as collecting information regarding the client from all departments of the firm, reviewing all written agreements with the client, and convening a meeting of appropriate constituents from legal, compliance and operations to assess the situation and decide on next steps.

The panel also discussed the impact of recently adopted "pay-to-play" rules in the municipal area that have had an impact on hedge funds. In this regard, the panel discussed California and New York rules and prohibitions on contingent compensation for placement agents. One panelist noted that portfolio managers should consider whether they need to register as lobbyists under the new rules.

The panel briefly noted issues relating to the use of "expert networks," and the responsibilities of broker-dealers in connection with soft-dollar arrangements entailing fees for such networks. The panel also noted the SEC's large trader rule proposal.

Developments in Savings and Retirement Plans

This panel featured updates from Phyllis Borzi, Assistant Secretary of Labor for the Employee Benefits Security Administration, and Susan Nash, a senior staff person in the SEC's Division of Investment Management, on recent developments impacting savings and retirement plans. The Assistant Secretary of Labor reported on DOL's interim fee disclosure rule under Section 408(b)(2) of ERISA, requiring service provider disclosure to plan fiduciaries. She also reported on DOL's request for information on its lifetime income initiative in response to which DOL received more than 800 comment letters, as well as a soon-to-be released request for information on "e-disclosure" for ERISA plans. Finally, she reported briefly on DOL's initiative to update interpretive guidance on the definition of a "fiduciary" under ERISA.

Ms. Nash reported on the SEC's proposed rule for target date funds published in June 2010, noting that the SEC staff is evaluating comments on the rulemaking. She also reported on the staff's study of a potential uniform standard for broker-dealers and investment advisers, and the harmonization of their regulatory schemes, undertaken in response to a mandate in the Dodd-Frank Act. Both regulators emphasized the coordination and cooperation between the two agencies on issues of mutual concern and expressed their intention to work together.

There was considerable discussion among the panelists regarding the impact of the various proposals on the business activities of service providers to retirement plans and whether their service delivery models will need to be revised in response to changes in what activities will trigger fiduciary status under ERISA. Assistant Secretary Borzi expressed a preference for using DOL's authority to grant prohibited transaction exemptions to address industry concerns rather than revise the proposed fiduciary definition.

Equity Trading

This panel discussed rules or rule amendments that will have recently gone, or will shortly go, into effect in the trading area, including the "price test" amendments to SEC Regulation SHO (effective May 10, 2010; compliance date of February 28, 2011) and new SEC Rule 15c3-5 (Risk Management Controls for Brokers or Dealers with Market Access), effective January 14, 2011; compliance date of July 14, 2011). FINRA will be examining member firms for written policies and procedures that address how a firm determines whether an order is short, short exempt, or riskless principal. SEC staff indicated that it hopes to publish updated Regulation SHO "Frequently Asked Questions" (FAQs) soon. At this point, SEC staff is not likely to publish FAQs for new Rule 15c3-5 because it has not received many interpretative questions from broker-dealers. The staff seemed receptive, however, to answering such questions. SEC staff also clarified that Rule 15c3-5 will apply to fixed income broker-dealers. The panel also discussed the disciplinary action brought against Merrill Lynch on January 25, 2011 (press release here: http://www.sec.gov/news/press/2011/2011-22.htm), with SEC staff stating that the case should be studied by broker-dealers for what it says about a broker-dealer's obligation to protect customer information and a broker-dealer's obligation to accurately disclose its order routing practices to customers. SEC staff also indicated that SEC Chairman Mary Schapiro wants to move ahead with post-Flash Crash initiatives, as well as a consolidated audit trail and large trader reporting.

Equity Market Structure Issues

This panel discussed the SEC's Concept Release on Equity Market Structure (issued January 19, 2010) and the SEC staff's opinions regarding likely follow-up actions by the Commission. SEC staff indicated that, in the short term, the staff would like to update Regulation NMS Rule 605 (Disclosure of Order Execution Information) and enhance broker-dealer obligations to disclose their order routing strategies to customers. SEC staff also stated that a consolidated audit trail and the large trader rule remain priorities. SEC staff would not comment on whether leveraging FINRA's OATS system is a possibility with respect to the consolidated audit trail; instead, the staff stated that its audit trail proposal is intentionally neutral. Ideally, the staff would like to begin the audit trail with NMS securities and then expand its coverage to all securities and then futures. The panel also discussed further likely regulatory responses to the May 6, 2010 "Flash Crash." In this regard, SEC staff on the panel stated that it favors the adoption of a "limit up/limit down" rule (which was proposed by the exchanges on April 5, 2011). The panel also discussed the Volcker Rule, noting that because the rule does not apply outside the U.S., non-U.S. financial institutions may have a competitive advantage.

III. Particular Regulatory Issues

AML Compliance Hot Topics

A panel including compliance officers, in-house counsel, and a FINRA representative discussed recent developments in the area of Anti-Money Laundering (AML).

The panel began the discussion with the Joint Guidance issued by the Financial Crimes Enforcement Network (FinCEN), banking regulators and the SEC, which consolidated the existing regulatory requirements that banking financial institutions must follow when obtaining beneficial ownership information for certain accounts. The Joint Guidance mandates that financial institutions establish and maintain Customer Due Diligence (CDD) procedures as part of their Bank Secrecy Act/AML compliance programs. The panel noted that the CDD procedures should be tailored to the financial institution's business; however, the panel recognized the difficulty in providing concrete guidance regarding what accounts must be subject to the verification process. Once the financial institution sets parameters to identify "higher risk" accounts (which may include offshore trusts, shell corporations, or accounts that exhibit unusual trading activity), the financial institution may need to identify and verify beneficial owners, reasonably understand the sources of funds in the account and the relationship between the customer and beneficial owner. With respect to institutional accounts, the panel identified "red flags" of suspicious activity that firms should consider: (1) flat accounts; (2) a significant increase in trading activity at the end of the month; (3) continuous attempts to exceed trading limitations; and (4) breaking up trades into smaller amounts.

The panel also discussed a number of recent enforcement actions that involved significant sanctions. For example, in Pinnacle Capital Markets, LLC (FinCEN/SEC/FINRA 2010), the regulators alleged a failure to implement an adequate AML program by: (1) not employing an automated system for review of transactions; (2) not tailoring its procedures to reflect the heightened risks posed by foreign customers; and (3) not implementing independent testing of the program. The regulators also alleged that the firm failed to establish and implement a risk-based due diligence program for correspondent accounts. Pinnacle paid $25,000 and $300,000 in fines to the SEC and FINRA, respectively, and agreed to certain undertakings, including AML training for its employees and the hiring of an independent consultant to review its AML compliance program. Similarly, Pension Financial Services (FINRA, 2010), a clearing broker-dealer, paid a $450,000 fine to FINRA for failing to establish automated systems which would, in part, assist introducing brokers with identifying suspicious activity.

Finally, the panel discussed statements from the DOJ and SEC indicating that the Foreign Corrupt Practices Act is a high enforcement priority. Moreover, the panel observed that the Foreign Account Tax Compliance Act goes into effect on January 1, 2013. This new Act regulates offshore account reporting and will require foreign banks to report and disclose American interest in foreign financial institutions. On September 30, 2010, FinCEN issued a notice of proposed rulemaking that would require certain depository institutions and money services businesses to affirmatively produce–not just maintain–information to FinCEN regarding certain cross-border transactions.

Senior Investors

A panel from the SEC, law firms, in-house counsel, FINRA, and the AARP discussed issues related to senior investors. The panel first discussed marketing to the senior client, especially in light of the fact that baby boomers today control more than $13 trillion in household investable assets or more than 50% of total U.S. household investment assets. The panel discussed possible practices, including (1) banning securities professionals from using marketing materials to target particular age groups, (2) providing an online brochure for employees with detailed instructions describing the approval process required for seminars where seniors may be invited, and (3) providing a library of materials approved by compliance personnel. The panel also discussed preventing the use of misleading senior designations in marketing and communications with the public.

The panel also grappled with the interplay between FINRA's Regulatory Notice 07-43 on senior investors and the new suitability rules now planned to become effective on July 9, 2012. Notably, the panel discussed how the inclusion of age, liquidity, and investment time horizon codifies the main aspects of 07-

43. Moreover, the new rule specifically imposes a suitability obligation on recommendations to hold and on investment strategies—two items that particularly affect seniors who may have long-term positions and strategies in place. The SEC's John Fahey specifically explained that, while there is no heightened standard for dealing with senior customers, regulators are particularly concerned about seniors because many are retired and have no other sources of income and have little time to allow their assets to recover if they lose money.

Finally, the panel discussed products that may prove problematic for seniors, including variable annuities, complex or illiquid products, and life settlements. The regulators continue to take hard looks at these products as they relate to the ever-growing senior population. The panel also discussed potential red flags involved in elder abuse, such as the following: a new power of attorney given to a non-relative; changed mailing address to an unfamiliar and unexplained address; unavailability of the investor to talk when contacted; an investor who is isolated from friends and family; a sudden, unexplained, or unusual change in the investor's transaction patterns; unexplained disbursements made in an investor's account that are outside of the norm; and the sudden appearance of a new individual involved in the investor's financial affairs.

Dodd-Frank: Investor Protection

A panel of in-house counsel, outside counsel, and SIFMA counsel discussed new provisions of Dodd-Frank related to investor protection. The panel first discussed Dodd-Frank's provisions that require the SEC to study two issues: (1) the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers, and associated individuals for providing personalized investment advice and recommendations about securities to retail customers and (2) whether there is a need to address, by rule or statute, any legal or regulatory gaps, shortcomings or overlaps in legal or regulatory standards of care imposed on brokers, dealers, investment advisers or associated individuals for the protection of retail customers. The panel observed that the SEC study recommended the adoption of a uniform fiduciary duty standard over the objection of the two Republican Commissioners. Given the objections of the Republican Commissioners, the panel predicted that the study would not lead directly to rulemaking and predicted further study would be needed to satisfy the concerns of the dissenters. As with other panels addressing this topic, this panel expressed great concern over the DOL's proposals concerning the imposition of a fiduciary duty standard to IRA and ERISA accounts with no ability to cure conflicts through disclosure.

The panel likewise discussed Dodd-Frank Title IX § 921, which grants the SEC the authority to reaffirm, prohibit, or impose conditions or limitations on mandatory predispute arbitration agreements between broker-dealers, investment advisers and customers. Notably, the new provision does not set a timetable for rulemaking and does not require the SEC to promulgate rules on these agreements. The panel predicted that the SEC would not immediately act on this provision given the fact that Dodd-Frank does not require immediate action and given the other numerous requirements for SEC rulemaking within the Act. The panel noted that Public Investors Arbitration Bar Association's (PIABA) position on the subject is not to eliminate customer arbitrations entirely but rather to make arbitration optional for customers. This would eliminate mandatory arbitration but permit customers the choice of whether to file in court or in arbitration. Thus, the panel observed, customers and their attorneys would be able to pursue stronger claims in court but maintain weaker claims—potentially claims that would be subject to legal defenses in court—in arbitration, where there is less assurance that legal defenses will be recognized. Finally, the panel raised a potential problem with the scope of the Dodd-Frank provisions relating to mandatory arbitration. These provisions relate only to federal claims and are silent as to state claims. This possible limitation could create a problem for claimants who wish to bring their state claims in court despite a mandatory arbitration clause if the SEC bans predispute, mandatory arbitration with respect to federal claims only.

The panel also discussed Dodd-Frank Title IX § 929, which requires the SEC to conduct a study on whether private rights of action for aiding and abetting should be granted to investors. A report from the SEC addressing this issue is due in July.

Finally, the panel spent a considerable time discussing the whistleblowing provisions of Dodd-Frank. The Act directs the SEC to pay whistleblowers—individuals providing to the SEC “original information” relating to a securities law violation—a 10% to 30% award of the monetary sanctions imposed upon a violator in SEC enforcement actions where monetary sanctions exceed $1 million. The new law protects whistleblowers even if they are involved in the wrongdoing of which they complain and protects them from being terminated pursuant to the anti-retaliation provisions of the Act. Indeed, the Act refuses to protect a wrongdoing whistleblower only if he/she is criminally convicted of the wrongdoing at issue. The panel discussed how this system appears to encourage wrongdoers to report their own wrongdoing to the SEC in an effort to prevent being fired.

Employment: High Profile Issues

This panel, consisting of employment counsel from both the industry and law firms, focused on recent high profile issues in the employment area, including new whistleblower protections under Dodd-Frank. Some of the most controversial areas of the Dodd-Frank Act are the expanded incentives and protections for whistleblowers. Dodd-Frank authorizes the SEC to reward eligible whistleblowers with cash awards from 10% to 30% of the monetary sanctions collected by the SEC in excess of $1 million. The amount of the award ultimately paid is left to the discretion of the SEC. To be eligible for this bounty, a whistleblower must voluntarily provide the SEC with “original information” (as defined by the Act) “that leads to the successful enforcement by the SEC of a federal court or administrative action.” Certain employees are ineligible for an award under this Act, including but not limited to, those employees with a legal or contractual duty to report or employees in legal, compliance, audit, supervisory, or governance positions charged with investigating possible misconduct. Dodd-Frank also provides whistleblowers with a private right of action for retaliation claims in federal court. The Act provides significantly more remedies for retaliation claims compared to Sarbanes-Oxley. Remedies under Dodd-Frank include reinstatement, double back pay, interest, and attorney’s fees and costs.

The panel also discussed legal developments in the social networking arena, including *American Medical Response of Connecticut, Inc.* (AMR) NLRB Reg. 34, No. 34-CA-12576 (Oct. 27, 2010), which involved an employee who, after allegedly being denied a request for union representation during an investigatory interview, posted insulting comments about her supervisor to her Facebook page, spurring additional comments from coworkers. At the time, AMR had a blogging and internet policy that prohibited employees from making disparaging or defamatory comments about the company and/or supervisors, coworkers, and competitors. The employee was subsequently terminated. The National Labor Relation Board and AMR reached a settlement whereby AMR agreed to revise its blogging and internet policy so that employees were not prohibited from discussing wages, hours, and working conditions with coworkers and others while not at work. The panel members discussed the pros and cons of having an anti-disparagement provision in their compliance and/or HR manuals. Also within the discussion of social media, the panel discussed potential consequences when decision-makers use social media sites or other internet postings to run background searches on potential employees during the hiring process. The panel recommended that if social media is used during the hiring process, a non-decision maker should be running the searches and should only provide the decision-maker with appropriate information. Further, written records should be kept, and firms should have a clear training policy implemented detailing what searches can be made and what information should and should not be obtained.

Finally, the panel discussed DOL and Equal Employment Opportunity Commission statistics and recent wage and hour employee classification and off-the-clock claims, and provided an update on legislative

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and regulatory initiatives. The panel expects the DOL to push to have more workers classified as nonexempt.

IV. Exams and Investigations

Handling a Regulatory Investigation

This panel discussed various ethical and legal considerations implicated by regulatory investigations of broker-dealer firms. Using a series of hypotheticals, the panel discussed the SEC's new Cooperator Policy, proposed whistleblower rules, submission of a Wells notice, self-reporting and handling multiple investigations.

The panel was joined by George Canellos from the SEC's enforcement division. Mr. Canellos reported briefly on the enforcement division's experience with its cooperator policy, noting that there have been 21 cooperation agreements and one non-prosecution agreement so far. With regard to a discussion of the impact a Wells notice may have on the careers of individuals registered with broker-dealers, Mr. Canellos encouraged discussion early in the process but acknowledged that the practice is not uniform among attorneys in the SEC's enforcement division.

Examination by Regulators—The Regulator Perspective

This panel, moderated by SIFMA Compliance & Legal Society Executive Director R. Gerald Baker, consisted of Arthur Angulo, SVP Bank Supervision Group of the Federal Reserve Bank of New York; Susan Axelrod, FINRA Executive Vice President Member Firm Regulation; Carlo di Florio (via phone), Director Office of Compliance Inspections and Examinations of the SEC; and Grace Vogel, FINRA Executive Vice President Member Firm Regulation. Panel members identified examination priorities for 2011.

FINRA's 2011 exams will focus on the following areas:

- Verification and protection of customer assets;
- Structured products and sales to retail investors, including leveraged exchange traded funds (ETFs), principal protected notes, reverse convertibles, and life settlements;
- Variable annuities, with a focus on FINRA Rule 2821 and the use of variable annuities in lieu of life settlements;
- Use of social networks and e-communications to the public;
- Fraud detection (including affiliate relationship, money movement);
- Alternative investments;
- Unregistered sales of restricted securities;
- Private placements/Regulation D offerings with focus on accredited investor status, suitability, communications, and due diligence by the firm;
- Trading in non-public securities;
- High yield investments;
- Municipal securities;
- Online trading Web sites (emulating trading strategies of "experts");
- Closed-end funds (yield versus trading at a premium);
- Fraud elements;
- Compensation practices (recruiting registered representatives);
- Accounting controls;
- Use of margin (day trading accounts, leveraged ETFs, credit default swaps);

- Anti-money laundering;
- Information barriers;
- Valuations (for instance, with firms with sizeable municipal bond portfolios, FINRA will look at the municipal bond valuations);
- High frequency trading;
- Outsourcing;
- Intercompany activities;
- Reg. SHO
- High frequency trading, algorithms, trading pauses;
- Sponsored access;
- Liquidity;
- Consolidated accounting statements;
- Vulnerable customers; and
- Outside business activities and professional designations.

The SEC's exam priorities and key risk areas for 2011 include:

- Risky products, including complex securities, leveraged ETFs, and fixed income products;
- Retail distribution channels;
- Asset verification;
- Derivatives market;
- Executive compensation;
- Mortgage backed securities;
- Enterprise risk management; and
- Best execution and short sales.

Panel members also discussed improvements that their organizations were making to their respective exam processes. For instance, the SEC has developed an enhanced risk-based approach to its exam process so that its examiners are more focused on a firm's key risk areas. The SEC has also brought experts on board in critical areas, such as derivatives and structured products, to assist in the exam process. FINRA, too, is enhancing its risk-based focus on exams and eliminating low-risk, low-yield elements in its exams. Further, FINRA will be focusing more on high-risk branch offices. FINRA has also made significant changes to the structure of its district offices and its member application process. The Federal Reserve is making changes to its supervision of banks and, among other things, will be seeking more detailed data requests from firms and will place teams onsite at the largest firms.

V. Arbitrations

Arbitration-Related Panels

George Friedman, Executive Vice President and Director of Dispute Resolution at FINRA, discussed arbitration filing trends. In 2010, parties filed 5,680 cases, a 20% decrease compared to the 7,137 cases filed in 2009. Customer claims decreased by 28% in 2010 compared to 2009. In 2010, customers were awarded damages in 47% of the cases, up from 42% in 2008 and 45% in 2009. Cases are going to hearing 48% of the time, up from 42% in 2008. Processing times from service of claim to the close of the case are 12.7 months, a 10% increase from 2009, and cases that go to hearing are taking 15 months, up 7% from 2009. Cases involving mutual funds and individual securities are the two most commonly filed claims.

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The panel also discussed the impact of FINRA's new all-public arbitrator rules, which went into immediate effect on February 1, 2011. Under the rule change, FINRA provides customers with the option to choose between two panel selection methods before FINRA sends the lists of arbitrators to the parties. One option continues to provide for a panel of one chair-qualified public arbitrator, one public arbitrator, and one non-public arbitrator (Majority Public Panel Option). The new option under the rule change allows parties to select an all-public arbitration panel (All-Public Panel Option). The new rules are the result of the all-public pilot program that ran from October 2008 through February 2011. Under the pilot program, all-public panels issued 22 awards, granting customers monetary damages in 67% of the cases as compared to a 48% success rate in non-pilot program cases. While the sample size is small, the statistics suggest that all-public panels may be more likely to award damages than majority public panels. Not surprisingly, the initial report is that claimants are opting for all-public panels in the vast majority of the post-effective-date cases.

The panels discussed the proposed rule changes to the Discovery Guide, which were approved by the SEC on April 1. The new proposal: (1) replaces the 14 current document production lists with two lists – one for customers and one for firms/associated persons. Each item on the lists (with a few exceptions) would be presumptively discoverable in every customer case; (2) clarifies that arbitrators may order that certain documents do not have to be produced in a particular case; (3) specifies that only named parties must produce documents pursuant to the Discovery Guide; (4) expands the discussion of arbitrator confidentiality orders; and (5) clarifies that parties are not required to create documents in response to items on the lists. *See* Release No. 34–664166; File No. SR-FINRA-2010-035. The panel discussed the new Discovery Guide provisions that expressly include electronic files within the definition of "documents" and the considerable burdens that may be imposed on broker-dealers in responding to onerous discovery requests. Also, the new Discovery Guide directs arbitration panels to take into consideration the type of firm involved in the case (*e.g.,* full service firm, discount firm, clearing firm, or online broker) in determining the appropriate discovery.

VI. Issues for Securities Attorneys

General Counsel Roundtable

Panel discussion centered on an increasing personal liability imposed on general counsel, including an increase in the number of enforcement actions brought by the SEC against corporate attorneys for misconduct. There was a good deal of discussion by this panel, and several others, concerning the decision in *In the Matter of Theodore W. Urban* (Click here for the decision). In this case, a general counsel was deemed to be a "supervisor" even though "he did not have any of the traditional powers associated with a person supervising brokers," yet his opinions as general counsel "were viewed as authoritative and his recommendations were generally followed … ." *Urban* was described as an unwarranted expansion of the Commission's *Gutfreund* factors. The decision is on appeal by both sides to the full Commission and has been the subject of an amicus brief jointly filed by SIFMA and the Association of Corporate Counsel. The SEC takes issue with the decision, arguing that it creates a "futility defense" for supervisors. *Urban* undoubtedly will be the subject of continued discussion and analysis.

The whistleblower protection provisions under Section 922 of Dodd-Frank may impact the role traditionally played by in-house counsel and compliance personnel in the investigation and remedy of alleged internal wrongdoing. In-house counsel generally do not qualify as "whistleblowers" unless the subject entity fails to disclose the misconduct to the SEC within a reasonable time or proceeds in bad faith. The Dodd-Frank whistleblower provisions apply to all companies, including non-public, and thus is substantially broader than the Sarbanes-Oxley whistleblower provision, which is limited to public companies and their contractors and agents, including in-house counsel.

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Ethical Considerations for a Securities Lawyer

The panel spent a considerable amount of time discussing the *Rivera* decision, a recent New York case involving the following factual scenario: an outside lawyer representing a corporation in pending litigation contacted present and former employees to notify them that they were expected to be fact witnesses in a case, and in the course of the conversation, the lawyer told an employee that the lawyer's firm would be available to represent the employee in his capacity as a witness at the company's expense. *Rivera v. Lutheran Medical Center*, 22 Misc.3d 178 (Sup. Ct. Kings Co. 2008), *aff'd*, 73 A.D.3d 891, 899 N.Y.S.2d 859 (N.Y. App. Div. 2010). The court was faced with the issue of whether the lawyer's conduct violated his ethical obligations by soliciting and offering free representation to witnesses.

In *Rivera*, the law firm representing a hospital identified the various current and former employees who were potential witnesses in response to interrogatories but instead of providing their home addresses and telephone numbers, as requested, listed their contact information as "c/o" the law firm. When plaintiff's counsel demanded direct contact information, the law firm stated that all of the individuals were represented in their capacity as witnesses by the law firm. Prior to submitting the interrogatories, the firm had contacted the individuals by telephone, offering to represent them at the hospital's expense, and the witnesses had all agreed to be represented by the law firm.

In that case, the court held that the attorney violated New York Rule of Professional Conduct 7.3 and referred the firm to the Disciplinary Committee for potential sanctions. Rule 7.3 generally defines "solicitation" as "any advertisement initiated by or on behalf of a lawyer or law firm that is directed to, or targeted at, a specific recipient or group of recipients, or their family members or legal representatives, the primary purpose of which is the retention of the lawyer or law firm, and a significant motive for which is pecuniary gain." The rule also provides that "A lawyer shall not engage in solicitation . . . by in-person or telephone contact, or by real-time or interactive computer-accessed communication unless the recipient is a close friend, relative, former client or existing client."

The panel discussed the case and cautioned that lawyers in New York should tread carefully when contacting witnesses and offering representation. On a motion to disqualify filed by plaintiff's counsel, the court found that, even though there was no conflict of interest in representing the hospital and its witness employees, the firm had violated the solicitation rule as to four of the seven listed witnesses. The court's determination turned on the witnesses' ability to bind the company. Because three of the potential witnesses had the ability to bind the company, the court held that they were tantamount to parties and could not have been contacted directly by plaintiff in the case. Thus, the defense counsel's actions in offering representation did not violate the solicitation rule. As to the remaining four witnesses, the court held that the witnesses were not in a position to bind the company and thus were nonparty witnesses. The court held that, but for these four individuals' retention of the hospital's counsel at that counsel's suggestion, the plaintiff's counsel could have communicated directly with those four individuals and interviewed them *ex parte* without the prior knowledge or presence of the hospital's counsel. The court determined that defense counsel's offer of free services to the nonparty witness was an improper solicitation and an improper attempt to prevent opposing counsel's permissible fact witness interviews.

Moving on, the panel focused on the potential ethical issues associated with social networking, blogs and other forms of "new media." The panel noted the potential for the perceived informal nature of various new media sources to lull either the attorney or a client into a false sense of security. In pointing to disparate decisions regarding the privacy expectations that should be attributed to statements made on Web sites such as facebook.com, the panel made apparent that the landscape in this area is far from clear.

In addition, the panel discussed the potential ethical issues related to blogging. Model Rule 1.6 requires that lawyers maintain the confidentiality of their clients' information. This duty encompasses not only attorney-client privileged information, but also information which clients request remain confidential. Even an attempt at anonymous blogging that reveals confidential client information could subject an attorney to disciplinary action.

Ethical Considerations for the Compliance Department Lawyer

This panel focused on the role of a lawyer in a broker-dealer's compliance department in light of the conflicts that can arise from the multiple roles that such lawyers may play. Using a hypothetical situation for illustration purposes, the panel discussed the various ethical and compliance issues for lawyers. Beginning first with a discussion of everyday internal communications, the panelists noted the benefits of a lawyer's identifying his or her relevant role in each of these communications and emails. The panelists also offered practice pointers on gathering and presenting information in response to regulator inquiries in order to avoid being cast as the "fact witness" for the response.

This panel also discussed the role of lawyers on internal committees, including compliance committees that may have the authority to impose heightened supervision on a registered person. In this regard, the panelists focused on what actions or activities might cause a lawyer to "cross the line" and take on supervisory responsibility for the registered person being placed on heightened supervision. One of the panelists noted that, once a person takes on the responsibility, that person must exhaust all powers available in order to meet supervisory standards.

Finally, the panel discussed whether and in what circumstances attorney-client privilege attaches to communications involving lawyers in the compliance department. Several panelists offered tips for handling the minutes of compliance committee meetings that encompassed discussion of privileged information in order to better ensure that the privileged discussions remain privileged.

One panel member suggested reading two articles written by Sutherland attorneys on compliance officer and in-house counsel liability:

- Click here for "While You Were Complying: SEC and FINRA Disciplinary Actions Taken Against Chief Compliance Officers"
- Click here for "While You Were Complying: SEC and FINRA Disciplinary Actions Taken Against Chief Compliance Officers (Again)"

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