GC and CCO Risks and Safeguards: Ethics in Practice

24TH ANNUAL
PRIVATE INVESTMENT FUNDS SEMINAR
JANUARY 21, 2015

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Practices

Regulatory & Compliance
Hedge Funds
Investment Management
Litigation

Marc E. Elovitz

Marc is the chair of SRZ's Investment Management Regulatory & Compliance Group. He advises private fund managers on compliance with the Investment Advisers Act of 1940 and other federal, state and self-regulatory organization requirements, including establishing compliance programs, registering with the SEC and CFTC, and on handling SEC and NFA examinations. Marc provides guidance to clients on securities trading matters and represents them in regulatory investigations and enforcement actions, arbitrations and civil litigation. He also regularly leads training sessions for portfolio managers, analysts and traders on complying with insider trading and market manipulation laws, and has developed and led compliance training sessions for marketing and investor relations professionals. Marc works closely with clients undergoing SEC examinations and responding to deficiency letters and enforcement referrals. He develops new compliance testing programs in areas such as trade allocations and conflicts of interest. He also leads macro-level compliance infrastructure reviews with fund managers, identifying the material risks specific to each particular firm and evaluating the compliance programs in place to address those risks.

The Legal 500 United States, *Who's Who Legal: The International Who's Who of Private Funds Lawyers* and *New York Super Lawyers* have recognized Marc as a leading lawyer in his field. He is a member of the Steering Committee of the Managed Funds Association's Outside Counsel Forum, the American Bar Association's Hedge Funds Subcommittee and the Private Investment Funds Committee of the New York City Bar Association. A prolific writer in his areas of expertise, Marc recently co-authored "JOBS Act Update: CFTC Relief Removes Impediment to General Solicitation" for *The Hedge Fund Journal*. He is also a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press), the "Protecting Firms Through Policies and Procedures, Training, and Testing" chapter in the *Insider Trading Law and Compliance Answer Book* (Practising Law Institute, 2011-2015) and the "Market Manipulation" chapter in the leading treatise, *Federal Securities Exchange Act of 1934* (Matthew Bender). He also wrote the chapter on "The Legal Basis of Investment Management in the U.S." for *The Law of Investment Management* (Oxford University Press). Marc is also frequently invited to discuss current industry-related topics of interest at leading professional and trade association events. He most recently presented "Staying Ahead of the Curve(ball): How to Respond as Authorities Shift Focus from Creating New Regulations to Enforcing Them," at the Houlihan Lokey 2014 Alternative Asset Valuation Symposium, and "SEC Inspections and Examinations of Hedge and Private Equity Funds," at the PLI Hedge Fund and Private Equity Enforcement and Regulatory Developments 2014 conference.

Marc received his J.D. from New York University School of Law and received his B.A., with honors, from Wesleyan University.

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Bill represents financial institutions and officers and directors in complex commercial litigation, including securities fraud actions, fraudulent transfer actions, mergers and acquisitions litigation, private post-acquisition disputes and derivative actions. His clients have included leading hedge funds, private equity firms, major corporations, investment banks, prime brokers, lenders and individuals. Bill has substantial trial experience, having tried cases in federal and state courts throughout the United States and in a variety of alternative dispute resolution venues, including AAA, FINRA and JAMS arbitrations. He frequently litigates in bankruptcy court, often representing creditors in enterprise valuation and asset ownership disputes, and he has broad experience representing both buyers and sellers in deal-related disputes, including in shareholder class actions. He has also assisted clients in connection with SEC investigations. Bill's jury trial experience includes the successful defense of a leading prime broker in a $141.4-million fraudulent transfer action brought by the trustee of a defunct hedge fund. In that two-week federal trial, he helped to secure a unanimous verdict in favor of the prime broker. He is currently representing a former officer and director of Merck & Co. in connection with proceedings relating to the painkiller Vioxx. That high-profile matter has included the defense of federal and state securities law claims, breach of duty claims, product liability claims and other matters.

Recognized as a leading litigator by *The Legal 500 United States*, Bill is a frequent speaker and writer on a wide range of topics. He recently co-authored "Beyond *Halliburton*: Securities Fraud Class-Action Appeals to Watch" for *Westlaw Journal — Securities Litigation & Regulation*, and he contributed "Obtaining Information from Corporate Insiders" to the *Insider Trading Law and Compliance Answer Book* (Practising Law Institute). His speaking engagements include addressing the FEA's Private Equity Litigation and Liability Avoidance: Practical Advice Regarding "Alter Ego" Liability and Post-Acquisition Disputes conference and presenting "Recent Court Decisions Affecting Distressed Investors" at the SRZ 3rd Annual Distressed Investing Conference.

Bill received his J.D. from Harvard Law School and his B.A., *summa cum laude*, from Dartmouth College, where he was Phi Beta Kappa.

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David Nissenbaum

David's practice focuses on corporate, bank regulation and securities matters and he primarily represents institutional and entrepreneurial investment managers, financial services firms and private investment funds in all aspects of their business. David structures and advises investment management and financial services firms as well as hedge, private equity, credit, distressed investing and hybrid funds, funds of funds and scalable platforms for fund sponsors. He also advises on management company partnerships, succession planning, seed capital deals, mergers and acquisitions of investment firms and on all aspects of U.S. banking laws that affect investment and financial services firms and investment funds, including investments in banking organizations, bank-sponsored funds and investments in funds by banking organizations.

David has been recognized by *Chambers Global*, *Chambers USA*, *Expert Guide to the World's Leading Investment Funds Lawyers*, *The International Who's Who of Private Funds Lawyers*, *The Legal 500 United States* and *PLC Cross-border Private Equity Handbook*. A member of the advisory board of The Financial Executives Alliance and past member of the Banking Law Committee of the New York City Bar Association, David is a sought-after writer and speaker in his areas of expertise. "Just Like Starting Over: A Blueprint for the New Wall Street Firm," published by *The Deal*, "Hedge Fund Manager Succession Planning" and "Federal Reserve Provides Greater Flexibility for Non-Controlling Investment in Banks and Bank Holding Companies" are among his publications, and he also co-authored the chapter "Management Company Structures and Terms" in *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). David recently participated in "The Final Volcker Rule: What Private Fund Managers Not Affiliated with a Bank Need to Know," an SRZ webinar, and presented a talk on capital raising at a prior SRZ Annual Private Investment Funds Seminar.

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Lisa A. Prager

Lisa represents corporations and individuals in a wide variety of federal criminal and regulatory matters. She focuses on government investigations and enforcement actions relating to the Foreign Corrupt Practices Act (FCPA), U.S. export controls and economic sanctions laws, anti-money laundering laws, the Dodd-Frank Act's whistleblower provisions and government contracts matters. She represents clients before multiple U.S. enforcement agencies and bodies, such as the U.S. Department of Justice, Department of Commerce, Department of State, Department of the Treasury's Office of Foreign Assets Control, Securities and Exchange Commission, and other authorities. Lisa conducts extensive internal investigations on behalf of multinational corporations and has represented them and their boards in FCPA and export control matters involving issues arising around the world. In connection with these investigations, she provides advice to general counsels and senior management regarding company practices, remedial measures such as compliance program enhancements and disciplinary action for company employees, and settlement options. She also works with companies in the administration of consent decrees, monitorships and other post-settlement agreements. In addition, she represents individuals in white collar criminal matters, including representing senior management in FCPA and export control investigations. Prior to entering private practice, Lisa was an Assistant U.S. Attorney for the District of Columbia and Acting Assistant Secretary and Deputy Assistant Secretary for Export Enforcement at the U.S. Department of Commerce's Bureau of Industry and Security. Her work at the Department of Commerce included managing many of the agency's largest export control settlements and indictments to date, including criminal investigations related to Chinese exports and the freight-forwarding industry. As an Assistant U.S. Attorney, Lisa handled federal cases involving terrorism, wire and mail fraud, economic espionage, and export control violations, among many other matters.

Recognized by *The Legal 500 United States* in the area of White Collar Criminal Defense, *The International Who's Who of Investigations Lawyers* and *New York Super Lawyers*, Lisa is a member of the American Bar Association, the AUSA Association and the International Bar Association. She frequently speaks on topics in the area of the FCPA and U.S. export controls. She recently participated in "FCPA, M&A and Private Equity," an SRZ webinar, and she presented "Regulatory Examinations and Enforcement" at the SRZ 23rd Annual Private Investment Funds Seminar. She is a co-author of "Sanctions Update: Sectoral Sanctions Against Russia Escalate," which was published in the *Westlaw Journal — Securities Litigation & Regulation*.

Lisa earned her J.D., *magna cum laude*, from Western New England College School of Law and her B.A. from Yale University.

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Howard Schiffman

Howard is co-chair of SRZ's Litigation Group. Nationally known in the area of securities litigation and regulatory developments, his practice focuses on investigations and enforcement proceedings brought by various exchanges and government agencies, including the SEC, the DOJ and FINRA, as well as a diverse array of civil litigation, including securities class actions and arbitrations. A corporate problem solver, Howard is as adept at dispute containment and resolution as he is at arguing to a jury. He counsels clients, including major financial institutions and investment banks, leading Nasdaq market-makers, institutional and retail brokerage firms and their registered representatives, trade execution and clearing firms, prime brokers, national accounting firms, hedge funds, and public and private companies and their senior officers in risk analysis and litigation avoidance. With his extensive trial experience and solid record of success in numerous SEC enforcement actions, SRO proceedings and FINRA arbitrations, Howard has the confidence to take a case to trial when necessary. Recently, he won dismissal on statute of limitations grounds in the U.S. Court of Appeals for the Second Circuit for The Royal Bank of Scotland Group, as successor to National Westminster Bank PLC, of a suit brought by investors alleging fraud in connection with loans related to a tax shelter scheme known as Bond Linked Issue Premium Structure, or BLIPS. He also obtained victories in other significant matters, including prevailing in a price adjustment case involving the dispute of several hundred million dollars for a portfolio of real estate mortgages. He also represented the former CEO of the largest Nasdaq market-making firm, Knight Securities, in a federal court action brought by the SEC. After a 14-day bench trial, all parties were completely cleared of wrongdoing. Howard began his career as a trial attorney with the SEC Division of Enforcement. In private practice for more than 30 years, he has long been at the forefront of securities litigation and regulatory developments, including his current representation of hedge funds, leading prime brokers and clearance firms in regulatory and civil litigation.

Howard was included in *Washingtonian* magazine's "800 Top Lawyers" listing (a ranking of "Washington's best — the top one percent") and in *Washington DC Super Lawyers*, and he has been recognized by *Chambers USA*, *The Legal 500 United States*, *Benchmark Litigation* and *Lawdragon* as a leading individual in the securities regulation area. He is a member of American Bar Association sections on Litigation, Corporation, Finance and Securities Law and was a director and former president of the Association of Securities and Exchange Commission Alumni Inc. He is the author of the "Tipper and Tippee Liability" chapter in the *Insider Trading Law and Compliance Answer Book* (Practising Law Institute) and most recently presented "Insider Trading and Dealing with Reputational and Operational Risk" at the HFMWeek U.S. Operational Leaders Summit.

Howard received his J.D., *cum laude*, from Fordham University School of Law, where he was a member of the *Fordham Law Review*, and his B.A., *cum laude*, from Colgate University.

GC and CCO Risks and Safeguards: Ethics in Practice

I. Regular Operations of the Business

A. Who Is the Client?

1. Entity Theory: A Lawyer Represents *the Organization*

(a) General Rule

(i) A lawyer employed or retained by an organization *represents the organization* acting through its duly authorized constituents.[1]

A lawyer representing only an organization does not owe duties of care, diligence or confidentiality to constituents of the organization.[2]

(ii) A lawyer *shall explain* the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.[3]

(1) By representing the organization, a lawyer does not thereby also form a client-lawyer relationship with all or any individuals employed by it or who direct its operations or who have an ownership or other beneficial interest in it, such as its shareholders.[4]

(iii) Rule 4.3 of the Model Rules of Professional Conduct reinforces a lawyer's obligation to explain the identity of the client by stating that "[w]hen the lawyer knows or reasonably should know that an unrepresented person misunderstands the lawyer's role in the matter, the lawyer shall make reasonable efforts to correct the misunderstanding."[5]

(b) Corporate Form Variations

(i) Closely Held Corporation

Even where a corporation only has one shareholder, a corporation exists as an entity apart from its shareholders. Therefore, in such a case, the attorney's client is the corporation and not the shareholder(s).[6]

(ii) Representation of a [General] Partnership[7]

(1) A lawyer who represents a partnership represents the "entity" and not the individual partners that constitute the partnership.

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[1] Model Rules of Prof'l Conduct R. 1.13(a) (1983).

[2] Restatement (Third) of the Law Governing Lawyers § 96 cmt. b (2000).

[3] Model Rules of Prof'l Conduct R. 1.13(f) (1983).

[4] Restatement (Third) of the Law Governing Lawyers § 96 cmt. b (2000).

[5] Model Rules of Prof'l Conduct R. 4.3 (1983).

[6] *See Fassihi v. Sommers, Schwartz, Silver, Schwartz & Tyler, P.C.*, 107 Mich. App. 509, 514 (Mich. App. 1981).

[7] ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 91-361 (1991).

(2) As such, a lawyer undertaking to represent a partnership with respect to a particular matter does not enter into an attorney-client relationship with each member of the partnership.

(3) Therefore, information received by a lawyer during his representation of the partnership from individual members of the partnership may not be withheld from other members of the partnership.

(iii) Conflicts of Interest in the Corporate Family Context[8]

An affiliate of a lawyer's corporate client is not also a client for conflict of interest purposes unless:

(1) The two companies operate as alter egos;

(2) The two companies have integrated operations and management;

(3) The two companies have the same in-house legal counsel; *or*

(4) The representation of the client has provided the law firm with confidential information about the affiliate that is relevant in any matter adverse to the affiliate.

2. Reporting Bad Officer Conduct

(a) Cause for Reporting

If a lawyer knows that an officer, employee or other person associated with the organization is engaged in, or intends to engage in, something illegal that will hurt, or be imputed to, the organization and will likely result in substantial injury to the organization, then the lawyer *shall proceed* as is reasonably necessary *in the best interest of the organization*.[9]

(b) [Internal] Reporting "Up the Ladder"

(i) "[T]he lawyer shall refer the matter … including, if warranted by the circumstances, to the highest authority that can act on behalf of the organization as determined by applicable law."[10]

(ii) If the highest authority within the corporation fails to address the violation and the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to organization, the attorney can reveal information necessary to prevent substantial injury to the organization (even confidential information protected by the attorney-client privilege under Rule 1.6).[11]

B. Advising Principals and Employees on Personal Matters

[8] *See* ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 95-390 (1995) (Conflicts of Interest in the Corporate Family Context).

[9] Model Rules of Prof'l Conduct R. 1.13(b) (1983).

[10] *Id.*

[11] Model Rules of Prof'l Conduct R. 1.13(c) (1983).

1. General counsel should advise principals and other firm employees seeking the general counsel's advice that the general counsel is operating in his/her capacity as the firm's counsel.

2. General counsel should be mindful of any conflicts of interest arising out of the general counsel's relationships with the firm's principals and employees.

C. Responding to Investor and Counterparty Requests for Information

1. In the course of representing a client, a lawyer shall not knowingly:

(a) Make a false statement of material fact or law to a third person; or

(b) Fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, *unless* disclosure is prohibited by another Rule.[12]

2. A lawyer generally has no affirmative duty to inform an opposing party of relevant facts. A misrepresentation can occur if a lawyer incorporates or affirms a statement of another person that the lawyer knows to be false.[13]

D. Taking on a Business Role at the Firm

1. A general counsel who takes on a business function at the firm and serves in an executive capacity may be considered a "supervisor" of other employees, which may result in liability for failure to supervise such employees.[14]

2. A general counsel who takes on a business function at the firm may be subject to additional conflicts of interest.

II. When Compliance Issues Arise

A. Failing to Identify or Act on "Red Flags"

1. *Sands Bros. Asset Mgmt., LLC*, Inv. Adv. Act Rel. No. 3960 (Oct. 29, 2014) (action against hedge fund CCO who is alleged to have "substantially assisted" the manager's violations of the custody rule, where the CCO reminded colleagues of the custody rule deadlines but took no actions when they missed the deadlines, and where he was allegedly aware of prior Securities and Exchange Commission ("SEC") deficiency letters and consent orders regarding custody rule noncompliance but failed to implement policies and procedures to ensure compliance).

2. *Parallax Investments, LLC*, Sec. Exch. Act Rel. No. 70944 (Nov. 26, 2013) (investment adviser's CCO and principal charged with willfully aiding and abetting firm's violations of its principal trading disclosure obligations, failure to comply with custody rule, failure to adopt and implement written procedures, and failure to adopt and implement written code of ethics).

[12] Model Rules of Prof'l Conduct R. 4.1 (1983).

[13] *See* Model Rules of Prof'l Conduct R. 4.1 cmt. 1 (1983).

[14] *See Theodore W. Urban*, Adm. Proc. File No. 3-13655 (Sept. 8, 2010) (initial decision); Division of Trading & Markets, U.S. Sec. & Exch. Comm'n, Frequently Asked Questions about Liability of Compliance and Legal Personnel at Broker-Dealers under Sections 15(b)(4) and 15(b)(6) of the Exchange Act, U.S. Sec. & Exch. Comm'n (Sept. 30, 2013), *available at* http://www.sec.gov/divisions/marketreg/faq-cco-supervision-093013.htm.

3. *Ronald S. Rollins*, Sec. Exch. Act Rel. No. 70058 (July 29, 2013) (CCO of registered investment adviser charged with, inter alia, failure to supervise employee who misappropriated $16,000,000 from firm's investment advisory accounts; because of CCO's inability to pay civil monetary penalty, SEC barred him from securities industry for one year; firm required to retain independent compliance consultant, censured by SEC and settled for $120,000 penalty).

4. *Equitas Capital Advisors, LLC*, Inv. Adv. Act Rel. No. 3704 (Oct. 23, 2013) (investment adviser assessed civil penalty of $100,000 and its principal fined $35,000 after the firm, its principal and its CCO violated the securities laws by, inter alia, disseminating misleading marketing materials; failing to disclose that the firm was not directly responsible for the $1,000,000,000 that, as the firm advertised, its clients had earned since the firm's inception; failing to disclose conflicts of interest in connection with increased fees associated with certain investments; and inadvertently over- and under-billing clients).

5. *Wunderlich Sec., Inc.*, Sec. Exch. Act Rel. No. 64558 (May 27, 2011) (registered broker-dealer and investment adviser settled with SEC for violations of Advisers Act after failing to satisfy the disclosure and consent requirements for principal trades; firm settled for disgorgement of $369,366.15 and civil penalty of $125,000; firm's CCO also charged with aiding and abetting those violations by failing to tailor firm's compliance policies to those of an investment adviser after it became one (in addition to its preexisting broker-dealer business); CCO settled for $50,000, a cease-and-desist order, and a censure).

B. Failing to Address Custody Rule Noncompliance

1. *Sands Bros. Asset Mgmt., LLC*, Inv. Adv. Act Rel. No. 3960 (Oct. 29, 2014) (see Section II.A.1, below).

2. *Further Lane Asset Mgmt., LLC*, Sec. Exch. Act Rel. No. 70759 (Oct. 28, 2013) (investment adviser and its principal/CCO sanctioned for, inter alia, failing "to form a reasonable belief that a qualified custodian was sending account statements to fund investors at least quarterly" and to subject the firm to annual surprise examinations; firm to retain external compliance consultant, and it is censured and assessed disgorgement of $347,122; CCO is censured, suspended for 12 months and assessed a civil penalty of $150,000).

3. *Knelman Asset Mgmt. Group, LLC*, Inv. Adv. Act Rel. No. 3705 (Oct. 28, 2013) (sanctioning investment adviser and its principal/CCO for, inter alia, failing to arrange surprise examinations of assets and failing to provide fund members with audited financial statements, despite SEC notification that firm was in custody of client assets although the firm was not a qualified custodian; firm to designate new CCO, and it is censured and assessed civil penalty of $60,000; CCO barred from acting as CCO and assessed civil penalty of $75,000).

C. Disclosures to Investors and Prospective Investors

1. *CapitalWorks Investment Partners, LLC*, Inv. Adv. Act Rel. No. 2520 (June 6, 2006) (hedge fund manager and its head of compliance charged where RFP responses and other communications with investors and prospective investors misrepresented that prior SEC examinations resulted in no violations).

2. *Aletheia Research & Mgmt., Inc.*, Sec. Exch. Act Rel. No. 64442 (May 9, 2011) (hedge fund manager, principal and CCO charged where RFP responses and other communications with investors and prospective investors misrepresented that prior SEC examinations resulted in "no significant findings").

3. *Signalpoint Asset Mgmt., LLC*, Sec. Exch. Act Rel. No. 72515 (July 2, 2014) (CCO charged where Form ADV Schedules A and B did not identify affiliated broker-dealer principals as owners of the registered investment adviser despite their actual control of the firm).

4. *Strategic Capital Group, LLC*, Inv. Adv. Act Rel. No. 3924 (Sept. 18, 2014) (settling with investment adviser that violated Advisers Act, and its CEO/CCO, who caused firm's violations by failing to implement compliance policies and procedures and by signing untrue Forms ADV; firm agreed to hire independent compliance consultant, to be censured, and to pay disgorgement of $386,290.50 and civil penalty of $200,000; CCO agreed to pay civil penalty of $50,000).

5. *Edgar R. Page*, Inv. Adv. Act Rel. 3904 (Aug. 26, 2014) (SEC proceeding against investment adviser and its principal/CCO for hiding conflicts of interest from clients by, inter alia, making material misrepresentations in its Forms ADV).

D. Dealing with Whistleblowers

1. *Paradigm Capital Mgmt., Inc.*, Sec. Exch. Act Rel. No. 72393 (June 16, 2014) (hedge fund charged with retaliating against whistleblowing employee; note that firm is criticized for taking away whistleblower's responsibilities, which raises questions about how to proceed if you believe a whistleblower is not being truthful and not acting in the firm's and investors' interests).

E. Communications with Examiners

1. *Fredrick D. Scott*, Inv. Adv. Act Rel. No. 3894 (June 3, 2014) (finalizing initial decision of *Fredrick D. Scott*, Rel. No. 592 (April 22, 2014), in which hedge fund manager who pled guilty to one count of conspiracy to commit wire fraud and one count of knowingly and willfully making materially false statement to SEC staff during examination was barred from associating with any broker, dealer, etc.).

2. *George B. Franz III*, Sec. Exch. Act Rel. No. 72058 (April 30, 2014) (investment adviser and its principal/CCO sanctioned for, inter alia: (1) lying to the SEC during its investigations of the principal's son, who, during his employment by the firm, stole over $490,000 from its clients; (2) destroying evidence of the son's thefts; (3) giving the SEC fabricated documents related to the son's thefts; and (4) lying under oath during the SEC's investigation; sanctions include: (1) barring CCO from association with any broker, dealer, etc.; (2) revoking firm's registration as investment adviser; and (3) requiring firm and CCO jointly and severally to pay disgorgement of $425,000 and civil penalties of $675,000).

F. Recidivism: Potential GC/CCO Liability Where Firms Fail to Correct Deficiencies

1. *Sands Bros. Asset Mgmt., LLC*, Inv. Adv. Act Rel. No. 3960 (Oct. 29, 2014) (see Section II.A.1, below).

2. *Transamerica Financial Advisors, Inc.*, Sec. Exch. Act Rel. No. 71850 (April 3, 2014) (a 2009 examination revealed fee calculation issues that were still problematic when the exam staff came back in 2012; firm was charged despite the fact that it had taken steps to correct the miscalculations).

3. "The [National Examination Program] conducts a limited number of Corrective Action Reviews in order to verify whether entities, including investment advisers, investment companies, and transfer agents, take the corrective actions discussed in their response to a deficiency letter."[15]

III. Internal Investigations

A. Landscape

1. It is no secret that federal law enforcement agencies, including both the Department of Justice ("DOJ") and SEC have, in the last several years, stepped up enforcement efforts.

   (a) In the last year, the DOJ, working with other federal and state agencies, has conducted investigations of, and insisted on record-setting corporate penalties for, major U.S. corporations and banks. For example:

      (i) In January 2014, Preet Bharara, U.S. Attorney for the Southern District of New York, announced an agreement with JPMorgan, under which the bank agreed, among other things, to pay a $1,700,000,000 penalty to the victims of the Madoff fraud.

      (ii) In March 2014, Credit Suisse AG pleaded guilty to conspiracy to aid and assist U.S. taxpayers in filing false income tax returns and other documents with the Internal Revenue Service ("IRS"). The plea agreement required that Credit Suisse pay a total of $2,600,000,000 — $1,800,000,000 to the DOJ for the U.S. Treasury, $100,000,000 to the Federal Reserve, and $715,000,000 to the New York State Department of Financial Services.

      (iii) In June 2014, BNP Paribas S.A. agreed to pay total financial penalties of $8,973,600,000, including forfeiture of $8,833,600,000 and a fine of $140,000,000 and enter a guilty plea to conspiring to violate the International Emergency Economic Powers Act and the Trading with the Enemy Act by processing billions of dollars of transactions through the U.S. financial system on behalf of Sudanese, Iranian and Cuban entities subject to U.S. economic sanctions.

      (iv) In August 2014, U.S. Attorney General Eric Holder announced that the DOJ had reached a $16,650,000,000 settlement with Bank of America Corporation — the largest civil settlement with a single entity in American history — to resolve federal and state claims against Bank of America and its former and current subsidiaries, including Countrywide Financial Corporation and Merrill Lynch.

   (b) In Mary Jo White's Message from the Chair in the SEC's 2014 Financial Report, she touted that: "The Division of Enforcement continued to mount increasingly sophisticated investigations, redoubling efforts in traditional areas, like accounting fraud, and expanding its focus on gatekeepers who must act in investors' interests."[16]

2. We can expect these aggressive enforcement activities to continue throughout 2015, with the aid of whistleblowers, and with additional focus on individuals.

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[15] *See* Office of Compliance Inspections & Examinations, U.S. Sec. & Exch. Comm'n, Examination Information for Entities Subject to Examination or Inspection by the Commission 4 (2014), *available at* http://www.sec.gov/about/offices/ocie/ocie_exambrochure.pdf.

[16] Mary Jo White, Message from the Chair, in U.S. Sec. & Exch. Comm'n, Agency Financial Report 2, 2 (2014), *available at* http://www.sec.gov/about/secpar/secafr2014.pdf.

(a) During a September speech at New York University Law School, Attorney General Holder projected charges against bank executives are on the horizon. Citing a re-emergence of "some of the very same profit-driven risk-taking that contributed to the 2008 collapse," he emphasized "the inherent value of bringing enforcement actions against individuals, as opposed to simply the companies that employ them."[17]

(b) During the same speech, Attorney General Holder noted that "since no financial fraud case is prosecutable unless we have sufficient evidence of intent — we should seek to better equip investigators to obtain this often-elusive evidence. This means, among other things, thinking creatively about ways to incentivize witness cooperation and encourage whistleblowers at financial firms to come forward."[18]

3. In connection with their enforcement priorities, federal law enforcement agencies have increasingly focused on firms' "culture of compliance," two key components of which are the extent to which business lines understand their responsibility to report potential wrongdoing up the ladder to GCs and compliance personnel like you, as well as CCOs' related responsibility to report wrongdoing to their firms' CEOs.

(a) During a keynote speech at the Compliance Week 2014 conference, SEC Enforcement Director Andrew Ceresney observed that "companies that have done well in avoiding significant regulatory issues typically have prioritized legal and compliance issues, and developed a strong culture of compliance across their business lines." Among the factors that will determine the likelihood of an enforcement action is whether "legal and compliance officers report to the CEO and have significant visibility with the board."[19]

(b) In fact, the DOJ's guidance on the FCPA specifically states that, when appraising compliance programs, the DOJ and SEC alike consider, among other things, whether compliance executives have "appropriate authority within the organization" and "adequate autonomy from management." According to the guidance, "[a]dequate autonomy generally includes direct access to an organization's governing authority, such as the board of directors and committees of the board of directors (e.g., the audit committee)."[20]

(c) In a FinCEN advisory released in August 2014, FinCEN advised firms that they can strengthen their compliance culture by ensuring that "relevant information from the various departments within the organization is shared with compliance staff to further BSA/AML efforts."[21]

4. With increased enforcement activity by federal regulators, a focus on individual liability (and, therefore, responsibility), "culture of compliance" issues and use of whistleblowers, we can expect to see more internal investigations and more pressure on you to ensure that they are done properly and to ensure that privilege is protected.

B. Protecting the Privilege in Internal Investigations

[17] Eric Holder, Attorney General Remarks on Financial Fraud Prosecutions at NYU School of Law (Sept. 17, 2014), *available at* http://www.justice.gov/opa/speech/attorney-general-holder-remarks-financial-fraud-prosecutions-nyu-school-law.

[18] *Id.*

[19] Andrew Ceresney, Dir. of the Div. of Enforcement, Keynote Address at Compliance Week 2014 (May 20, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370541872207.

[20] Criminal Div. of the U.S. Dep't of Justice and Enforcement Div. of the U.S. Sec. & Exch. Comm'n, A Resource Guide to the U.S. Foreign Corrupt Practices Act 58 (2012), *available at* http://www.justice.gov/criminal/fraud/fcpa/guide.pdf.

[21] Financial Crimes Enforcement Network, U.S. Dep't of the Treasury, Advisory to U.S. Financial Institutions on Promoting a Culture of Compliance 1 (2014), *available at* http://www.fincen.gov/statutes_regs/guidance/pdf/FIN-2014-A007.pdf.

1. Establishing the Privilege

There are a few relatively simple things you should do at the outset of an investigation to establish the attorney-client privilege:

(a) Ensure that a lawyer — either in-house counsel or outside counsel — is directing the investigation, and document that fact.

(i) Compliance personnel should not conduct the investigation themselves if they want documents created in connection with the investigation to be privileged. They need to involve lawyers acting in a legal capacity to direct the investigation.

(1) Compliance-driven inquiries generally are not privileged, nor are investigations undertaken for business, rather than legal, purposes.

(2) The mere fact that a company is structured so that the compliance department operates under the supervision and oversight of the legal department does not necessarily render compliance department documents or communications privileged.

(3) It is likewise not enough that compliance personnel have law degrees, which is increasingly the case.

(ii) This is a critical component of establishing the privilege, as reiterated by the U.S. Court of Appeals for the District of Columbia Circuit in a June 2014 decision in *In re Kellogg Brown & Root* — also known as the KBR decision.[22]

(1) In that case, the plaintiff worked for KBR, a defense contractor, and filed a False Claims Act complaint alleging that KBR defrauded the U.S. government by inflating costs and accepting kickbacks while administering military contracts in Iraq. In the course of his litigation against KBR, the plaintiff sought documents relating to KBR's prior internal investigation regarding the alleged fraud. The district court ordered KBR to produce the documents.

(2) The D.C. Circuit reversed, and one of the primary factors motivating the court's decision was the fact that the internal investigation was overseen by the company's law department. The court wrote, for example: "As in *Upjohn*, KBR initiated an internal investigation to gather facts and ensure compliance with the law after being informed of potential misconduct. And as in *Upjohn*, KBR's investigation was conducted under the auspices of KBR's in-house legal department, acting in its legal capacity. The same considerations that led the Court in *Upjohn* to uphold the corporation's privilege claims apply here."[23]

(b) Make clear at the outset of the investigation in a written memorandum that the investigation is being conducted for the purpose of obtaining legal advice and/or in anticipation of litigation.

(i) Ideally, the purpose of the investigation should be documented in the written memorandum.

[22] *See In re Kellogg Brown & Root, Inc.*, 756 F.3d 754 (D.C. Cir. 2014).

[23] *Id.* at 757 (referring to *Upjohn Co. v. United States*, 449 U.S. 383 (1981), in which U.S. Supreme Court held the attorney-client privilege applies to corporations).

(ii) The memorandum should remind the team that: (1) the investigation is being directed by counsel and is privileged; (2) the investigation should not be discussed with anyone without counsel's permission; and (3) documents generated in connection with the investigation should be marked with a header "Privileged and Confidential; Attorney-Client Privilege; Attorney Work Product."

(1) To the extent the reports and other documents are prepared at the request of counsel by non-attorneys in connection with an investigation, the documents should bear the header "Privileged and Confidential; Attorney-Client Privilege; Work Product Prepared at the Request of Counsel in Anticipation of Litigation."

(2) To the extent documents or communications are prepared by non-attorneys for the purpose of requesting legal advice, the documents or communications should bear the header "Privileged and Confidential; Attorney-Client Privilege; Prepared for Purposes of Requesting Legal Advice."

(iii) The memorandum should also advise employees to segregate legal from business communications.

2. Conducting the Investigation

To maintain privilege during the course of the investigation, your firm should take the following additional steps:

(a) If the investigation is ongoing for some time, the memorandum previously described should be redistributed periodically as a reminder.

(b) When conducting interviews, the following steps should be taken:

(i) Limit those present at interviews or meetings to those with common legal interests and their lawyers.

(1) Anyone whose conduct is potentially at issue (including senior management or board members) should not be present (and should not be informed of substance of investigation).

(2) Avoid the use of investigators or non-lawyers in conducting interviews.

(ii) Always give clear "*Upjohn* warnings" to witnesses that:

(1) The lawyer represents the corporation (or other corporate body) and *not* the witness.

(2) The interview is being conducted so that the lawyer can provide legal advice to the client, which is the corporation. You may wish to provide a more detailed explanation of the purpose and scope of the investigation.

(3) The substance of the interview is privileged, and the employee must keep confidential the contents of the interview except from his or her own attorney.

(4) The privilege belongs to the corporation (or corporate body), which may or may not elect to waive the privilege and disclose some or all of the communications to third parties (including, possibly, the government, regulators or law enforcement).[24]

(iii) In situations where counsel, particularly outside counsel, represents multiple parties and/or the firm as well as employees, proper warnings should be given in writing, and the employee should provide a written indication that he or she has read the warnings, understands them and agrees to various conditions. Specifically, counsel should:

(1) Disclose the joint representation, e.g.:

Counsel also represents _____ and other current _____ employees with respect to the same matter. Counsel also represents and has represented _____with respect to other matters.

(2) Make clear that the representation will not cover personal acts or conduct engaged in by the employee outside the scope of employment.

(3) Disclose right and opportunity, at employee's own cost, to have his or her own personal counsel represent him or her. Recommend that employee consult with independent counsel, at a minimum, prior to agreeing to being represented by same counsel as others.

(4) Document that, at present, no conflicts of interest exist in connection with joint representation, but conflicts of interest can arise.

(5) Disclose that counsel's obligation to each represented party is to provide advice on an equal and open basis to all represented parties.

(6) Have client confirm understanding and intent that:

a. Information provided by client to counsel in the course of the counsel's representation may be used by counsel not only in connection with its representation of client, but also in connection with the counsel's representation of the other clients;

b. To the extent that counsel shall cease to represent specific client but shall continue to represent others, counsel shall be free to continue to use information obtained from client in connection with its representation of the others. In connection with that, counsel shall be permitted, but shall not be required, to disclose to the other clients, including management, information received from client that is received in the course of its representation; and

c. The attorney-client privilege that applies to and protects communications between a specific client/employee and the firm may be waived by the firm and therefore disclosed to others, including regulators, even over employee's objection.

(7) Have client agree that if any actual dispute or actual conflict should arise between or among clients, or if counsel no longer believes that it can adequately represent the interests of all clients, counsel shall have the right to withdraw at such time from

[24] *See* American Bar Ass'n and The Bureau of Nat'l Affairs, ABA/BNA Lawyers' Manual on Professional Conduct §§ 91:2201, 91:2203-4 (2014).

representing specific client, and shall have the absolute right to continue its representation of some or all of the other clients with respect to the matter or any other dispute or conflict, and client shall not take the position, by motion to disqualify or otherwise, that counsel's prior representation of him or her (or it) precludes counsel from further continued representation of some or all of the other clients.[25]

(iv) When the witness is not an employee, board member or individual with a common legal interest to the corporate client, recognize that the interview will not be privileged but may be subject to protection under the work-product doctrine.

(v) When creating memoranda of interviews or meetings, include the headers mentioned above, as well as an initial paragraph stating explicitly that the writing is not a verbatim transcription of the interview but contains the mental impressions of the lawyer preparing the document.

3. Sharing Information

(a) To maintain maximum protection for privileged information, ensure that those who receive that information share a common legal interest and understand the need to maintain the confidentiality of the communication.

(b) Where possible, limit distribution of the relevant documentation to counsel.

(i) Some courts have held that where communications are sent to both lawyers and non-lawyers, the corporation will not be able to establish that the communication was primarily for purposes of seeking legal advice.

(c) When contemplating sharing information with someone outside the zone of common interest — such as a regulator, external auditor or insurance carrier — consider:

(i) Whether disclosure of any information is really necessary, and, if it is, disclosing only the minimum amount of information required.

(ii) The possibility of delaying or deferring disclosure.

(iii) Whether an oral presentation or communication may suffice.

(iv) Whether a summary is acceptable in lieu of providing interview memos or direct communications between attorney and client, if a writing is required.

(v) Whether you can provide the writing only on a temporary basis and retrieve the document at the end of a presentation.

(vi) Whether you can obtain assurances of confidentiality and non-disclosure from the party to whom you are making the disclosure. If the party is a government entity or regulator, make

[25] *See*, *e.g.*, Ass'n of the Bar of the City of N.Y., Frequently Asked Ethics Questions, New York City Bar, http://www.nycbar.org/ethics/ethics-faq (last visited Dec. 30, 2014); N.Y. Rules of Prof'l Conduct R. 1.7 (2013), *available at* https://www.nycourts.gov/rules/jointappellate/NY-Rules-Prof-Conduct-1200.pdf; *Lieberman v. City of Rochester*, 681 F. Supp. 2d 418, 423 (W.D.N.Y. 2010) (noting that "the court is charged with ensuring that each client is fully aware of any conflict and its potential impact upon his or her interests and nonetheless desires to proceed with joint representation," and, once that assurance is provided, "the court may not interfere with or obstruct a party's knowing choice of counsel"); *Frontline Commc'ns Int'l, Inc. v. Sprint Commc'ns Co. L.P.*, 232 F. Supp. 2d 281, 288 (S.D.N.Y. 2002) ("When an attorney represents an employer and an employee jointly, the employee cannot reasonably expect the attorney to keep any information from the employer.").

sure you request exemption from disclosure under Freedom of Information laws, rules and regulations.

(d) If a document is disclosed inadvertently, take immediate steps to request its return.

4. Presenting Findings

(a) Consider whether your findings can or should be presented orally, through a PowerPoint presentation or in some other summary form before providing written findings. This is a particularly important consideration in connection with investigations of foreign companies or subsidiaries.

(b) If written materials are provided to the client, consider collecting or retrieving them after the presentation.

C. Special Considerations with Privilege

1. Use of In-House Counsel

(a) Under U.S. law, no distinction exists between a corporation's in-house counsel, acting in that capacity, and its outside counsel for purposes of establishing attorney-client privilege.

(b) However, if you believe the investigation will be particularly sensitive or your firm will likely be the subject of civil litigation as a result of alleged wrongdoing, you should consider carefully the merits of retaining outside counsel.

(i) Courts recognize that in-house counsel frequently have multiple roles at a firm and provide both legal and business advice. Because business advice is not privileged, courts can and likely will closely scrutinize communications involving in-house counsel to ensure that they are truly made for the purpose of securing legal, as opposed to business, advice.

(ii) Moreover, in the European Union, communications between firm executives and in-house lawyers are generally not protected by the attorney-client privilege.[26]

2. Recognition of Privilege Generally in Foreign Jurisdictions

(a) Foreign jurisdictions accord varying degrees of privacy protection to documents, emails and communications involving individuals within the jurisdiction, whether done at the direction of in-house or outside counsel. Consequently, when conducting an internal investigation involving entities outside of the United States, particularly where foreign regulators or litigants may have an interest in the results of your investigation, you may wish to consult with counsel familiar with the applicable privilege rules to maximize their effect.

(b) For example, Chinese law does not recognize any attorney-client privilege or the work-product doctrine.[27]

3. Crime-Fraud Exception

[26] *See, e.g.*, *Akzo Nobel Chemicals, Ltd. and Akcros Chemicals, Ltd. v. Comm'n.*, Case 550/07 P (Sept. 14, 2010).

[27] *See* Leah M. Christensen, A Comparison of the Duty of Confidentiality and the Attorney-Client Privilege in the U.S. and China: Developing a Rule of Law, 34 T. Jefferson L. Rev. 171, 180-85, 191-3 (2011); Preston M. Tobert, Other Chinese Laws, Compliance Programs & Corp. Sent. Gdlns. § 21A:18 (2012).

(a) Courts will not protect attorney-client communications if they were made in connection with future wrongdoing, as opposed to past wrongdoing. Pursuant to the "crime-fraud exception," the privilege can be overcome when, at the time of the communication: "(1) the client was committing or intending to commit a fraud or crime, and (2) the attorney-client communications were in furtherance of that alleged crime or fraud."[28]

(i) It is important to note that the focus of this inquiry is the client's intentions, not the attorney's.

(ii) Because the attorney's state of mind is irrelevant, unwitting attorney communications made in connection with even facially innocent acts may be discoverable.

(b) There have been a number of high-profile and significant decisions in this area this year.

(i) The most significant case is *In re Grand Jury Subpoena*, 745 F.3d 681 (3d Cir. 2014). In that case, which has been highly publicized, a president and managing director (the "client") of a consulting corporation hired to obtain financing from a bank for various projects consulted an attorney regarding payments that the client planned to make to an officer of the bank (the "banker") to ensure that the project proceeded quickly. The attorney shared office space with, but practiced law independently of, the corporation. After conducting some preliminary research and learning about the FCPA, the attorney asked the client whether the bank was a government entity or the banker was a government official. Ultimately, the attorney was unable to determine whether the conduct was illegal but nevertheless advised the client not to make the payments. Notwithstanding the attorney's advice, the client informed the attorney that he did not believe that the payments violated the FCPA and that he intended to make the payments. The corporation ultimately made payments totaling $3,500,000 to the banker's sister, who was not affiliated with the bank and was not apparently involved with any of the projects.

After an FBI investigation, a grand jury served the attorney with a subpoena seeking his testimony about his conversation with the client. Although the corporation and the client tried to prevent the attorney from testifying based on privilege, the district court allowed the testimony under the crime-fraud exception. The U.S. Court of Appeals for the Third Circuit affirmed. First, the Third Circuit held that there was sufficient evidence showing that the client had a pre-existing intent to make the payment based on two facts: (1) the client told the attorney that he was going to make the payment notwithstanding the attorney's advice that he should not do so; and (2) the corporation made the payment in the same month the bank approved the project financing. Second, the Third Circuit held that the advice was used by the client to fashion its conduct in furtherance of its crime. According to the Third Circuit, the "[a]ttorney's questions about whether or not the [b]ank was a governmental entity … would have informed [the] [c]lient that the governmental connection was key to violating the FCPA" and "would lead logically to the idea of routing the payment through [b]anker's sister … in order to avoid the reaches of the FCPA or detection of the violation."[29] In other words, the court found that the attorney's questions suggested ways that the client could make an end-run around the FCPA.

The defendant filed a petition for certiorari to the U.S. Supreme Court; that petition was denied.

[28] *In re Grand Jury*, 705 F.3d 133, 151 (3d Cir. 2012).

[29] 745 F.3d at 693.

(c) This decision suggests, among other things, that, in order to preserve privilege:

(i) Counsel need to be careful when discussing the subject matter of investigations with employees and take steps to ensure that they are not enabling obstructive conduct;

(ii) When requesting advice from counsel, employees should be careful about how they phrase their inquiries. Specifically, employees need to avoid conveying the impression that the decision is a foregone conclusion or that legal review is a formality. Employees may want to consider phrasing their requests in terms of hypotheticals; and

(iii) Counsel should be brought in to evaluate the legality of conduct at the earliest possible stage, so as to avoid the perception that the action is predetermined.

IV. Regulatory Investigations

A. Areas of Consistent SEC Interest

1. Cases over the past year highlight several areas of SEC focus. Compliance policies and procedures for these areas have been heavily scrutinized by the SEC, and failures to have sufficient compliance policies and procedures in place for these areas have resulted in fines for the compliance officer in his or her individual capacity.

2. Insider Trading

(a) *Thomas E. Meade*, Inv. Adv. Act Rel. No. 3855 (Jun. 11, 2014)

(i) Meade, the president and CCO of Private Capital Management Inc. ("PCM Inc."), knew of a unique risk for misuse of material nonpublic information by a vice president at PCM Inc. The vice president's father served on the board of at least one public company, but despite knowing this, Meade failed to design PCM Inc.'s compliance policies and procedures in light of the risk that the vice president might trade on information he received from his father. Additionally, Meade failed to collect, review and maintain reports of the vice president's personal securities transactions as required under Section 204A of the Advisers Act. Furthermore, Meade failed to put the securities of the company where the vice president's father served as a board member on a restricted or watch list of securities as required by PCM Inc.'s insider trading policy and also failed to investigate suspicious trading made by the vice president in that security. Pursuant to an offer of settlement, Meade was censured, ordered to pay a civil money penalty of $100,000, and barred from associating in a compliance capacity and supervisory capacity with any broker, dealer, investment adviser, etc.

(ii) *Meade* demonstrates that compliance personnel can be held individually liable for significant fines and can receive bars when the SEC believes they have failed to do certain aspects of their jobs properly, and that these personal penalties are imposed even if the compliance officer did not personally engage in any misconduct or personally profit from another's misconduct. This case also demonstrates that the risks compliance officers must protect against are not limited to those relating to information their firms' employees obtain in the course of business; they also include information the compliance officer has reason to know an employee might learn in his or her personal capacity, such as from a family member. In *Meade*, the CCO happened to have known that the vice president's father was on the board of a particular public company, but the case sets a precedent that could allow the SEC to argue in future cases that compliance officers must determine whether their employees

have relatives who are insiders at public companies and put those companies' securities on their watch list if they do.

(b) *Judy K. Wolf*, Sec. Exch. Act Rel. No. 73350 (Oct. 15, 2014)

(i) Judy K. Wolf, a compliance officer at Wells Fargo Advisors LLC, is alleged to have altered a document turned over to the SEC as part of an insider trading investigation. Wolf was responsible for reviewing the trade under investigation and had closed the review with a label of "no findings." The SEC found other versions of the document that, coupled with the document's metadata, showed that Wolf had added a statement to a document to the effect that rumors about an acquisition had been circulating for several weeks before the acquisition was announced and before the trade was under investigation by the SEC. The SEC believes Wolf violated Section 17(a) of the Exchange Act and Section 204(a) of the Advisers Act.

(ii) Although most people do not need an SEC enforcement release to make them aware that one should not alter documents when responding to regulatory requests, *Wolf* serves as a reminder that attempts to mislead regulators usually do not succeed and can create more serious problems. The case also demonstrates the importance of contemporaneously and comprehensively documenting the reasons for, and factors considered in, resolving internal reviews of potentially suspicious trading or other types of potential misconduct. Had Wolf conducted a thorough review at the time of the trading, including noting the pre-announcement rumors and attaching copies of relevant press reports, the case never would have occurred.

(c) *United States v. Newman*, 2014 WL 6911278 (2d Cir. Dec. 10, 2014)

(i) *Newman* reverses the conviction of two portfolio managers for insider trading. The court found, first, that the government failed to provide evidence that the alleged insiders received any personal benefit sufficient to establish tipper liability, and without tipper liability no tippee liability can arise; and second, that the government failed to present evidence showing that the portfolio managers knew that they were trading on information obtained from insiders in violation of the fiduciary duties of those insiders. The Second Circuit held that tipper liability requires a personal benefit of some consequence be received in exchange for confidential information. The court furthermore held that knowledge of a breach of the fiduciary duties of an insider cannot be inferred from the disclosure of confidential information alone, even when the information in question is detailed and accurate.

(ii) While *Newman* makes it more difficult for the government to prove tippee liability, legal and compliance personnel should understand — and make sure their portfolio managers understand — that it is not a get-out-of-jail-free card. Policies and procedures designed to prevent insider trading are still needed just as they were before, and *Newman* makes clear that conscious avoidance of the source of a disclosure will not allow one to avoid liability.

3. Conflicts of Interest

(a) *Alan Gavornik*, Sec. Exch. Act Rel. No. 73678 (Nov. 24, 2014)

(i) Concord Equity Group Advisors, LLC ("Concord"), through its principals Gavornik (the firm's CCO), Mariniello (the firm's president) and Argush (the firm's CEO, CFO and CTO), entered

an arrangement where an unaffiliated broker-dealer would provide execution for Concord's clients at a commission rate of $0.01 per share but would charge those clients between $0.04 and $0.06 per share. The amount charged above the $0.01 per share commission rate was then paid to Concord's affiliated broker-dealer, Tore Services LLC ("Tore") as a "referral fee." This commission-sharing arrangement was not adequately disclosed to Concord's clients, with Concord's Form ADV Part II disclosures stating that Tore "may receive referral fees," which the SEC found not to be a complete and accurate disclosure. Because the arrangement resulted in a higher commission rate for clients, the respondents also failed to seek to obtain best execution for Concord's advisory clients. The SEC noted that the failure to disclose the arrangement accurately "rested principally" with Gavornik as CCO. As a result, and pursuant to an offer of settlement, Gavornik was suspended from associating with any broker, dealer, investment adviser, etc. for 12 months and was ordered to pay a $150,000 civil money penalty. Mariniello and Argush were not suspended, but they were each ordered to pay a $150,000 civil money penalty, and all three individuals were found jointly liable for disgorgement of $1,005,000, plus interest.

(ii) *Gavornik* highlights the fact that the SEC often holds compliance personnel to a higher standard than business personnel, as here the agency suspended only Gavornik even though it was Mariniello who was the "principal architect" of the arrangement with the executing broker. The case also demonstrates that compliance personnel must ensure that their firms specifically and accurately disclose any situation wherein money paid by their clients ends up going to the adviser, or where the adviser receives remuneration from a third party with which it has an arrangement to provide services to the adviser's clients.

4. Procedures for Internal Matters

(a) *Knight Capital Americas LLC*, Sec. Exch. Act Rel. No. 70694 (Oct. 16, 2013); *George B. Franz III*, Sec. Exch. Act Rel. No. 72058 (April 30, 2014)

(i) In *Knight Capital Americas LLC*, an error in Knight Capital Americas LLC's ("Knight's") automated routing system for equity orders resulted in Knight losing over $460,000,000. Following that incident, the SEC found that Knight had violated Exchange Act Rule 15c3-5, which requires that a broker or dealer have a system of risk management controls and supervisory procedures reasonably designed to limit the risks associated with market access. Perhaps more importantly, the SEC found that Knight did not have adequate supervisory procedures concerning incident response. Pursuant to an offer of settlement Knight was censured and ordered to pay a civil money penalty of $12,000,000.

(ii) In *Franz*, George Franz was founder, owner and CCO of investment adviser Ruby Corporation. An employee of Ruby Corporation, Andrew Franz (who was also respondent George Franz's son), committed acts of fraud and theft of client funds, but even once he had been made aware of these acts, George Franz failed to implement policies and procedures to keep such actions from happening again. Furthermore, George Franz did not disclose the actions of his son and instead covered up the acts of fraud and theft. After George Franz failed to put in place policies and procedures reasonably designed to prevent the unauthorized withdrawal of advisory client funds, Andrew Franz committed additional acts of fraud and theft of client funds. As a result of these failures and his attempt to cover up the actions of his son, George Franz agreed to an Offer of Settlement, under which he was barred from associating with any broker, dealer, investment adviser, etc., and was ordered (jointly and severally with Ruby Corporation) to pay civil penalties of $650,000.

(iii) *Knight* and *Franz* emphasize the need to have policies and procedures addressing how a firm and its compliance officers should respond in the event a problem arises, whether that problem is an accidental computer error or deliberate wrongdoing by an employee. It is important to look at your own organization and think of areas where problems could occur, and to proactively put in place safeguards and policies to follow in the event that a problem does occur.

V. Civil Litigation

A. Tension Between Requirements of Zealous Advocacy and Court Rules

1. Requirement of Zealous Advocacy

(a) Each state has its own code of professional conduct.

(b) The New York Disciplinary Rules provide: "A lawyer shall not intentionally … [f]ail to seek the lawful objectives of the client through reasonably available means permitted by law and the Disciplinary Rules."[30]

(c) The zealous advocacy provision of the American Bar Association's Model Code of Professional Responsibility reads identically to that of the New York Disciplinary Rules.[31]

2. Court Rules

(a) Each state court system has its own set of rules, as does the federal court system.

(b) Federal Rule of Civil Procedure 11

(i) Every pleading, written motion or other paper must be signed by at least one attorney of record (unless the party is unrepresented). The paper must state the signer's address, email address and telephone number.[32]

(ii) What's represented to court: By presenting to the court a pleading, written motion or other paper — whether by signing, filing, submitting or later advocating it — an attorney certifies that to the best of his or her knowledge, formed after a reasonable inquiry, the paper:

(1) Is not being presented for any improper purpose, such as to harass, cause unnecessary delay or needlessly increase the cost of litigation;

(2) The legal contentions are warranted by existing law or by a non-frivolous argument for extending, modifying or reversing existing law or for establishing new law;

(3) The factual contentions have evidentiary support or, if specifically so identified, will likely have evidentiary support after a reasonable opportunity for further investigation; and

[30] New York Lawyer's Code of Prof'l Responsibility DR 7-101 (2007) ("Representing a Client Zealously").

[31] *See* Model Code of Prof'l Responsibility DR 7-101 (1980) ("Representing a Client Zealously").

[32] Fed. R. Civ. P. 11(a).

(4) The denials of factual contentions are warranted on the evidence or, if specifically so identified, are reasonably based on belief or a lack of information.[33]

(iii) "Rule 11 permits sanctions against a litigant who submits a pleading or motion that, evaluated under an objective standard of reasonableness, … [has] no chance of success and [makes] no reasonable argument to extend, modify or reverse the law as it stands."[34]

(iv) Who can be sanctioned: "If … the court determines that Rule 11(b) has been violated, the court may impose an appropriate sanction on any attorney, law firm, or party that violated the rule or is responsible for the violation."[35]

(1) The court may sanction the parties themselves.[36]

(2) A court may sanction individuals it concludes are responsible for the violation, and in-house counsel have been sanctioned.[37]

(v) A "sanction may include nonmonetary directives; an order to pay a penalty into court; or, if imposed on motion and warranted for effective deterrence, an order directing payment to the movant of part or all of the reasonable attorney's fees and other expenses directly resulting from the violation."[38]

B. Discovery Issues

1. States have their own rules about document preservation; federal courts have their own rules, and there may be differences among the circuits. The Second Circuit is one of the most authoritative.

(a) Documents must be preserved once litigation is anticipated, not merely when it's actually filed. "Once a party reasonably anticipates litigation, it must suspend its routine document retention/destruction policy and put in place a 'litigation hold' to ensure the preservation of relevant documents."[39]

(b) Documents that must be preserved include documents in a party's possession, custody or control.

(c) Hard copies as well as electronic documents must be preserved.

(d) Inside and outside counsel should participate in the process of determining what documents are relevant and in assuring their preservation.

2. Potential Sanctions for Document Spoliation

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[33] Fed. R. Civ. P. 11(b).

[34] *Smith v. Westchester Cnty. Dep't of Corr.*, 577 Fed. Appx. 17, 17 (2d Cir. 2014) (internal quotation marks omitted).

[35] Fed. R. Civ. P. 11(c)(1).

[36] *See, e.g.*, *Fraige v. American-Nat'l Watermattress Corp.*, 996 F.2d 295, 296 n.1 (Fed. Cir. 1993) (sanctioning defendant corporation under Rule 11 after corporation's president forged documents in an attempt to defeat plaintiff's motion for preliminary injunction).

[37] *See, e.g.*, *Empire State Pharmaceutical Soc. v. Empire Blue Cross*, 778 F. Supp. 1253 at 1260 (S.D.N.Y. 1991) (sanctioning, for submitting meritless contentions to the court, a corporation and its general counsel, who was also the corporation's executive director, because "the legal activity of the corporation's counsel [was] virtually indistinguishable from the business activity of the client corporation").

[38] Fed. R. Civ. P. 11(c)(4).

[39] *Zubulake v. UBS Warburg LLC*, 220 F.R.D. 212, 218 (S.D.N.Y. 2003).

(a) "Spoliation is the destruction or significant alteration of evidence, or the failure to preserve property."[40]

(b) Sanctions imposed for spoliation should accomplish three goals: (1) correcting prejudice suffered by the non-spoliating party; (2) placing the risk of an erroneous judgment on the spoliating party; (3) and deterring future spoliation. As a rule, courts impose the least harsh sanction that will provide an adequate remedy, but that does not mean the sanctions will not be harsh.[41]

(c) The range of sanctions — from least harsh to most harsh — include requiring additional discovery, cost-shifting, fines (including the payment of the non-spoliating party's attorneys' fees), special jury instructions (such as an adverse inference), preclusion and termination of sanctions, and the entry of a default judgment or dismissal.[42]

(d) A party seeking sanctions based on spoliation of evidence must establish that: "(a) the party having control over the evidence had an obligation to preserve it; (b) the records were destroyed with a 'culpable state of mind'; and (c) the destroyed evidence was relevant to the moving party's claim or defense, 'such that a reasonable trier of fact could find that it would support that claim or defense.'"[43]

(e) Although courts disagree as to the level of culpability necessary to secure certain sanctions, "in the Second Circuit even the mere negligent destruction of evidence may be sufficient to warrant sanctions."[44]

(f) In 2012, the Second Circuit held that "the better approach is to consider [the failure to adopt good preservation practices] as one factor" in the determination of whether discovery sanctions should issue.[45]

(g) Individuals in-house may be sanctioned for document spoliation.[46]

C. Liability for Misrepresentations/Omissions to Investors

1. Liability is provided for by federal statutes, as well as by state statutes and common law.

2. Basic federal liability is under Section 10(b) of the Securities and Exchange Act of 1934 and Rule 10b-5 promulgated thereunder.

(a) The elements of a private action under Rule 10b-5 are: "(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or

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[40] *West v. Goodyear Tire & Rubber Co.*, 167 F.3d 776, 779 (2d Cir. 1999).

[41] *See id.*

[42] *See, e.g.*, *id.* at 780; *Coleman (Parent) Holdings Inc. v. Morgan Stanley & Co.,* 2005 WL 674885 (Fla. Cir. Ct. March 23, 2005) (sanctioning Morgan Stanley by ordering jury to presume that Morgan Stanley had helped to defraud Coleman, where Morgan Stanley technology executive had certified that the firm had produced all responsive emails even though he had previously told Morgan Stanley's lawyers that there were others).

[43] See *Sekisui America Corp. v. Hart,* 2013 WL 2951924 *3 (S.D.N.Y. 2013) (citing *Chin v. Port Auth. of N.Y. & N.J.*, 685 F.3d 135, 162 (2d Cir. 2012), *cert. denied*, 133 S. Ct. 1724, 185 L. Ed 785 (2013)).

[44] *Id.* (citing *Residential Funding Corp. v. DeGeorge Fin. Corp.,* 306 F.3d 99, 107 (2d Cir. 2002)).

[45] *Chin v. Port Auth. of N.Y. and N.J.*, 685 F.3d 135, 162 (2d Cir. 2012).

[46] *See, e.g.*, *Metropolitan Opera Ass'n, Inc. v. Local 100*, 212 F.R.D. 178 (S.D.N.Y. 2003) (sanctioning in-house counsel to a union for, inter alia, allowing the union to destroy documents responsive to its adversary's subpoenas).

omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation."[47]

(b) Besides the entity making the pronouncement, individuals involved may have liability as well.

(i) *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011)

(1) Shareholders of Janus Capital Group ("JCG") brought suit against its subsidiary Janus Capital Management ("JCM") for violation of Rule 10b-5(b).

(2) The U.S. Supreme Court held that JCM, as the investment adviser, did not "make" any of the statements in the Janus Investment Fund prospectuses, as it did not have "ultimate authority" over the statements. Therefore, it could not be held liable under Rule 10b-5(b).

(ii) *Janus* established that an individual may be liable when he or she "is the person … with ultimate authority over the statement, including its content and whether and how to communicate it."[48]

(c) In-house counsel may be liable for drafting investor documents.[49]

3. The Southern District of New York has allowed an adversary to access documents that would ordinarily be considered privileged — including notes written by outside counsel — where the fund had "voluntarily supplied" those documents to the SEC during an earlier internal investigation.[50]

D. Representation of Multiple Firms by One Outside Counsel

1. General counsel should participate in making judgments about the appropriateness of having one outside counsel represent multiple firms.

2. Different states have different rules regarding multiple representation depending on their code of professional responsibility.

3. The New York Rules of Professional Conduct provide:

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if a reasonable lawyer would conclude that either:

(1) the representation will involve the lawyer in representing differing interests; or

(2) there is a significant risk that the lawyer's professional judgment on behalf of a client will be adversely affected by the lawyer's own financial, business, property or other personal interests.[51]

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[47] *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2301 n.3 (2011).

[48] *Id.* at 2302.

[49] *Touchtone Group, LLC v. Rink*, 913 F. Supp. 2d 1063, 1079 (D. Colo. 2012) (declining to dismiss, under the *Janus* standard, a Section 10(b) claim against a general counsel who had drafted allegedly false statements).

[50] *Gruss v. Zwirn*, 2013 WL 3481350 at *1 (S.D.N.Y. July 10, 2013).

[51] N.Y. Rules of Prof'l Conduct R. 1.7(a) (2009).

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;

(2) the representation is not prohibited by law;

(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

(4) each affected client gives informed consent, confirmed in writing.[52]

4. Conflicts can be waived, but counsel, outside and inside, should be comfortable that outside counsel can effectively represent all involved, whether the clients are co-plaintiffs or co-defendants, or are working together as an ad hoc group (such as similarly situated creditors in bankruptcy).

5. Issues arise more frequently when multiple clients are defendants or potential joint counterclaim defendants.

6. One consideration, expressly reflected in the New York rule, is whether there are likely to be cross-claims between the parties. This would typically arise when clients are defendants, not plaintiffs.

7. Another consideration is whether some of the jointly represented parties have defenses or arguments in support of claims that are not available to the other represented parties. Assertion of such defenses or arguments in support of claims can cast the defenses or affirmative arguments of other represented parties in a less favorable light.

8. Sometimes problems may not appear, or be anticipated, at first, in which case joint representation may be appropriate, subject to separate counsel being obtained later if problems arise.

9. Joint representations should be subject to clear agreements providing for the terms of the representation and the rights of all involved should the joint representation terminate.

[52] N.Y. Rules of Prof'l Conduct R. 1.7(b) (2009).

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