Wall Street LAWYER
Securities in the Electronic Age

June 2016 ▪ Volume 20 ▪ Issue 6

THE ROAD TO CAT: WHAT THE SEC'S CONSOLIDATED AUDIT TRAIL MEANS FOR FIRM COMPLIANCE AND BLOCKCHAIN

By Jim Mullen

Jim Mullen is Co-Founder and Chief Technology Officer of Firm58, a financial management software company serving the capital markets industry.
Contact: www.firm58.com.

Today's market structure is a labyrinth of complexity and fragmentation. Despite widespread efforts to bolster regulations and increase sanctions for non-compliance, much of the activity within the capital markets still happens in the dark. Dark pool liquidity venues—which emerged in the 1980s to bring a bit of obscurity to big institutional block trades—are now the modus operandi for a much larger group of traders. According to *Rosenblatt's Monthly Dark Liquidity Tracker*, dark pools carried out nearly 17% of US equities trades in January.[1] Add the proliferation of high-frequency trading into the mix and you're left with a highly complex market that poses big problems for regulatory enforcement.

That's where the Consolidated Audit Trail (CAT) comes into play. Ordered by the Securities and Exchange Commission (SEC) following the confusion of 2010's Flash Crash, the CAT will provide a data repository for regulators to comprehensively track all equities and options trading activity in US markets. It aims to create a more transparent market—one in which regulators can better identify market manipulations, noncompliance and the precipitating factors behind incidents like the Flash Crash.

While plans for the CAT have been gestating for years, it's finally on a concrete path to implementation. The introduction of the CAT carries significant implications for broker-dealer firms. Now that the project is no longer on the SEC's backburner, firms must prepare by prioritizing data organization and centralization. The momentum surrounding the CAT also brings up questions about the possible role that blockchain—a technology that seems functionally suited to the needs of the CAT—could play in the process.

CAT: Mapping the Trail

The mandate for an audit trail is one thing; actually planning and building one is another. And that's been a protracted process. Although the SEC proposed building a CAT in 2010, it didn't take the next big step until July 2012, when it adopted a rule mandating self-regulatory organizations (SROs) to jointly cre-

IN THIS ISSUE:

THOMSON REUTERS

41852280

ate and maintain the centralized repository.[2] The SEC's decision to outsource CAT development to the SROs makes sense in terms of ensuring accountability, but it certainly didn't speed up the process. As the SROs slowly worked to fulfill their directive, disruptive market events like last August's massive selloff further affirmed the need for a greater degree of transparency surrounding market activity. And as SEC Commissioner Kara M. Stein put it in her remarks at a Securities Traders Association event last September,[3] "Transparency is not just about disclosure. It's also about verification."

Verification is exactly what the CAT will provide—and the implementation process for the tool is finally picking up speed. Recently, the SROs and the Financial Industry Regulatory Authority (FINRA) delivered their joint industry plan to the SEC, and on April 27, the SEC shared the 1,000-plus-page plan with the public.[4] The SEC is looking for public comment on the plan before approving it,[5] which means that building of the CAT likely won't begin until 2017. That said, the plan does lay out a concrete course of action for the construction of the central repository, beginning with the selection of a "Plan Processor" to build the CAT and then operate and update it as needed.

What Does the CAT Plan Mean for Broker-Dealers?

Now that the CAT is on a formal path to implementation, it's time for broker-dealers to get prepared. Once the CAT plan is approved, large broker-dealers will have two years to start reporting data, while small firms will have three. While two to three years may seem like significant lead time for brokerages, there's a lot these firms must do in the interim. Here are some of the key considerations for broker-dealers as they prepare for a market with a comprehensive, consolidated audit trail:

- **Regulators will have unprecedented oversight:** In a highly fragmented market, many firms are able to fly under the regulatory radar with non-compliant activities. But that will change once regulators have a CAT at their disposal. Because the CAT will be highly searchable, regulatory bodies will be able to easily analyze the continuous data stream and quickly identify questionable activity. Equipped with these actionable insights, regulatory groups will be able to more efficiently patrol for lower-level infractions like late reporting (fines range from $5,000 to $146,000)[6] and net capital deficiencies ($1,000 to $73,000). As a result, broker-dealers can expect

Wall Street Lawyer
West LegalEdcenter
610 Opperman Drive
Eagan, MN 55123

©2016 Thomson Reuters

For authorization to photocopy, please contact the **West's Copyright Clearance Center** at 222 Rosewood Drive, Danvers, MA 01923, USA (978) 750-8400; fax (978) 646-8600 or **West's Copyright Services** at 610 Opperman Drive, Eagan, MN 55123, fax (651) 687-7551. Please outline the specific material involved, the number of copies you wish to distribute and the purpose or format of the use.

This publication was created to provide you with accurate and authoritative information concerning the subject matter covered; however, this publication was not necessarily prepared by persons licensed to practice law in a particular jurisdiction. The publisher is not engaged in rendering legal or other professional advice and this publication is not a substitute for the advice of an attorney. If you require legal or other expert advice, you should seek the services of a competent attorney or other professional.

Copyright is not claimed as to any part of the original work prepared by a United States Government officer or employee as part of the person's official duties.

One Year Subscription ● 12 Issues ● $ 867.96
(ISSN#: 1095-2985)

an increase in sanctions for infractions that might have otherwise been overlooked.

● **Data organization will be top priority:** While market competition has sidelined data organization for many firms, the CAT will change that. The adoption of the CAT demands data centralization from all firms, which is a tall order for many broker-dealers that have placed information oversight on the backburner. But now that the deployment of a CAT is drawing closer, firms will have to elevate data management to the top of their priority list. Firms that haven't prioritized data organization can take a key step by devoting more time, staff and resources to compliance and surveillance. The need for data centralization should also push firms to expand their leadership with experts devoted to data analytics. If your firm doesn't have an analytics expert in its C-suite, it's time to bring someone on board.

● **Small and large firms will face an equal level of scrutiny:** When it comes to regulatory scrutiny of trading activities, the CAT will create an even playing field, with each broker-dealer being assigned a singular identifier by which their activities can be tracked. In short, all brokerages can expect the same degree of regulatory tracking. This will be a departure from the current model, in which large traders face more stringent tracking under the SEC's 2011 large trader reporting rule.[7] But small brokerages that are accustomed to flying under the regulatory radar should prepare for a much higher degree of scrutiny once the CAT is rolled out.

A Role for Blockchain?

The development of the CAT is running alongside the evolution of the public ledger blockchain, and some industry experts are suggesting that blockchain technology could be the perfect vehicle for creating and operating the CAT. While it was designed to serve as the ledger to track all Bitcoin exchanges—indexing each transaction in an unalterable registry—the technology has significant potential within the capital markets, and industry leaders are already making notable investments in blockchain ventures.[8] Will the CAT end up being one of these ventures? Blockchain's construction suggests as much: As a distributed database that enables comprehensive and ordered data tracking without a storage burden, it's functionally suited to meet the needs of the CAT.

While blockchain technology isn't part of the CAT design proposal—it isn't mentioned once in the 1,090-page document—it does have some significant supporters within the SEC. One of those proponents is SEC Chair Mary Jo White, who took time in her keynote address at the SEC-Rock Center on Corporate Governance Silicon Valley Initiative to highlight the potential blockchain technology has to "modernize, simplify, or even potentially replace, current trading and clearing and settlement operations."[9] At a separate event, Commissioner Stein—one of the driving figures behind the CAT—similarly touted blockchain's transformative potential.[10]

The fact that blockchain is a public ledger does present a security issue if it's integrated into the CAT project. Blockchain's public accessibility means that were it used for the CAT, anyone could have access to the trade information contained within it. However, given that the CAT project is several years away from mainstream deployment, this could give blockchain developers the time they need to modify blockchain technology for integration into the CAT project.

A Look Ahead

The CAT is not a silver bullet. It won't eliminate illicit trading, fully illuminate the darker corners of the market, or stop disruptive events from happening. But it will be a key step toward actively reducing these problems. With the path to a CAT laid out, it will be interesting to see if blockchain technology comes to play a role in the development process.

In the meantime, brokerage firms must start prepar-

ing for a much more stringent atmosphere of monitoring and enforcement. The most important element of this preparation is to start doing it now. While the exact timeline for the CAT hasn't been solidified, the reality of it is looming. And when it's unveiled, firms need to be ready.

ENDNOTES:

[1]*See* "LET THERE BE LIGHT: Rosenblatt's Monthly Dark Liquidity Tracker"; Feb. 26, 2016; available at http://www.rblt.com/lettherebelight__details.aspx?id=601.

[2]SEC's Rule 613 "Consolidated Audit Trail"; available at https://www.sec.gov/divisions/marketreg/rule613-info.htm.

[3]See SEC Commissioner Kara M. Stein speech (Sept. 30, 2015), available at https://www.sec.gov/news/speech/stein-market-structure.

[4]SEC Release No. 34-77724 (File No. 4-698) April 27, 2016; available at https://www.sec.gov/rules/sro/nms/2016/34-77724.pdf.

[5]"SEC Seeks Public Comment on Plan to Create A Consolidated Audit Trail"; April 27, 2016; available at https://www.sec.gov/news/pressrelease/2016-77.html.

[6]"2015 FINRA Enforcement Actions" Jonathan N. Eisenberg, K&L Gates LLP; January 10, 2016; available at https://corpgov.law.harvard.edu/2016/01/10/2015-finra-enforcement-actions.

[7]*See* http://www.sifma.org/issues/operations-and-technology/large-trader-reporting/overview.

[8]*See*, for example http://www.forbes.com/sites/laurashin/2015/09/09/visa-citi-nasdaq-invest-30-million-in-blockchain-startup-chain-com/#142ad4ec9143.

[9]Keynote Address at the SEC-Rock Center on Corporate Governance Silicon Valley Initiative; SEC Chair Mary Jo White (March 31, 2016); available at https://www.sec.gov/news/speech/chair-white-silicon-valley-initiative-3-31-16.html.

[10]Surfing the Wave: Technology, Innovation, and Competition—Remarks at Harvard Law School's Fidelity Guest Lecture Series; SEC Commissioner Kara M. Stein (Nov. 9, 2015); available at https://www.sec.gov/news/speech/stein-2015-remarks-harvard-law-school.html.

BEYOND BITCOIN—BLOCKCHAIN AND THE LEGAL IMPACT

By Joseph Raczynski

Joseph Raczynski is a Legal Technologist and Futurist for Thomson Reuters Legal. Raczynski is an innovator and early adopter of all things computer related. His primary bent is around the future of law and legal technology in several fields including machine learning, mobile, security, cryptocurrency, and robotics (drone technology).
Contact: joseph.raczynski@thomsonreuters.com.

While Bitcoin may disappear in a few years—doubtful, but possible—the underlining technology is by far the most important development going forward. Blockchain is a public ledger.[1] It can be applied to almost anything that you would normally save to a database or spreadsheet.

In the Bitcoin example, the blockchain shows the exchange of all the money that has ever changed hands in Bitcoin transactions. It does not list who owns the coins per se, just that they exist or that they changed hands. It is controlled by no single person but by all parties connected to the exchange. This public, but encrypted spreadsheet in the sky is in theory more secure and open than our current system of money exchange. The network maintains a collective history of all of the transactions that have ever occurred on the network. You can view all of the Bitcoins changing hands every moment of the day at Blockchain.info.[2]

And as you see the transactions scroll up, you soon identify several important legal implications. For one, none of this money has been passed through a bank or other financial institution, nor has it be screened by any government agency. That is, if you have a major transaction of $10,000 or more coming or going from the US—one that is normally required to be reported—it is not being reported via Bitcoin today. As you might surmise, many positives with this technol-

 © 2016 Thomson Reuters

ogy exist, but significant challenges, mostly concerning government regulators and current US laws, are also present.

While Bitcoin created the first blockchain, many other such chains have been created since. For example, there are other cryptocurrencies that use the technology. However, where this becomes most interesting is how related businesses could use a ledger-based blockchain platform. Fundamentally it is a program from which to build a system of accounting or process. One network called Ethereum,[3] which has been described as a "decentralized virtual machine that can execute peer-to-peer contracts" is leading the charge with smart contracts and the law.

Here is how I see blockchain affecting the legal industry.

Blockchain and the Law

Creation of Contracts: The blockchain could alter the landscape of contract attorneys. Part of what makes the blockchain so special is that not only does it keep records which are immutable, it also creates a process around that. For example, I could create a contract which stipulates that when my patent was approved by the Patent and Trademark Office (PTO), my four partners would receive a 10% share in my company. How would that work? The contract on the blockchain would check to see if the patent was approved, then trigger a process releasing the shares to the partners. All of this would be automated and fall outside of human legal action. Indeed, you could go one step further and tie-in a payment system so that when that patent was granted, bonus funds could be dispersed automatically into the accounts of said partners.

Intellectual Property: If blockchain is ripe for anything it is IP. This technology creates a publically accessible, indisputable ledger of each filing which could be held not solely by jurisdiction but on a global scale benefiting everyone. This information would offer clean and clear rights of use for all parties. You could even submit your trademark through the system. Leveraging an algorithm identifying any likeness to the trademark, the system could then grant or dismiss it. All of which would become part of the public ledger for anyone to review.

Land Registry: Some Latin American countries are beginning to use blockchain as a means to keep track of who owns which land deeds. Wealth is created through ownership, and one of the most challenging aspects of developing countries is determining who owns a piece of land. Disputes often occur because of corrupt governments or individuals taking advantage of the under-educated. Having a public blockchain ledger would allow for everyone to be aware of who owns which parcel of land; and it would make the exchange of those plots much easier and more equitable.

If a family were to buy a plot of land that could be registered on the legal blockchain, it would be much more verifiable than even perhaps government records. All parties would be able to authenticate this as compared to one entity (the government) holding onto all the records. This process would even create a better base for the government to fairly tax individuals and businesses.

Establishing Records: In some African countries they are looking at using blockchain technology to keep census information. Voter records could also be added to this process as a means to have a central repository of eligible citizens. In this area, currently under development, blockchain seems primed for tremendous growth.

Financial Service Industry: The banking industry also is jumping into this arena. The theory is that our stock exchanges will become blockchain enabled. The idea is simply that every stock bought or sold would be on the ledger. You could

trace back your own ownership of that equity and even tie that to your estate-planning documents. Extrapolating this out, those documents also could be housed on a blockchain with respective triggers for when you eventually die. Ultimately that information is then released to your beneficiaries based on that event (Date of Death) recording by the Social Security Administration (SSA).

Personally I have little doubt that blockchain technology will revolutionize the legal industry in the coming years. The question is if it will be more like HTML—a behind the scenes technology—or if it will be a more obvious, almost tangible technology that we will all reference by name. There is almost no doubt that this technology will be a significant disrupter to the legal profession and the overall market on many fronts. The biggest industries—government, banking, legal, healthcare and others will either use it or be significantly impacted by it.

ENDNOTES:

[1] *See* https://en.wikipedia.org/wiki/Block__chain__(database).

[2] *See* https://blockchain.info.

[3] *See* https://en.wikipedia.org/wiki/Ethereum.

BREAKING NEWS: 11TH CIRCUIT LIMITS SEC POWER TO SEEK DISGORGEMENT AND DECLARATORY RELIEF

By Mark A. Perry, Richard W. Grime & Gabriel K. Gillett

Mark A. Perry and Richard W. Grime are litigation partners in the Washington, D.C. office of Gibson, Dunn & Crutcher LLP. Perry is also Co-Chair of the firm's Class Actions practice group, and a member of the firm's Appellate and Constitutional Law, Intellectual Property, Labor and Employment, Life Sciences, and Securities Litigation practice groups. Grime is also a member of the White Collar Defense and Investigations Practice Group and the Securities Enforcement Practice Group. Gabriel K. Gillett is an associate in the firm's New York office. Disclosure: Perry and Gillett represented the Securities Industry and Financial Markets Association as amicus curiae in SEC v. Graham.
Contact: mperry@gibsondunn.com and rgrime@gibsondunn.com.

On May 26, the US Court of Appeals for the 11th Circuit issued a significant decision, in *SEC v. Graham*,[1] holding that the Securities and Exchange Commission's (SEC's) claims for disgorgement and declaratory relief are subject to the five-year statute of limitations set forth in Section 2462 of the US Code.[2]

The decision is important to participants in the securities industry because the SEC often seeks disgorgement going back more than five years, and has long taken the position that such claims are not subject to a limitations period. Now, claims for disgorgement, declaratory relief, and penalties are subject to the same five-year statute of limitations. Coupled with the Internal Revenue Service's (IRS's) recent decision that SEC claims for disgorgement in settlements are not tax deductible because they are punitive,[3] and the US Supreme Court's unanimous decision in *Gabelli v. SEC*,[4] applying Sect. 2462 to civil money penalties, *Graham* provides strong support for other jurisdictions to hold the SEC to the strictures of Sect. 2462.

In January 2013, the SEC brought a civil enforcement action, in the Southern District of Florida, alleging that defendants had violated federal securities laws between November 2004 and July 2008.[5] As relief, the Commission sought (*i*) a declaration that defendants violated the securities laws; (*ii*) disgorgement of all profits, with prejudgment interest, from the allegedly improper conduct; and (*iii*) a permanent injunction from future securities law violations.[6]

The district court found that the SEC's claims were time barred under Sect. 2462, which prohibits any action "for the enforcement of any civil fine, penalty, or forfeiture" if brought more than five years from the date the claim first accrued.[7]

 © 2016 Thomson Reuters

On appeal, the 11th Circuit affirmed in substantial part. The Court squarely held that Sect. 2462 applies to declaratory relief because it is backward-looking and punitive, and to disgorgement because it is synonymous with forfeiture.[8] In so holding, the court expressly rejected the SEC's argument that declaratory relief was necessary to obtain other remedies.[9] The Court also explained that it was "loath to adopt" the SEC's "technical definition" of disgorgement, "because § 2462 applies to a wide variety of agency actions and contexts."[10] Although the Court held that circuit precedent "foreclose[d] the argument that § 2462 applies to injunctions" *per se*, it noted that an "obey-the-law" injunction barring future securities-law violations may be unenforceable.[11]

The *Graham* decision represents a significant victory for securities market participants. *Graham* builds on the Supreme Court's unanimous decision to apply Sect. 2462 to civil money penalties.[12] *Graham* also comports with the IRS's decision holding that a disgorgement payment for violations of the Foreign Corrupt Practices Act,[13] is not tax deductible because the payment is "primarily punitive."[14] As a result, *Graham* further limits potential exposure for conduct more than five years in the past, and limits the SEC's opportunity to pursue declaratory relief.

It remains to be seen how the SEC will respond to this significant blow to their ability to seek disgorgement for aged claims. The *Graham* Court's disgorgement holding creates an apparent circuit split.[15] But, given the soundness of the reasoning in *Graham*, the SEC may opt to hold its fire and wait to see how the D.C. Circuit rules in *Timbervest v. SEC*,[16] which presents similar issues.

ENDNOTES:

[1]*SEC v. Graham*, No. 14-13562 (11th Cir. May 26, 2016).

[2]*See* 28 U.S.C. § 2462.

[3]IRS Memorandum, No. 201619008 (May 6, 2016).

[4]*Gabelli v. SEC*, 133 S. Ct. 1216 (2013).

[5]Slip op. at 3.

[6]*Id*.

[7]*Id*. at 4.

[8]*Id*. at 9-14.

[9]*Id*. at 10-11.

[10]*Id*. at 13-14.

[11]*Id*. at 5, 9 n.2.

[12]*See Gabelli*.

[13]Foreign Corrupt Practices Act, 15 U.S.C. §§ 78dd-1, *et seq*.

[14]IRS Memorandum, No. 201619008 (May 6, 2016).

[15]*See Riordan v. SEC*, 627 F.3d 1230 (D.C. Cir. 2011) (citing *Zacharias v. SEC*, 569 F.3d 458 (D.C. Cir. 2009)); *SEC v. Rind*, 991 F.2d 1486 (9th Cir. 1993).

[16]*Timbervest v. SEC*, No. 15-1416.

THE IMPACT ON CLASS CERTIFICATION OF *HALLIBURTON II* AND *BASIC*

By Thomas O. Gorman

Thomas O. Gorman is a partner in the Washington, D.C. office of Dorsey and Whitney LLP. He also publishes a blog, "SEC Actions" (www.secactions.com) that focuses on the Securities and Exchange Commission (SEC) and other securities industry regulators. This article is taken from blog post that ran April 27. (Disclosure: The author and his firm was counsel to the defendants in the Genovese case referenced in the article.)
Contact: Gorman.tom@Dorsey.com.

The predicate for many securities class actions is the fraud-on-the-market theory, adopted by the Supreme Court almost three decades ago in *Basic, Inc. v. Levinson*.[1] There the Court held that a securities law plaintiff could invoke a rebuttable presumption of reliance—a key element of an action for damages—where it can be demonstrated that the stock traded in

an efficient market. The predicate for the *Basic* decision is the theory that the price of a security reflects the available material information about the stock when it is traded in an efficient market. Investors are entitled to rely on the integrity of the share price for a stock trading in such a market.

While *Basic* held that the presumption is rebuttable, it was not until *Halliburton Co. v. Erica P. John Fund, Inc.*,[2] (known as "*Halliburton II*") that the Court held that evidence demonstrating a lack of price impact could be introduced at the class certification hearing to address the point. That evidence, the Court noted, was typically developed through the use of economic event studies.

Two recent decisions illustrate the reach of *Basic* and *Halliburton II.* One is the ruling on April 12 by the US Court of Appeals for the Eighth Circuit in *IBEW Local 98 Pension Fund v. Best Buy Co., Inc.*[3] The case focused on two sets of statements, both made on Sept. 14, 2010. The first set was made in a Best Buy press release issued at 8 am, before the stock market opened for trading. The release announced an increase in full-year earnings per share (EPS) guidance by 10 cents to between $3.55 and $3.70. The release cautioned that it contained forward-looking information; nevertheless, the stock opened up 7.5% at $37.25.

Those statements were echoed by Best Buy CFO Jim Muehlbauer in a conference call two hours later. During the call, which began with a reminder that there may be forward-looking statements, Muehlbauer told investors and the market that "looking at the results for the first half of fiscal 2011, while there are many moving pieces that we manage, like always, we are pleased that our earnings are essentially, *in line* with our original expectations for the year."

"Overall, we are pleased that we are *on track* to deliver and exceed our annual EPS guidance," Muehlbauer stated. That day, the stock closed at $36.73 on volume of 21.3 million shares.

Three months later, on Dec. 14, 2010, Best Buy issued another press release. The release stated that the firm had a decline in fiscal third quarter sales and thus EPS guidance had been reduced to between $3.20 and $3.40 per share. The release was discussed in a conference call later that day. The stock closed down 14.8% at $35.52, down from $41.70 from the close the day before.

The lawsuit by the IBEW Local 98 Pension Fund followed. The complaint alleged that the September statements were false, resulting in an artificial price which was corrected by the December statements. A Minnesota District Court dismissed the claims based on the statements in the September press release, concluding that they were accompanied by meaningful cautionary language. The Court, however, did permitted the action to proceed based on the statements in the September press *conference* and certified the class. Plaintiffs' economic expert supported the motion for certification by conducting an event study. Based on that study, he concluded that the Best Buy stock price increased in reaction to the September 14 statements.

In contrast, an event study by Defendants' expert demonstrated that the price increase on September 14 occurred *after* the press release but *before* the call. Defendants' expert went on to conclude that the statements at the press conference thus had no discernable impact on the stock price.

In rebuttal, Plaintiffs' expert claimed that even if the September press release is not actionable, it does not mean that investors did not give it great weight. In addition, the conference call statements fraudulently maintained the share price until the corrective disclosure on December 14, the expert concluded. In certifying the class, the District Court held that "price impact can be shown by a decrease in price following a revelation of the fraud." The Court then found that Defendants "have not offered evidence to show that Best Buy's stock price did not decrease when the truth was revealed."

© 2016 Thomson Reuters

In April, the Eight Circuit reversed. The Court began by acknowledging that plaintiffs had presented a *prima facie* case that the *Basic* presumption applies. What the District Court ignored, however, was strong evidence that the presumption had been rebutted under *Halliburton II* by evidence presented by Plaintiffs' own expert. The expert opined that the economic substance of the non-fraudulent press release statements and the alleged misrepresentations "in the immediately following conference call was 'virtually the same,' and that the two 'would have been expected to be interpreted similarly by investors.' " An event study confirmed the fact that the EPS guidance in the press release had an immediate impact on the share price but the confirming evidence in the conference call had no additional impact. Defendants' expert agreed. This was "direct evidence that the investors did not rely on the executives' confirming statements two hours later," the Circuit Court stated.

Plaintiffs' contention that the December 14 corrective disclosure was evidence of the requisite price impact does not change these facts. The claimed "inflated price" was established by the non-fraudulent press release. Under these circumstances it is clear that "defendants rebutted the *Basic* presumption by submitting direct evidence (the opinions of both parties' experts) that severed a link between the alleged conference call misrepresentations and the stock price at which plaintiffs purchased."

Genovese

The second recent case impacted by *Basic* and *Halliburton II* is *Todd Stanaford v. Genovese*,[4] decided by the Florida Southern District Court on March 14. In that case, plaintiffs claimed that defendant Robert Genovese, an activist investor, and his hedge fund, BG Capital Group and its affiliates, used a series of false statements and, in conjunction with boiler room tactics employed by a broker, fraudulently inflated the share price of silver mining company Liberty Silver, Inc. in the late summer and fall of 2012. A trading halt by the Securities and Exchange Commission (SEC) in early-October 2012 acted as a corrective disclosure. Liberty Silver's shares were traded on the Toronto Stock Exchange (TSX) and on the over-the-counter exchange (OTC BB) in the U.S. Following the denial of a motion to dismiss, settlement by certain defendants and the conclusion of fact and expert discovery, the Court denied plaintiffs' request for class certification.

The fundamental question posed by the motion for class certification was whether plaintiffs were entitled to invoke the *Basic* presumption—that is, was the market for Liberty Silver shares efficient? Neither the US Supreme Court nor the Eleventh Circuit has defined a specific test for determining whether a market is efficient. The leading case on the point is the 1989 decision in *Cammer v. Bloom*.[5] In *Cammer*, a New Jersey District Court stated that the central question is whether

> the stock price. . . reflected misinformation alleged to have been disseminated. To determine whether a market is open and efficient, the court addressed the following factors: (*i*) the trading volume during the class period; (*ii*) the number of securities analysts following and reporting on a company's stock. . . (*iii*) the existence of market makers; (*iv*) whether the Company was required to file a S-3 Registration statement; and (*v*) [if there was] a cause and effect relationship between unexpected corporate events or financial releases and an immediate response to the stock price.

An analysis of those factors in the *Genovese* case supported the conclusion that Liberty Silver shares did not trade in an efficient market. For example, in considering the fifth factor—a cause and effect relationship—the Court found that there was none based on the testimony of the defendants' economic expert, former SEC Chief Economist, Prof. Gregg Jarrell:

> 'Liberty Silver's stock returns were not correlated with any general market or industry indexes during the Class Period. . . .' Specifically, Prof. Jarrell examined each of the 11 disclosures that [were] alleged in the Complaint to contain fraudulent statements. . . [and based

on event studies] found that none of the disclosures had a 'corresponding, statistically-significant reaction to Liberty Silver's stock price. . . . Therefore, Prof. Jarrell opined that 'whether we examine non-fraud-related news or allegedly fraud-related news, there is no evidence whatsoever of any cause-and-effect relationship between news and Liberty Silver's stock returns.'

Prof. Jarrell analyzed a series of additional factors frequently considered in evaluating the question of market efficiency, in addition to the *Cammer* factors. Those included such factors as the company's market capitalization, public float, bid/ask spread, media coverage and institutional ownership. An analysis of each of these factors supported the conclusion that the shares of Liberty Silver did not trade in an efficient market. He bolstered this conclusion by conducting a *Halliburton II* event study of each statement that the Plaintiffs' claimed was false. Those studies demonstrated that the claimed false statements had no material impact on the share price of Liberty Silver stock.

Plaintiffs, in contrast, claimed that the market was efficient based on the testimony of Candace Preston, principal and founding member of Financial Markets Analysis (FMA). While Ms. Preston did not evaluate all of the *Cammer* factors or the additional points considered by Prof. Jarrell, she opined that the market for Liberty Silver shares reflected available information during the last three months of the class period when there was a substantial price increase. In reaching her conclusion, Ms. Preston relied on the results of a statistical test which compared the amount of the price increase from the beginning of the class period up to the last three months to the rise during the final three months of the period. That comparison demonstrated that the price rise in the last three months of the period was abnormal, according to Ms. Preston. This point, coupled with her determination that three of the *Cammer* factors were met during the last three months of the class period, suggested that the market for Liberty Silver shares was efficient during the last three months of the class period.

In its opinion, the District Court rejected ''Ms. Preston's conclusion, which claimed that Liberty Silver shares traded on an efficient market. The Court finds Prof. Jarrell to be more credible.'' The Court denied Plaintiffs' Motion for Class certification, concluding that the market was not efficient. Thus Plaintiffs were not entitled to invoke the *Basic* presumption, and they agreed to dismiss the action with prejudice.

ENDNOTES:

[1]*Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

[2]*Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S.Ct. 2398 (2014) (known as "*Halliburton II*").

[3]*IBEW Local 98 Pension Fund v. Best Buy Co., Inc.,* No. 14-3178 (8th Cir. Filed April 12 2016).

[4]*Todd Stanaford v. Genovese*, Civil Action No. 13-cv-80923 (S.D. Fla. Opinion March 14, 2016).

[5]*Cammer v. Bloom*, 711 S. Supp. 1264 (D. N.J. 1989).

10 TOP CONCERNS FOR US COMPLIANCE OFFICERS IN 2016

By Todd Ehret

Todd Ehret is a Senior Regulatory Intelligence Expert for Thomson Reuters Regulatory Intelligence he has had more than 20 years' experience on Wall Street in investment professional, executive and compliance positions.
Contact: todd.ehret@thomsonreuters.com.

Compliance professionals in the U.S. finance industry are lucky to be heading into 2016 without having to blindly depend on unfounded predictions for the new year. Instead, the published exam priorities of the primary financial regulators, the Securities and Exchange Commission, (SEC) and the Financial Industry Regulatory Authority (FINRA), provide informed guidance on what will be on the agenda when they come knocking.

The regulators also are great at underscoring con-

 © 2016 Thomson Reuters

tinuing priorities by frequently reminding us what they've accomplished in the previous year. Below is a quick overview of 10 top concerns for compliance officers in the coming year, based on what has been revealed so far about exam priorities and other indications of the regulatory agenda. This look at issues likely to keep North American compliance officers up at night could be helpful for year-end reviews and year-ahead planning.

The list below is also in no particular order—all of the items have varying levels of importance at different types of firms. A firm's size, business type and client type greatly determines their top concerns. We will be sure to dig much deeper into each area throughout 2016 and will also provide multiple analyses of the exam priorities. The FINRA exam priorities for 2016 were released in January,[1] and the SEC's version followed a few days later.[2]

1. Insider trading and misuse of material non-public information—A major US Appeals Court decision in December 2014 that restricted the application of insider trading law made 2015 an eventful year. With the Supreme Court declining to review the appeals court decision in the case of *US v. Newman*, which held that for an insider trading tip to be unlawful, the original tipper must have received a benefit. There were still many settlements in 2015 in lower profile, easy wins for the SEC. Going forward, however, the enforcement emphasis may be on the misuse of material non-public information rather than insider trading.

With material non-public information often widely disseminated in firms, preventing its misuse is a top priority. Such sensitive information must constantly be walled off and documented so as to prevent its spread and possible misuse as well as to prove that such information is handled appropriately.

2. Outsourcing—The trend of outsourcing services, whether it be IT, accounting or other critical business functions, is occurring in virtually every industry. In the financial services industry, the selection of vendors as business partners has never been more important. All outside vendors should be vetted rigorously as a failure by a vendor does not remove the regulated financial firm of liability.

Risks inherent in compliance outsourcing were highlighted by the SEC in a Risk Alert published in November 2015.[3] The fact that compliance is outsourced does not remove the responsibility to run a firm with a culture of compliance or allow firms to cut corners. More importantly, outsourcing does not remove the liability of the partners or other officers at a firm.

The most important aspect of successful outsourcing is that while activities can be moved to a third party, the skills to manage those activities must be retained. Careful diligence when vetting an outsourced firm as well as continued monitoring are essential.

3. AML/KYC risk—With the concern over terrorism increased by attacks in Paris and San Bernardino, California, anti-money laundering (AML) policies and counter-terrorist financing policies have become vital. For many years in retail banking and brokerage the simple act of "knowing your customer" was seen as adequate AML policy. This is no longer the case, given the level of sophistication and severity of the criminal activity, and an enforcement crackdown by regulators.

AML also is a top concern internationally. Canada this year is awaiting the results of the Financial Action Task Force's (FATF) audit of Canadian AML policies, and new legislation there could follow publication of the findings. New international regulations tend to quickly make their way to the United States as well so compliance officers must

stay abreast of developments.

4. Culture and conflicts of interest—In 2015 there were a number of conflicts of interest cases involving private equity and private fund managers. Many regulatory actions surrounded fees and allocation of expenses. An SEC settlement with Blackrock Advisors[4] involved portfolio manager's personal investments. Conflicts of interest, or even the appearance of a potential conflict, must be consistently safeguarded against, disclosed, and documented.

Continuous and rigorous education and training are critical components of employee awareness of conflicts. These efforts also go a long way to create a "culture of compliance" within firms. FINRA made prominent mention of compliance culture in its 2016 exam priorities. Therefore, compliance departments will need to take a more quantifiable and measurable approach to culture in the future.

5. Fiduciary standard—Debate in Washington over new fiduciary rules proposed by the Department of Labor may well come to some sort of conclusion in 2016. There has been immense lobbying by industry participants both in favor and in opposition to the Labor Department's proposed rules, which would impose a fiduciary duty on brokers handling retirement accounts.

The SEC has yet to make its own proposal on a fiduciary standard for brokers, and SEC Chair Mary Jo White has championed a deliberate approach, following an agency study of the impact of a uniform financial industry standard. "We will move on it as expeditiously as we can," Ms. White said in November. "We must get it right and really take into account the complexities and impact. But we're very full-out focused on it." The delay, she said, is because the SEC wants to avoid any unintended consequences.

Any eventual resolution likely requires compliance departments to update policies, procedures and disclosures, particularly for retail brokers and investment advisers.

6. Sales practices and risk disclosure—In times of market stress compliance departments must review sales practices, marketing, and risk disclosures. Extra care should be taken in the area of complex products or so-called "liquid alternative" funds. Anything marketed or represented as a "safe alternative" should also be reviewed extra carefully.

Suitability issues are a major international concern. Extra caution should be exercised as regulators have investor protection as a top concern. In the United States, the protection of vulnerable, often senior, investors is a particular priority among regulators.

This is evidenced in a May 2015 speech titled "Structured Products—Complexity and Disclosure—Do Retail Investors Really Understand What They Are Buying and What the Risks Are?" given by Amy Starr, chief of the Office of Capital Markets Trends at the SEC.[5]

7. Liquidity risk and valuation risk—There has been much discussion in recent weeks about liquidity concerns in the credit markets, particularly in Level 2 or Level 3 assets. These thinly traded markets have become so problematic, it has caused the failure or closure of a number of hedge funds, liquid alternative funds, and most prominently, the Third Avenue Focused Credit Fund.

When a portfolio contains illiquid securities, compliance and portfolio managers must continuously analyze and monitor liquidity needs based on various market and redemption scenarios. Illiquid positions must be sold in advance of redemptions and their aggregate percentage within the portfolio must be constantly monitored and not allowed to increase due to redemptions.

© 2016 Thomson Reuters

Valuation process and procedures should always be a top concern and be constantly monitored. If illiquid assets represent a growing or significant portion of assets, it becomes even more critical. Accurate and fair valuations that include a liquidity component are critical. The valuation methodologies should be consistently applied as switching valuation methodologies, is sure to raise questions. Any change in policy should be thoroughly documented and defensible.

8. Technology management and data protection—The effective management of a firm's IT infrastructure is the heart of every compliance program. The protection and storage of data ranging from trading records to all correspondence and virtually all of a firm's compliance record keeping is critical. Secure off-site archiving and storage, business continuity, and disaster recovery plans all require significant planning and resources.

9. Cybersecurity—The threat of a data breach, data loss, or theft of sensitive customer data is every firm's greatest concern. The cost of a breach, its remediation, and reputational risk can be enormous and could put an entire firm's future in jeopardy.

Regulators are taking cybersecurity very seriously as well. The SEC issued a Risk Alert last year and continues to regularly remind the financial industry of the threat. Regulatory actions such as the SEC case against R.T JonesCapital Management—where the firm was fined for inadequate policies and procedures after a cybersecurity breach, despite a by-the-book response—should serve as a reminder that cybersecurity is being taken seriously by the regulators.

10. Personal liability—In the US, the Justice Department's "Yates memo"[6] drew a straight line between individual accountability and corporate wrongdoing and resulted in the U.S. Attorney's Manual being updated in November 2015. As a clear statement of regulatory expectations, Sally Quillian Yates, deputy attorney general at the U.S. Department of Justice stated that "one of the most effective ways to combat corporate misconduct is by seeking accountability from the individuals who perpetrated the wrongdoing. Such accountability is important as it is seen as a deterrent to future illegal activity and it ensures that the the proper parties are held responsible for their actions.

There were also a number of instances where officers or directors were held personally liable for the failures with their firms. Most notably, the Blackrock case[7] was an instance where a compliance professional was singled out in the regulatory actions. Also, the well-publicized State Street case[8] where two individuals eventually were successful in their appeal, should serve as a reminder to all professionals of the difficulty and lengthy path they might face when the regulator attempts to hold them personally accountable.

ENDNOTES:

[1] *See* https://www.finra.org/sites/default/files/2016-regulatory-and-examination-priorities-letter.pdf.

[2] *See* https://www.sec.gov/news/pressrelease/2016-4.html.

[3] *See* https://www.sec.gov/ocie/announcement/ocie-2015-risk-alert-cco-outsourcing.pdf.

[4] *See* https://www.sec.gov/news/pressrelease/2015-71.html.

[5] *See* https://www.sec.gov/news/speech/speech-amy-starr-structured-products-.html.

[6] *See* https://www.justice.gov/dag/file/769036/download.

[7] *See* https://www.sec.gov/litigation/admin/2015/ia-4065.pdf.

[8] *See* http://blogs.reuters.com/alison-frankel/files/2015/12/secvflannery-1stcircuitopinion.pdf.

NEW DIRECTIONS IN CORPORATE COMPLIANCE

A Speech by the SEC's Andrew J. Donohue

Andrew J. Donohue, Chief of Staff for the Securities and Exchange Commission (SEC), spoke at the Rutgers Law School Center for Corporate Law and Governance in Camden, NJ on May 20, This is a partial transcript of his remarks.

I have had responsibility for legal and for corporate compliance at large and small firms, for domestic and international operations, for broker-dealers, investment advisers, commodity trading advisors, investment companies, private funds, UCITS [mutual funds based in the European Union], trust companies and for private—and to a degree public—firms. I have also had the great privilege of doing two tours at the SEC. The first as the Director of the Investment Management Division from May 2006 until November 2010, and most recently as the Chief of Staff since June of last year. So I thought I might just share some thoughts and observations regarding corporate compliance with you based on that experience.

Integrity and Personal Responsibility

Throughout my career I have witnessed that a critical component of an effective corporate compliance program is the integrity of those people you have in your organization and their ownership of personal responsibility for themselves and the areas for which they are responsible. If you don't have the right people with integrity who accept responsibility, the likelihood of your corporate compliance program being effective is, at a minimum, diminished appreciably.

Culture

I can't stress enough the critical role a firm's culture has on its corporate compliance program and its effectiveness. A culture of always doing the right thing, not tolerating bad practices or bad actors is essential. The culture should encourage people to ask questions and to discuss openly what is the proper response to a particular issue and how conflicts should be resolved. It should hold the higher-up members of the firm to at least the same standard of conduct as those below them. I have always thought that the higher up you were in an organization, the less tolerant the firm should be of your non-compliance. If that is the culture of the firm, that sends a powerful message within an organization.

Another sign of the culture of a firm is whether there is a correlation between ethical behavior and the firm's reward structure, such as salaries, bonuses and promotions. Are people who are less compliant nevertheless rewarded? It is also telling in a firm when questions are being asked, conflicts being resolved or decisions being made, is the discussion solely about whether we can do this or is it also about whether we *should* do this? Is it the right decision or course of action for the firm and its clients? I always appreciated how extremely difficult it would be to have responsibility for the corporate compliance function within a firm that did not have a good culture.

Keep It Simple and Intuitive

When developing the policies and procedures you expect the firm and its personnel to follow, they will be most effective if they are as simple as possible, are explained in plain English and are intuitive to those that have to comply with them. Policies and procedures should be the result of clear thinking by individuals who understand the applicable requirements as well as the firm's operations and systems. Identify what you are trying to ensure compliance with and develop a means to that end which people who are less familiar with the law, the industry or the firm and its operations can understand and apply. The simpler and more intuitive your policies and procedures, the greater the likelihood that they will be understood and complied with. It may be a little more work on the front-end, but it will certainly, in my estimation, be well worth it.

© 2016 Thomson Reuters

Role of Technology

Advancements in technology over the past 40 years have been phenomenal and have greatly advanced, in many ways, the ability of firms to implement and monitor the firm's compliance with applicable requirements. I have been concerned, however, about the impact of technology on the responsibility of individuals for ensuring compliance.

Years ago it was quite clear within an organization who performed certain tasks or had certain responsibilities. Those individuals then bore the responsibility for ensuring that that task or responsibility was carried out properly. It was clear back then that compliance resided with the business and most compliance functions back then were back-end, done after the fact either manually or via some exception reporting. As technology developed, firm's correctly recognized the opportunity to automate a variety of functions relying on the system to replace or at least supplement the individual in performing a task or in discharging a responsibility. Done correctly, this created tremendous efficiencies and eliminated many human errors. Technology also created great opportunities for increased testing and monitoring within organizations. This all seems great for a corporate compliance program—eliminate human error, provide for increased testing and enhance monitoring capabilities.

Of course, not all technology is perfect, and the people developing the computer programs you are now relying on may not fully understand what you are seeking to achieve, may not access all the correct files that need to be accessed, or might just make a mistake. And it can be difficult at times for many in the firm to understand exactly what the system did and why it did it. And frequently, systems are being tasked with roles they were not designed to perform or solutions that are not perfect. So who now has the responsibility for ensuring that the firm is complying with the requirements? Is it the programmer? Or the business person who receives the output from the system? It is an important question. It is not about assigning blame when a problem occurs, but rather ensuring ownership of the process to lessen the likelihood that there will be a problem. This can be pervasive within an organization where technology has been employed extensively.

I do worry that firms may not be paying enough attention to this area and what can be done to insure that personal responsibility is not degraded by the existence of the very technology which was intended to help individuals do their jobs well. So I do hope that technology is the solution and not the problem.

Complexity of Firms, Their Operations, Their Products and Services

As firms' operations, products and services have become more complex, firms ability to develop and implement effective compliance programs has become a real challenge. In many cases, businesses have developed different computer systems to address specific operations. Where there are many businesses or a complex array of products and services within a business, there frequently is a need for business or compliance purposes to integrate those systems. They may not talk to each other very well, and data fields and sources that need to be integrated often can't be. But that is just part of the challenge.

As this phenomenon has developed it has required a cadre of experienced and highly talented executives who understand what the various businesses are doing, how they can and cannot interact with each other, and what the regulatory requirements are for each. The knowledge and expertise necessary for key personnel at complex firms has increased significantly, and I expect that this trend will continue. While you can segregate many tasks and responsibilities within a complex firm so they are manageable, you still need a number of key personnel who appreciate how it all works and can then identify where there may be gaps or inconsistencies.

What Don't I Know?

The thing I always worried about was what I did not know. I never thought ignorance was bliss. I believed that my colleagues and I could deal effectively with those things we knew about, but I recognized that we did not know everything. We did not know everything the businesses were doing. We did not know all the laws and regulations that might be applicable to the firm or its operations (although I did hope we had done a very responsible job in that regard). Were we comfortable with the approach that had been taken to insure compliance? And were we aware of the system limitations that might affect the ability to properly insure compliance? Do we have a bad actor in the firm? Is the firm engaged in certain businesses or transactions that were not fully vetted by legal and compliance? Do people in the firm feel comfortable in coming forward and bringing potential issues to the attention of the firm? In short, how can I improve the chances of uncovering issues that should be known and addressed? I was always asking myself how I knew everything was ok, especially in high-risk areas.

How Did I get Comfortable?

So how do you get comfortable having responsibility for the corporate compliance functions within a firm? Now that is a good question. I never really got comfortable, and I was always worried. But that was okay as it kept me constantly alert and thinking—and I was able to sleep most nights. Here are a few thoughts on how you might get more comfortable with these responsibilities:

- ***Get to know the businesses better than the people who run them***—When you understand the business really well you are in a much better position to identify potential problems that might arise and develop potential solutions to those problems.

- ***Have a deep understanding of the regulatory regimes you operate under***—Understanding the regulatory regimes you operate under is essential for developing your corporate compliance program but it is also necessary for anticipating changes that might affect your firm.

- ***Identify areas of key risk and focus on them***—This is basic for any corporate compliance program, but it is not always easy to remember to do because we all get caught up in the firm's day-to-day operations. To guard against this, step back every now and then and just focus on where the risks are and ask others where they see risks, then focus on those to see if the firm has addressed them adequately.

- ***Get to know all the key people in your organization and try and discern where you should focus your attention***—It is really helpful to appreciate how key people in the firm think, what they focus on, what they are good at, and what they are not so good at. And where particular individuals may benefit from assistance in an area, you can look at whether there are ways to supplement that potential weakness or increase monitoring of that area.

- ***Understand and appreciate the limitations inherent in any system that you rely on***—Understanding the limitations of systems you rely on is essential as you then have a better ability to assess where additional resources might be needed and better determine how much reliance you can place on that system. Remember, that system is not just the computer system but is also the people involved and the reliability of the data or other information being relied on.

- ***Constantly ask yourself, how you know everything is ok?***—This is my favorite as the answer is always that I don't. But asking the question does get me to focus on where I may have a question or where I may need to spend some time.

- ***Constantly ask yourself, what am I missing?***—I

© 2016 Thomson Reuters

know that the firm and I are not perfect, so there is always something we are missing. What is that? How can I discern that?

● ***Follow your instincts, and if something does not make sense to you work on it until it does***—Over time you develop instincts, and if you are not comfortable with something, work on it until you better understand why you are not comfortable with it. And if something does not make sense to you, work on it until it either makes sense or you resolve the matter in another way.

● ***If someone can't explain something to you in plain English, either they don't understand it well themselves or you need to do more homework on it***—My experience has been that really competent people can explain something in their area in a very simple manner. When people resort to buzz words or the use of highly technical terms I am always suspicious.

● ***Hire good people who are knowledgeable, hardworking and whose judgment you respect, and let them do their jobs***—You can't do everything yourself and you cannot be an expert in everything. Hire people who work hard, know their stuff and have judgment you trust—and then let them do their job. Also, it's important to hire people smarter than you and those with skill sets that complement your own.

● ***Only work at firms that have a good culture***—As discussed, a good culture is essential for an effective corporate compliance program.

● ***Encourage people to raise questions about practices at the firm***—This will help you and the firm better answer the question of what don't I know? This will also demonstrate the seriousness and importance of your corporate compliance program. Indeed, you may find out some things.

● ***Test a lot and ask a lot of questions***—Testing helps you verify whether your program is working and identifies areas where more work may be required. Asking questions enables you to better understand things and also enables you to better evaluate the areas that are providing the answers.

● ***Walk the floor***—It has been surprising to me how important it is to get out among the people doing the work. They get to know you better and are more comfortable with you to then ask questions or tell you about something that might be a problem. Also, you might see something or learn something that is important.

● ***When you identify an issue, address and resolve it quickly. Unlike wine it does not get better with age***—Dealing with issues promptly is important, and it demonstrates the willingness of the firm to address and resolve issues. Remember, problems don't ever seem to age well.

These are a few of the things I did during my career to get comfortable with the corporate compliance responsibilities I had. This list is certainly not exhaustive, but I hope it gives you some things to think about.

Conclusion

Corporate compliance programs are enormously important. Developing, implementing and maintaining a corporate compliance program in today's world is very challenging, but it certainly can and must be done.

SEC/SRO UPDATE: SEC APPROVES AMENDMENTS TO IMPLEMENT JOBS ACT AND FAST ACT REGISTRATION THRESHOLDS; SEC SEEKS PUBLIC COMMENT ON CONSOLIDATED AUDIT TRAIL PLAN; SEC ANNOUNCES 3 WHISTLEBLOWER ACTIONS AWARDING ABOUT $10 MILLION TO 4 PEOPLE IN 8 DAYS

By Peter H. Schwartz & Julie R. Blaser

Peter H. Schwartz is a partner and Julie R. Blaser is an associate in the law firm of Davis Graham & Stubbs LLP in Denver, Colo.
Contact: peter.schwartz@dgslaw.com or julie.blaser@dgslaw.com.

SEC Approves Amendments to Implement JOBS Act and FAST Act Registration Thresholds

On May 3, the Securities Exchange Commission (SEC) approved amendments to the final rules governing the registration, termination of registration, and suspension of reporting obligations under the Securities Exchange Act of 1934, as amended (Exchange Act). These rules implemented the registration thresholds established by the Jumpstart Our Business Startups (JOBS) Act and the Fixing America's Surface Transportation (FAST) Act.[1]

The JOBS Act, signed into law on April 5, 2012, increased the total asset and holder of record thresholds at which an issuer is required to register its securities under Section 12(g)(1) of the Exchange Act.[2] Formerly, an issuer was required to register its securities if the issuer had total assets exceeding $1 million and the securities were "held of record" by at least 500 persons. Section 501 of the JOBS Act increased the asset threshold to $10 million and modified the ownership threshold so that registration would be required if the securities were "held of record" either by 2,000 persons or (except for banks and bank holding companies) 500 persons who are not "accredited investors." The JOBS Act also increased the threshold at which a bank or bank holding company (but not other registrants) may terminate or suspend the registration of a class of its securities under the Exchange Act from 300 to 1,200 persons. The FAST Act increased the threshold for registration as well as termination and suspension of registration for savings and loan holding companies to match the thresholds applicable to bank and bank holding companies. The final rule amendments implement these thresholds established by the JOBS Act and Fast Act, and also:

- Clarify that the "accredited investor" definition for purposes of determining whether a security is held of record by fewer than 500 people who are not accredited investors under Section 12(g)(1) is as defined in Rule 501(a) under Regulation D; and
- Amend the "held of record" definition to exclude certain equity securities held by persons who received them under an employee compensation plan exempt from registration pursuant to Section 5 of the Securities Act of 1933 (Securities Act).

The rules do not define "employee compensation plan," but include a nonexclusive safe harbor for determining holders of record for purposes of registration that allow an issuer to:

- deem a person to have received the securities under an employee compensation plan if the plan and the person who received the securities under the plan met the conditions of Securities Act Rule 701(c); and
- solely for the purposes of Section 12(g), deem

 © 2016 Thomson Reuters

the securities to have been issued in a transaction exempt from, or not subject to, the registration requirements of Section 5 of the Securities Act if the issuer had a reasonable belief at the time of the issuance that the securities were issued in such a transaction.

The final rules become effective on June 9, 2016. By adopting these final rule amendments, the SEC has completed all rulemaking required under the JOBS Act.

SEC Seeks Public Comment on Consolidated Audit Trail Plan

On April 27, the SEC voted to publish for public comment a national market system (NMS) plan to create a consolidated audit trail (CAT) database that, if adopted, would allow regulators to track all trading in the US equity and options markets.[3] The CAT NMS plan was submitted to the SEC jointly by the national securities exchanges and the Financial Industry Regulatory Authority (FINRA).

[For more on this, see this issue's top story: *The Road to CAT: What the SEC's Consolidated Audit Trail means for Firm Compliance and Blockchain*.]

The CAT NMS proposal includes a plan processor who would create a central repository to receive, consolidate and save trade and order data from self-regulatory organizations (SROs) and broker-dealers to provide a complete lifecycle of all orders and transactions in the US equity and options markets. The responsibilities of the plan processor would include, among other things, operating the central repository, safeguarding the security and confidentiality of the data, and publishing technical specifications for data submission by the SROs and broker-dealers to the central repository. The CAT plan would apply to NMS securities and over-the-counter equity securities. The SROs and broker-dealers would be required to provide certain information about the order to the central repository at various stages in the lifecycle of the order, including:

- a unique identifier for the customer submitting the order, which would be provided by the broker-dealer;
- an identifier for the broker-dealer receiving, creating, routing or executing the order, which would be provided by the broker-dealer;
- the date and time of the order; and
- the security symbol, price, size, order type and other material terms of the order.

Under the proposed plan the foregoing data would be required to be recorded contemporaneously with the order event and reported to the central repository by 8 a.m. the following date.

Although the creation of this CAT system would place direct responsibilities on SROs and broker-dealers, investment advisers and other market participants may also be affected, including having to share the costs of implementation, duplicative reporting requirements, increased regulatory scrutiny on trading activity, access to clients' nonpublic personal information, and creation of additional access points for potential cyber-attacks.

Public comments on the CAT NMS plan may be submitted to the SEC through July 18, 2016.

SEC Announces 3 Whistleblower Actions Awarding About $10 Million to 4 People in 8 Days

Over the course of just eight days, the SEC announced three separate whistleblower awards to four people, and awarded about $10 million.[4]

The first award of $3.5 million was made to a "company employee whose tip bolstered an ongoing investigation with additional evidence of wrongdoing that strengthened the SEC's case." The second award of between $5 million and $6 million was given "to a former company insider whose detailed tip led the agency to uncover securities violations that would

have been nearly impossible for it to detect but for the whistleblower's information." This award was the third-largest ever made by the SEC. The final award of more than $450,000 was made jointly to "two individuals for a tip that led the agency to open a corporate accounting investigation and for their assistance once the investigation was underway."

According the SEC's statements in connection with these awards, the SEC's whistleblower program has awarded more than $68 million to 31 whistleblowers since the program's inception in 2011.

Whistleblowers may be eligible for an award when they voluntarily provide the SEC with unique and useful information that leads to a successful enforcement action. Whistleblower awards can range from 10% to 30% of the money collected when the monetary sanctions exceed $1 million. All payments are made out of an investor protection fund established by Congress that is financed through monetary sanctions paid to the SEC by securities law violators. In addition, no money has been taken or withheld from harmed investors to pay whistleblower awards, according to the SEC.

ENDNOTES:

[1]*See* SEC Press Rel. No. 2016-81(May 3, 2016), available at https://www.sec.gov/news/pressrelease/2016-81.html and Final Rule, Release Nos. 33-10075; File No. S7-12-14 (May 3, 2016), available at http://www.sec.gov/rules/final/2016/33-10075.pdf.

[2]*See* Pub.L. No. 112-106, 126 Stat. 306.

[3]*See* SEC Press Rel. No. 2016-77(April 27, 2016), available at https://www.sec.gov/news/pressrelease/2016-77.html, and Release No. 34-77724; File No. 4-698 (April 27, 2016), available at https://www.sec.gov/rules/sro/nms/2016/34-77724.pdf.

[4]*See* SEC Press Rel. No. 2016-88 (May 13, 2016), available at https://www.sec.gov/news/pressrelease/2016-88.html; SEC Press Rel. No. 2016-91 (May 17, 2016), available at https://www.sec.gov/news/pressrelease/2016-91.html; and SEC Press Rel. No. 2016-94 (May 20, 2016), available at https://www.sec.gov/news/pressrelease/2016-94.html.

© 2016 Thomson Reuters

FROM THE EDITOR

Reviewing SEC Chair White's First 3 Years: Strong Enforcement amid Political Rancor

Just a bit over three years ago, Mary Jo White was sworn in as the 31st Chair of the Securities and Exchange Commission (SEC) amid great expectations over her tough reputation as a no-nonsense prosecutor.

Coming in after Mary Schapiro's challenging tenure and the then-still reverberating financial meltdown, some thought Chair White would turn her gunsights on Wall Street and the financial institutions many blamed for the crisis. In part because the five-year statute of limitations had limited many SEC actions before she even took charge, and in part because of the difficulty in establishing individual responsibility for financial institutions' cultural failures, that didn't happen. Nevertheless, critics blasted the SEC's perceived timidity to take on big banks and Wall Street. Even Democratic politicians delivered some blistering criticism – much of it coming from newly elected Sen. Elizabeth Warren (D-Mass.).

Still, taking all in balance, what Mary Jo White has accomplished in her first three years as SEC Chair is substantial.

For one, her strongest single accomplishment may be the tough enforcement program she has continued to prioritize. To this end, she has staffed up with talented leadership, continuing the work of building up the SEC's Enforcement Division, which really began under Schapiro, who had placed experienced prosecutors in charge of the program. Under the Dodd-Frank Act, the SEC created the Office of the Whistleblower, which has hit its stride with a number of very large awards having been made to tipsters who brought the SEC information leading to penalties and significant recoveries for investors.

Another accomplishment is that — against stiff odds — she has pushed the SEC to complete the majority of the vast number of required rulemakings that mounted up under the Dodd-Frank Act. According to its recent numbers, the SEC has adopted final rules for 61 mandatory rulemaking provisions of Dodd-Frank, established five new offices and issued more than 30 studies and reports required under Act.

And this has been no small challenge given the political divisions of the Commission and the fact that the Commission has been short-handed for the past five-plus months. In fact, to the extent there have been failures under SEC Chair White, they may in large part be attributable to rancor and dysfunction caused by strong political and philosophical differences among the Commissioners and a hostile Congress, particularly the US House of Representatives, which is dominated by anti-government, right-wing Republicans.

Chair White has had to navigate those very troubled waters carefully, seeking Commission majorities willing to take action and face the hostility to the SEC's program from the Hill.

Given these accomplishments, what should the SEC Chair make a priority over the coming year or so?

Clearly, Chair White should and will continue to push the Commission to finally complete the mandated Dodd-Frank rulemakings and settle any market uncertainty that those unfinished rules have caused.

With an election this Fall, there is no certainty that Chair White will continue to lead the Commission for the long term. Even though she is a political independent, and has made real progress in her tenure to date, either a President Clinton or a President Trump may well choose a different leader by next Spring.

—John F. Olson & Gregg Wirth

EDITORIAL BOARD

MANAGING EDITOR:
GREGG WIRTH

CHAIRMAN:
JOHN F. OLSON
Gibson, Dunn & Crutcher
Washington, DC

ADVISORY BOARD:
BRANDON BECKER
WilmerHale
New York, NY

BLAKE A. BELL
Simpson Thacher & Bartlett
New York, NY

STEVEN E. BOCHNER
Wilson Sonsini Goodrich & Rosati
Palo Alto, CA

JORDAN ETH
Morrison & Foerster LLP
San Francisco, CA

EDWARD H. FLEISCHMAN
Former SEC Commissioner
New York, NY

ALEXANDER C. GAVIS
Senior VP & Deputy GC
Fidelity Investments

JAY B. GOULD
Winston & Strawn LLP
San Francisco, CA

PROF. JOSEPH A. GRUNDFEST
Professor of Law
Stanford Law School

MICALYN S. HARRIS
ADR Services
Ridgewood, NJ

PROF. THOMAS LEE HAZEN
University of North Carolina — Chapel Hill

ALLAN HORWICH
Schiff Hardin LLP
Chicago, IL

TERESA IANNACONI
Retired Partner
KPMG LLP

MICHAEL P. JAMROZ
Partner, Financial Services
Deloitte & Touche

STANLEY KELLER
Locke Lord LLP
Boston, MA

BRUCE W. LEPPLA
Lieff Cabraser Heiman & Berstein LLP
San Francisco, CA

SIMON M. LORNE
Vice Chairman and Chief Legal Officer at Millennium Partners, L.P.

MICHAEL D. MANN
Richards Kibbe & Orbe
Washington, DC

JOSEPH MCLAUGHLIN
Sidley Austin, LLP
New York, NY

WILLIAM MCLUCAS
WilmerHale LLP
Washington, DC

BROC ROMANEK
General Counsel, Executive Press, and Editor
TheCorporateCounsel.net

JOHN F. SAVARESE
Wachtell, Lipton, Rosen & Katz
New York, NY

JOEL MICHAEL SCHWARZ
Attorney, U.S. Government

STEVEN W. STONE
Morgan Lewis LLP
Washington, DC

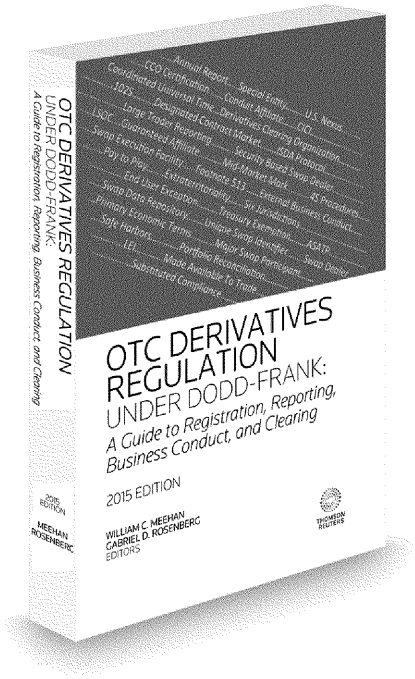
LAURA S. UNGER
Former SEC Commissioner & Acting Chairman

ERIC S. WAXMAN
Retired Partner
Skadden, Arps, Slate, Meagher & Flom LLP
Los Angeles, CA

JOHN C. WILCOX
Chairman, Sodali Ltd.

JOEL ROTHSTEIN WOLFSON
Bank of America Merrill Lynch

© 2016 Thomson Reuters



List Price: $249.00

SAVE 20%

Order online at legalsolutions.com and at checkout enter PROMOTION CODE WPD20 and the discount will be applied.

Or call 1-888-728-7677 to speak with a rep to place your order.

Offer valid for this book only.
Expires 12.31.15

OTC DERIVATIVES REGULATION UNDER DODD-FRANK:

A Guide to Registration, Reporting, Business Conduct, and Clearing

2015 EDITION

William C. Meehan
Gabriel D. Rosenberg

This book provides a comprehensive summary of the new swap regulatory regime under Title VII of the Dodd-Frank Act to assist industry professionals and their counsel in beginning to understand the substance of these new requirements and their practical implications.

The Dodd-Frank Act, enacted into law in July 2010, includes a comprehensive overhaul of the OTC derivatives regulatory regime. This book explains how the swaps markets are in the process of rapidly changing from bilateral, unregulated OTC markets to ones in which key market participants are required to register as swap dealers and major swap participants; transactions must be reported and trade data publicly disseminated; standardized swaps must be electronically executed and cleared; and counterparties are subject to complex business conduct, documentation, margin, and many other requirements. The implementation of this new regime has proceeded at a breakneck pace which, as of the date of this book, includes more than 60 rules totaling more than 2800 pages of the Federal Register and hundreds of related no-action letters, FAQ's, and other regulatory releases. This book simplifies the task of beginning to comply with the rules by summarizing the current state of the law and key implementation issues of the following broad topics:

- Products and Registrants Under Title VII
- Swap Data Reporting and Dissemination
- Large Trader Reporting
- Business Conduct and Pay-to-Play Regulations
- Swap Relationship Documentation
- Recordkeeping
- Mandatory Clearing
- Position Limits
- Registration and Regulation of Market Participants, Including Swap Dealers, MSPs, FCMs, CPOs, CTAs, Introducing Brokers, SEFs and DCOs
- Extraterritorial Application of Swaps Regulations

This Second Edition includes updates to all existing chapters, as well as 5 new chapters covering position limits, derivatives end users, futures commission merchants, introducing brokers and derivatives clearing organizations.

THOMSON REUTERS™

© 2015 Thomson Reuters 1-15

Wall Street LAWYER

West LegalEdcenter
610 Opperman Drive
Eagan, MN 55123

FIRST CLASS
MAIL
U.S.POSTAGE
PAID
WEST

Wall Street LAWYER

West LegalEdcenter
610 Opperman Drive, Eagan, MN 55123
Phone: 1-800-344-5009 or 1-800-328-4880
Fax: 1-800-340-9378
Web: http://westlegaledcenter.com

THOMSON REUTERS

YES! Rush me ***Wall Street Lawyer*** and enter my one-year trial subscription (12 issues) at the price of $867.96. After 30 days, I will honor your invoice or cancel without obligation.

Name _____

Company _____

Street Address _____

City/State/Zip _____

Phone _____

Fax _____

E-mail _____

METHOD OF PAYMENT

❏ BILL ME

❏ VISA ❏ MASTERCARD ❏ AMEX

Account # _____

Exp. Date _____

Signature _____

Postage charged separately. All prices are subject to sales tax where applicable.