Developments in Ethics
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8:30 a.m. – 9:30 a.m.

Chair
Gary Kalbaugh (ING)

Panel:
Guy Dempsey (Katten Law)
GuyLaine Charles (Teigland-Hunt)
Therese Doherty (Mintz Levin)
Julian Hammar (Morrison & Foerster)
Howard Schneider (Charles River)
Navigating Ethical Complexities in Negotiations

GuyLaine Charles
Partner
Teigland-Hunt LLP
127 West 24th Street
New York, New York
10011
A. Sources of Rules of Professional Conduct. The ABA Model Rules of Professional Conduct (the “Model Rules”) were drafted by the ABA’s Commission on Evaluation of Professional Standards, with input from different sections and committees of the ABA as well as academics, practitioners and various other bar associations. The Model Rules represent the basic framework for professional conduct and form the template for the professional conduct rules adopted by the bars of each State. California, which was the last remaining state having not adopted the Model Rules, did so recently, with effect on November 1, 2018. While the Model Rules provide the baseline, it is important to note that these rules have not been adopted verbatim by the various State bars, but with modifications and in some cases significant modifications. Therefore, while the Model Rules are persuasive in nature, they are not authoritative. The comments to the Model Rules will be helpful to the extent the State bar rule does not diverge from the Model Rule, however in all other circumstances, one should look to comments from to the State bar rules and other more relevant interpretation tools.

To determine the rules of professional conduct that apply to a lawyer’s conduct, the lawyer must look at the set of rules adopted in the State where the lawyer is admitted to practice as well and the conflict of laws provision contained in those rules. For example, to determine which rules apply to her conduct, a New York State admitted lawyer will look to the New York Rules of Professional Conduct which were promulgated as Joint Rules of the Appellate Divisions of the Supreme Court, (the “NY Rules”) and are found in Part 1200 of Title 22 of New York Codes, Rules and Regulations. In addition, the choice of law provision in the NY Rules states:

1. For conduct in connection with a proceeding in a court before which a lawyer has been admitted to practice (either generally or for purposes of that proceeding), the rules to be applied shall be the rules of the jurisdiction in which the court sits, unless the rules of the court provide otherwise; and

2. For any other conduct:
(i) If the lawyer is licensed to practice only in this state, the rules to be applied shall be the rules of this state, and

(ii) If the lawyer is licensed to practice in this state and another jurisdiction, the rules to be applied shall be the rules of the admitting jurisdiction in which the lawyer principally practices; provided, however, that if particular conduct clearly has its predominant effect in another jurisdiction in which the lawyer is licensed to practice, the rules of that jurisdiction shall be applied to that conduct.1

This provision does provide some certainty as to which rules govern a New York lawyer’s conduct, even when the lawyer is licensed to practice in other jurisdictions.

Once a lawyer has determined which rules are applicable to her conduct, she can look to various sources for the interpretation of the rules, such as the comments to the rules as well as bar association opinions. In New York State there are many options. Several bar associations issue different types of opinions with respect to the interpretation of professional responsibility rules. The New York State Bar Association Committee on Professional Ethics (“NYSBA Committee”) issues opinions which are advisory in nature. These opinions are prospective in nature and address a lawyer’s proposed conduct. The NYSBA Committee will not opine on past conduct or the conduct of another lawyer. The NYSBA Committee “does not consider anonymous inquiries, hypothetical inquiries or inquiries which have also been submitted to another bar association’s ethics committee”.2 The New York City Bar Association’s Committee on Professional Ethics (“NYCBA Committee”) also issues ethics opinions. The NYCBA Committee issues two types of advisory opinions - formal and informal opinions. Formal opinions provide general guidance to lawyers with respect to their obligations under the NY Rules and informal opinions are issued in response to specific inquiries by lawyers (which can also be answered by calling the Ethics Hotline). Like NYSBA Committee, the NYCBA Committee will only provide opinions based on inquiries by a lawyer of its own prospective conduct, but unlike the NYSBA, the NYCBA does not publish informal opinions on their

1 NY Rule 8.5(b).
website. The New York County Lawyers Association, the Suffolk County Bar Association and the Nassau County Bar Association all also issue ethics opinions.

There are other resources to guide lawyers in their interpretation and application of rules of professional conduct that are persuasive but not authoritative in nature. These sources include The Restatement of the Law-The Law Governing Lawyers (the “Restatement”) and as mentioned above, comments to the ABA Model Rules. In addition, the ABA also issues opinions on matters that are deemed of general interest to the bar.

B. Litigation Focus of Rules of Professional Conduct. The drafters of the Model Rules were mostly focused on litigators and the adversarial process when formulating the rules. As a result, rules specifically governing the conduct of lawyers during contract or transactional negotiations, as compared to rules governing litigation or general rules of conduct e.g., the duty of diligence, competence, confidentiality and the duty to keep clients informed of developments, are fewer and in some cases not entirely helpful. In the following section we will discuss some of the issues arising in negotiations and the rules that guide a lawyer’s conduct when faced with these issues.

C. Issues in Negotiation

1. What is a lawyer’s ethical duty in making statements to third parties?

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6 Nassau County Bar Association, https://www.nassaubar.org/ethics-opinions/.
8 ABA, https://www.americanbar.org/groups/professional_responsibility/committees_commissions/ethicsandprofessionalresponsibility/.
Ethical rules as well as rules of criminal law, tort law, and contract law will apply to statements of fact made by lawyers to third parties. The relevant laws from the areas of criminal, tort and contract law are, respectively, theft by deception, the law of misrepresentation, and the law of mistake and fraud, while the applicable ethics rules are:

Model Rule 4.1:

“Rule 4.1: Truthfulness in Statements to Others

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 Rule 1.6.”

NY Rule 4.1:

“NY Rule 4.1 Truthfulness in Statements to Others:

In the course of representing a client a lawyer shall not knowingly make a false statement of material fact or law to a third person.”

Note that there is no clause (b) in the NY Rule, as disclosure to avoid a criminal or fraudulent act is addressed in NY Rule 1.6(b) (Confidentiality of Information):

“(b) A lawyer may reveal or use confidential information to the extent that the lawyer reasonably believes necessary:

(1) to prevent reasonably certain death or substantial bodily harm;

(2) to prevent the client from committing a crime;

(3) to withdraw a written or oral opinion or representation previously given by the lawyer and reasonably believed by the lawyer still to be relied upon by a third

9 Restatement § 98, Comment (b).
10 The word “knowingly” in NY Rule 4.1 “denotes actual knowledge of the fact in question. A person’s knowledge may be inferred from circumstances.” NY Rule 1.0(k).
person, where the lawyer has discovered that the opinion or representation was based on materially inaccurate information or is being used to further a crime or fraud;”

For the purposes of this article, we will focus on a lawyer’s prohibition from making false statements of material fact or law. The comments provide: “A lawyer is required to be truthful when dealing with others on a client’s behalf, but generally has no affirmative duty to inform an opposing party of relevant facts.”\(^{11}\) This particular requirement of truthfulness could be a notable hindrance to negotiation, however, NY Rules do exclude certain types of statements even if the lawyer knows that a particular assertion is inaccurate. For instance, in a negotiation, statements relating to potential sales prices or a party’s valuation of an item would fall into this safe harbor.\(^{12}\) The comments to Section 98 of the Restatement provide further guidance on whether a statement would be considered a misrepresentation of fact:

“A knowing misrepresentation may relate to a proposition of fact or law. Certain statements, such as some statements relating to price or value, are considered nonactionable hyperbole or a reflection of the state of mind of the speaker and not misstatements of fact or law (see Restatement Second, Contracts § 168; Restatement Third, Unfair Competition § 3, Comment d). Whether a misstatement should be so characterized [as ‘puffing’] depends on whether it is reasonably apparent that the person to whom the statement is addressed would regard the statement as one of fact or based on the speaker’s knowledge of facts reasonably implied by the statement or as merely an expression of the speaker’s state of mind. Assessment depends on the circumstances in which the statement is made, including the past relationship of the negotiating persons, their apparent sophistication, the plausibility of the statement on its face, the phrasing of the statement, related communication between the persons involved, the known negotiating practices of the community in which both are negotiating, and similar circumstances. In general, a lawyer who is known to represent a person in a negotiation will be understood by nonclients to be making nonimpartial statements, in the same manner as would the lawyer’s client.”\(^{13}\)

That said, lawyers must be cognizant of the fact that a third-party need not rely on the misstatement or suffer any harm in order for a lawyer to be subject to disciplinary action.\(^{14}\) It should also

\(^{11}\) NY Rule 4.1, Comment (1).
\(^{12}\) NY Rule 4.1, Comment (2).
\(^{13}\) Restatement § 98, Comment (c).
\(^{14}\) Restatement § 98, Comment (g).
be noted that omissions are not necessarily exempt from NY Rule 4.1. On the subject of omissions, the comments to NY Rule 4.1 provide that the lawyer is required to be “truthful” and that an actionable omission may occur as the result of a partially true but misleading statement. However, NY Rule 4.1 also provides that the lawyer generally does not have an obligation to inform an opposing party of relevant facts.

2. A business person from the counterparty calls you directly to discuss a business issue. You know the counterparty is represented by counsel. What do you do?

The Model Rule and the NY Rule have similar provisions restricting a lawyer’s ability to communicate with persons who are represented by counsel.

ABA Model Rule 4.2 states:

“In representing a client, a lawyer shall not communicate about the subject of the representation with a person the lawyer knows to be represented by another lawyer in the matter, unless the lawyer has the consent of the other lawyer or is authorized to do so by law or a court order.”

NY Rule 4.2(a), corresponding to the Model Rule directly above, states:

“In representing a client, a lawyer shall not communicate about the subject of the representation with a party the lawyer knows to be represented by another lawyer in the matter, unless the lawyer has the prior consent of the other lawyer or is authorized to do so by law.”

The comment to the NY Rule, explains that the purpose of the rule is to protect those who have chosen to be represented by a lawyer in a matter against “possible overreaching by other lawyers who are participating in the matter, interference by those lawyers with the client-lawyer relationship, and uncounseled disclosure of sensitive information.”

15 NY Rule 4.2(a).
16 NY Rule 4.2, Comment (1).
Notwithstanding Rule 4.2(a), Rule 4.2(b) permits a lawyer, to advise their client to communicate directly with a represented person. The lawyer must give reasonable advance notice to the represented person’s counsel that such communications will be taking place.\textsuperscript{17}

3. The business person from the counterparty is no longer represented by counsel, and calls you directly to discuss a business issue. What do you do?

Though the restrictions on communicating directly with a counterparty of NY Rule 4.2 do not apply if the counterparty is unrepresented, a lawyer faces restrictions on saying anything that may be construed as advice and may face certain affirmative obligations to explain the lawyer’s role as a nonimpartial party when communicating with an unrepresented person. NY Rule 4.3 states:

“In communicating on behalf of a client with a person who is not represented by counsel, a lawyer shall not state or imply that the lawyer is disinterested. When the lawyer knows or reasonably should know that the unrepresented person misunderstands the lawyer’s role in the matter, the lawyer shall make reasonable efforts to correct the misunderstanding. The lawyer shall not give legal advice to an unrepresented person other than the advice to secure counsel if the lawyer knows or reasonably should know that the interests of such person are or have a reasonable possibility of being in conflict with the interests of the client.”

The rule, unambiguously, conditions the lawyer’s ability to engage with an unrepresented party on the presence of a conflict; allowing the lawyer to provide the lawyer’s view of certain factual or legal matters to an unrepresented party if that party’s interests are not in conflict with the interests of the lawyer’s client, but prohibiting any giving of advice (other than the advice to obtain counsel) if there is a conflict.

4. What is your ethical responsibility when receiving information that you know has been sent to you in error?

\textsuperscript{17} NY Rule 4.2(b).
When a lawyer receives information which relates to the representation of a client in error, the lawyer has an affirmative obligation to promptly notify the sender of the occurrence. In addition, comment [2] to NY Rule 4.4 clarifies that the NY Rules themselves, do not prohibit a lawyer from reading information that the lawyer knows was received in error. Also supporting the non-existence of such obligation is NY Rule 1.2(g), which states that “[a] lawyer does not violate these Rules by being punctual in fulfilling all professional commitments, by avoiding offensive tactics, and by treating with courtesy and consideration all persons involved in the legal process.”

The corresponding ethics rule in New Jersey is more prescriptive for the recipient and therefore more forgiving for the sender. It states:

“A lawyer who receives a document or electronic information and has reasonable cause to believe that the document or information was inadvertently sent shall not read the document or information or, if he or she has begun to do so, shall stop reading it. The lawyer shall (1) promptly notify the sender (2) return the document to the sender and, if in electronic form, delete it and take reasonable measures to assure that the information is inaccessible.”

Given the differences in requirements under different rules, it is very important for a lawyer to ensure that she knows what constitutes her standard of conduct.

D. Conclusion

While rules of professional conduct governing negotiations are not as robust as the ones surrounding litigation, they are equally as important. Contract and transactional lawyers should ensure that they are aware of the rules that govern their conduct and abide by them.

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18 NY Rule 4.4(b), Model Rule 4.4(b).
19 The second comment to NY Rule 4.4 states: “Although this Rule does not require that the receiving lawyer refrain from reading or continuing to read the document, a lawyer who reads or continues to read a document that contains privileged or confidential information may be subject to court-imposed sanctions, including disqualification and evidence-preclusion.”
20 Rules of Professional Conduct, (New Jersey), 4.4(b).
A Continued Focus by the CFTC on Individual Accountability

“Individual Accountability” continues to be a prominent theme for the CFTC’s Division of Enforcement (the “Division”). In its annual report issued in November 2018, the Division named “individual accountability” as one of four priorities upon which the Division focused its enforcement efforts in 2018.² It is the Division’s view that effective enforcement requires holding both the company and the individuals that make up that company accountable for wrongdoing. The Division explains:

Individual accountability must sit at the center of any effective enforcement program. It’s not enough simply to hold the responsible companies accountable. The responsible individuals must be held accountable too. Individual accountability ensures that the person committing the illegal act is held responsible and punished; it deters others, fearful of facing individual punishment, from breaking the law in the future; it incentivizes companies to develop cultures of compliance and to report to regulators when they find bad actors in their entity; and it promotes the public’s confidence that we are achieving justice.³

The Division’s view of individual accountability is broad in that it extends beyond the primary wrongdoer to supervisors and others in control who may bear only indirect responsibility for alleged wrongdoing. The Division explains further:

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¹ Authored by Therese M. Doherty, Member, LisaMarie F. Collins, Of Counsel, and Nathalie Gorman, Associate at Mintz Levin Cohn Ferris Glovsky and Popeo, PC (January 2019).
³ Id. at 2.
In pursuing these goals, we must look beyond the low-level employees who actually commit the wrongful acts; we must work to hold accountable the supervisors and others in control who may be culpable for an employee’s wrongdoing as well.\textsuperscript{4}

The Division contends that holding individuals at every level of a company accountable for wrongdoing aids the Division in attaining its “ultimate goal” of “incentivizing companies to develop cultures of compliance and to report to regulators when they find bad actors in their entity…”\textsuperscript{5} Indeed, in 2018 the Division brought actions against “supervisors and desk heads, CEOs, and a Chairman of the Board.”\textsuperscript{6} As discussed fully below, certain of the individuals charged in these actions were not the primary wrongdoers or direct supervisors, but failed to fulfill their supervisory obligations under CFTC Regulation 166.3.\textsuperscript{7} These actions illustrate the Division’s commitment to individual accountability and offer guidance to individuals at all levels of a company regarding the broad scope of supervisory obligations under Regulation 166.3.

The Chairman of the Board of TFS-ICAP Charged with Violation of Regulation 166.3

In September 2018, the CFTC commenced an action in the United States District Court for the Southern District of New York against TFS-ICAP LLC and TFS-ICAP Ltd. (\textit{“TFS-ICAP”}), the company’s CEO, James Woolfenden, and a senior manager, Ian Dibb.\textsuperscript{8} The Division alleges that, for more than seven years, TFS-ICAP brokers routinely attempted to and did deceive customers by communicating to them fake bids and offers (a practice known as

\textsuperscript{4} Id.
\textsuperscript{5} Id.
\textsuperscript{6} Id. at 11.
\textsuperscript{7} 17 C.F.R. § 166.3 provides that:
Each Commission registrant, except an associated person who has no supervisory duties, must diligently supervise the handling by its partners, officers, employees, agents (or persons occupying a similar status or performing a similar function) of all commodity interest accounts carried, operated, advised or introduced by the registrant and all other activities of its partners, officers, employees and agents (or persons occupying a similar status or performing a similar function) relating to its business as a Commission registrant.
\textsuperscript{8} \textit{CFTC v. TFS-ICAP LLC, et al.} No. 18-CV-8914 (S.D.N.Y.).
“flying prices”) and fake trades (a practice known as “printing”) in the FX options market. The complaint alleges that defendants Dibb and Woolfenden were involved with and/or knew, or had constructive knowledge, that TFS-ICAP brokers regularly flew prices and printed trades, but took no action to prevent or deter these alleged deceptive trade practices. For example, the complaint alleges that Woolfenden circulated a memorandum to senior TFS-ICAP officials recommending that brokers fly prices and suggesting that flying prices was a critical way to win more business. The complaint also alleges that brokers contacted Dibb expressing concern about the practice of flying prices and printing trades and Dibb took no action to discourage or prevent the practice. The Division asserts claims against all defendants for alleged violations of: Section 4(b)(a)(2) of the Act, 7 U.S.C. § 6b(a)(2) (fraud in connection with swaps); Section 6(c)(1) of the Act, 7 U.S.C. § 9(1); Regulation 180.1, 17 C.F.R. § 180.1(a) (use of manipulative or deceptive devices); Section 4c(a)(1)-(2) of the Act, 7 U.S.C. §§ 6c(a)(1)–(2) (confirming fictitious sales and transactions used to cause reporting of untrue and non-bona fide prices); and Regulation 166.3, 17 C.F.R. § 166.3 (failure to diligently supervise).

In light of the allegations in the federal court complaint, it is hardly surprising that the CFTC took action against these specific defendants. However, what may be surprising is that, simultaneously, Michael Liebowitz, the Chairman of the Board of TFS-ICAP and a registrant, entered into a consent order with the CFTC settling failure to supervise charges. Despite the lack of any direct supervisory responsibilities, the CFTC found that Liebowitz violated

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9 Id., Dkt. No. 5 at ¶ 1.
10 Id. at ¶ 4.
11 Id. at ¶ 66.
12 Id. at ¶¶ 118-19; 122-23.
13 In the Matter of: Michael Leibowitz (CFTC Docket No. 18-52) at 4-5.
Regulation 166.3 and imposed a civil monetary penalty of $250,000. The CFTC determined that, as Chairman of the Board and a registered AP, Leibowitz had “supervisory responsibilities for TFS-ICAP.” The Commission stated that Leibowitz “could have,” but did not, “individually or together with the senior managers at TFS-ICAP, impose a policy of prohibiting flying prices or printing trades.” The Commission concluded that “Leibowitz failed to diligently supervise the handling of FX Options Trades by TFS-ICAP brokers and senior managers on the emerging markets desk.”

The CFTC’s findings against Leibowitz served as a significant warning to the industry. At no point in the consent order does the Commission allege that Leibowitz had any knowledge, constructive or otherwise, that TFS-ICAP brokers were engaging in unlawful trading practices. Nor does the Commission suggest that Leibowitz, as Chairman of the Board, was responsible for or involved with developing compliance policies and procedures for the company. Rather, the Commission sent a harsh reminder that Regulation 166.3 “requires each CFTC registrant, except an associated person who has no supervisory duties, to diligently supervise the handling of all commodity interest accounts ... introduced by the registrant and all other activities of its partners, officers, employees and agents relating to its business as a Commission registrant.” The consent order boldly declares that, “[i]ndeed, once supervisor status is established, the Commission need only show that the defendant lacked diligence in his oversight of his employees and agents.”

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14 Id.
15 Id. at 4.
16 Id. at 3.
17 Id.
18 Id. (emphases added).
19 Id. at 4.
This matter highlights the breadth of the CFTC’s view with respect to “individual accountability” and sends a clear message: each and every registrant within the chain of supervisory responsibility is required to diligently supervise as defined in Rule 166.3, including implementing policies and procedures designed to prevent and detect unlawful trading practices.

**CEO of Introducing Broker Charged with Violation of Regulation 166.3**

In another matter, the CFTC charged both the company and its CEO with violations of Regulation 166.3 and imposed civil monetary penalties in connection with an introducing broker’s failure to supervise a client that was a CTA (the “CTA”).

Glenn Swanson was the CEO of Global Asset Advisors (“GAA”), an introducing broker. The CTA placed orders through an electronic trading platform into a bunched account held at an FCM to which GAA introduced the business. An AP of GAA received the CTA’s allocation instructions after the execution of the bunched order and transmitted those instructions to the FCM. The CTA used the bunched order account to engage in a post-execution allocation scheme to the benefit of the CTA and to the detriment of the CTA’s customers. To effectuate the scheme, the CTA consistently sent allocation orders “after execution and, at times, after the close of trading.”

The CFTC alleged that the CTA did this in order to “disproportionately allocate… profitable trades to the accounts in which [it] or [its] associates had a proprietary interest, [while allocating] unprofitable or less profitable trades to customer accounts or the Pool account.” In October 2012, GAA received a notice from the FCM that the CTA was sending instructions after

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20 In the Matter of Global Asset Advisors LLC d/b/a Daniels Trading and Glenn A. Swanson (CFTC Docket No. 18-30).
21 Id. at 3.
22 Id. at 2.
23 Id.
24 Id. at 4.
25 Id. at 3-4.
execution and/or after the close of trading. Approximately 8 months later, while the CTA continued to engage in the same conduct, Swanson sent an email to the CTA and the FCM “mandat[ing] that the client must send its allocation instructions to GAA within 30 to 60 minutes of the trade, and in no even later than 4:00 p.m. Central time.”26 However, Swanson took no action to ensure compliance with his “mandate” and the CTA continued to submit allocations outside of the timeframe mandated by Swanson and the AP of GAA had continued to transmit the CTA’s post-execution allocation instructions to the FCM.27

In September 2013, the NFA issued a Member Responsibility Action (“MRA”) against the CTA for unrelated conduct. The MRA prohibited the CTA from soliciting funds from customers or disbursing funds from any account the CTA owned or controlled without NFA approval.28 Swanson, who was aware of the MRA, took no action when the GAA AP requested that the FCM open a second account under the CTA’s wife’s name (“Spouse Account”). The Spouse Account was owned and controlled by the CTA. Swanson also did nothing when the GAA AP requested the FCM to link the Spouse Account to the CTA’s bunched order account so that it could accept post-execution allocations.29 Indeed, the AP was aware that the CTA was exercising discretion over the “Spouse Account,” but had facilitated the CTA’s repeated withdrawals from the account, in violation of the MRA. This continued for several weeks after the NFA issued a trading ban against the CTA.30

Swanson was found to have violated Regulation 166.3 because of his failure to “design an adequate program of supervision and ensure that the program [was] followed” and because he

26 Id. at 4.
27 Id.
28 Id.
29 Id.
30 Id. at 5.
“failed to conduct a sufficient inquiry into, or report to regulatory authorities, red flags and other questionable activity involving customer accounts.”31 The consent order focused on Swanson’s failure to appropriately investigate and respond to a series of red flags related to the CTA’s conduct and accounts.32

The CFTC’s findings against Swanson underscore the CFTC’s commitment to individual accountability and make clear that the CFTC demands proactive investigations by supervisors when red flags surface. In other words, supervision means more than ensuring there are policies and procedures in place – it is means being proactive to ensure the effectiveness of those policies and procedures by promptly and diligently investigating red flags.

The CFTC Rewarded Detection, Self-Reporting and Remediation with A Public Declaration That it Would Not Assert Charges Against Deutsche Bank

In November 2018, the CFTC found that Jacob Bourne, a former managing director of the inflation trading desk at Deutsche Bank, violated Section 6(c)(1) of the Act, 7 U.S.C. § 9(1) (prohibition regarding manipulation and false information), and Regulation 180(a)(1)-(3), 17 C.F.R. §180(a)(1)-(3) (prohibition on the employment, or attempted employment, of manipulative and deceptive devices) and imposed upon him a $350,000 civil monetary penalty.33 The CFTC found that Bourne “mismarked the valuations of inflation swap instruments … in an attempt to cover up significant trading losses.”34 He did so intentionally and with full awareness that bank policy was that there was “no discretion” when entering such valuations.35 The bank discovered Bourne’s mismarking of the swap valuations as part of a routine review of its

31 Id.
32 Id. at 6.
33 In the Matter of Jacob Bourne (CFTC Docket No. 18-51), at 5.
34 Id. at 2.
35 Id.
marking procedures.\textsuperscript{36} When Deutsche Bank discovered discrepancies between the valuation by Bourne and a third party, Bourne lied to management, alleging that the differences were due to a spreadsheet error. The bank did not accept the explanation at face value, but rather was proactive. The bank “conducted an additional review… [which] included a review of the relevant documents, [and] a further evaluation, which included participation by a technology group within the bank and … analysis of metadata relating to certain documents.”\textsuperscript{37} The metadata analysis proved that Bourne himself had modified the spreadsheet apparently in an effort to cover up his mismarking of the swap valuations. \textit{Id}. Within three days of this discovery, the bank self-reported the issue to the Division.\textsuperscript{38}

In November 2018, the CFTC issued its first-ever public letter announcing that it declined to bring charges against a registrant (the “Letter”).\textsuperscript{39} The Letter provides a detailed explanation as to the CFTC’s reasons for not prosecuting Deutsche Bank or its executives. The Director of the Enforcement Division wrote that the “decision to close the investigation is based on … the Bank’s: (1) timely, voluntary self-disclosure of the matters described above, among others; (2) full cooperation in this matter (including providing all known relevant facts about the individuals involved in or responsible for the misconduct); and (3) proactive remediation efforts directed at strengthening and enhancing the Bank’s swap valuation process.”\textsuperscript{40}

The CFTC’s decision not to prosecute Deutsche Bank based on its handling of Bourne’s misconduct again demonstrates the CFTC’s commitment to “individual accountability.” Here, the bank had effective policies and procedures in place to detect wrongdoing. Through such

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\textsuperscript{36} \textit{CFTC Letter to Andrew Stemmer, Deutsch Bank Securities, Inc.} (November 8, 2018) at 1.  \\
\textsuperscript{37} \textit{Id.}  \\
\textsuperscript{38} \textit{Id.}  \\
\textsuperscript{39} \textit{Id.}  \\
\textsuperscript{40} \textit{Id.}
\end{flushright}
policies and procedures the bank detected wrongdoing, responded to red flags by conducting a thorough investigation, and promptly self-reporting to the CFTC. These practices protected the bank and the supervisors -- other than the primary wrongdoer -- against being charged by the CFTC.
Some Ethical Considerations with Whistleblower Rules

by Howard Schneider, Senior Consultant
Charles River Associates
1411 Broadway
New York, NY 10018
(212) 520-7104
hschneider@crai.com
Whistleblower rules in the financial services industry are now an established fact of life. The SEC has announced substantial whistleblower awards in multimillion dollar amounts — clear monetary incentives for individuals to report public company wrongdoing. Management and compliance officials must learn to live with whistleblower rules and must establish policies and procedures to facilitate them. And, when a whistleblower surfaces, there is little tolerance for retaliation for the whistleblowing activities.

One issue for consideration is whether the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") whistleblower rules have essentially eliminated the Sarbanes-Oxley Act of 2002 ("SOX") rules with respect to internal reporting up the corporate ladder and whether that is a good thing. This Paper will also address two additional issues: 1) whether public companies are constrained from using provisions in employment or end of work type agreements that do not allow employees or ex-employees to discuss his or her whistleblower observations with a government agency or impedes his or her acceptance of a whistleblower award; and 2) whether attorneys ethically can be whistleblowers under the SEC view, as well as under certain Bar Association pronouncements.

As background, SOX set up internal corporate reporting procedures for whistleblowers. The concept was that someone (an employee or others) seeing something wrong at a public

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company would report the wrongdoing internally up the corporate ladder and have the affected company do the necessary internal investigation to ascertain the wrongdoing and provide appropriate remediation. The public policy considerations behind these procedures were:

- Stop the violations quickly
- Provide prompt remediation
- Avoid heavy government investigations
- Allow companies to self-report
- Save scarce government resources

Dodd-Frank, almost 10 years later, also covered whistleblowers\(^2\). In 2018, the Supreme Court, in a significant decision\(^3\), narrowed the definition of a whistleblower (for purposes of being afforded anti-retaliation protections under Dodd-Frank) to only someone who reports directly to the SEC. That case may have effectively gutted the SOX internal corporate reporting procedures (and the public policy rationale behind those procedures).

**SEC RULES\(^4\)**

Dodd-Frank added a new section 21F to the Securities Exchange Act entitled “Securities Whistleblower Incentives and Protection.” Under its provisions, the SEC is required to pay an award of 10% - 30% to a whistleblower who voluntarily provides “original” information about a violation of the Federal Securities laws that leads to a successful prosecution of the violators.

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\(^2\) Dodd-Frank mandated whistleblower programs at the SEC (§922) and CFTC (§748). The SEC’s Rules (SEC Rules 21F 1-17) became effective August 12, 2011. The CFTC Rules (CFTC Rules 165.1-165.19) became effective October 24, 2011.


\(^4\) For these purposes, the SEC Rules are essentially the same as CFTC Rules and this Paper will use the SEC Rules.
resulting in monetary sanctions exceeding $1 million. Section 21F prohibits retaliation against the whistleblower.

As background to the Digital Realty Trust case in the Supreme Court, a division of opinion had occurred in the Circuit Courts over the question of whether an employee who reports internally (and not to the SEC) is afforded the anti-retaliatory protections of Dodd-Frank. 5 Prior to Digital Realty Trust, at least two Circuit Courts had reached opposite conclusions: 1) the decision of the 5th Circuit in 2013 in the case of Asadi v G.E. Energy (USA) LLC6 where the Court held that an internal report up the corporate ladder did not qualify for the Dodd-Frank anti-retaliatory protections because the clear statutory language in Dodd-Frank (see ftn. 8), requires a report directly to the SEC and 2) a contrary decision by the 9th Circuit in Somers v. Digital Realty Trust7 where the court held that the anti-retaliation provisions of Dodd-Frank were available to a whistleblower who reported internally, but did not report to the SEC.

5 Dodd-Frank anti-retaliatory protection clearly applies when the whistleblower provides information directly to the SEC or assists an SEC investigation, but the statute was considered problematic if disclosures are made that are required or protected when reporting internally under SOX, the securities laws or regulations. The difference to a whistleblower can be significant: SOX permits a whistleblower to seek back pay and other damages, but requires the claim to be filed within 6 months and to be initiated in an OSHA administrative proceeding. Dodd Frank, on the other hand, allows the whistleblower to receive double back pay as damages and imposes a three year statute of limitations to bring the claim, which can be brought in a Federal District Court.
6 720 F. 3d 620 (5th Cir 2013)
7 850 F. 3d 1045 (9th Cir, March, 2017). See also, Berman v Neo @ Ogilvy LLC, WPP Group USA, Inc, 801 F.3d 145 (2nd Cir Sept., 2015) to the same effect.
The differing views (conflict among Circuits) resulted in the Supreme Court’s decision in *Digital Realty Trust*,\(^8\) requiring that individuals report alleged violations to the SEC to be afforded anti-retalitory protections under Dodd-Frank, and, conversely, that individuals who report alleged violations only internally are not protected whistleblowers under Dodd-Frank.

Will the Supreme Court decision in *Digital Realty Trust* essentially gut an entity’s internal compliance program (required by SOX) because of the substantial financial incentives (see, e.g., ftn. 1) provided to whistleblowers to report to the SEC and CFTC and stand first in line to collect the bounty provided, thereby by-passing internal reporting processes and procedures?

The Supreme Court decision in *Digital Realty Trust* places strong incentives on whistleblowers to by-pass internal reporting and report directly to the SEC. Accordingly, the decision is bound to have a significant chilling effect on internal corporate reporting for potential whistleblowers. To get full statutory protection, a putative whistleblower would be well advised to report to the SEC and forget about internal corporate reporting.

The SEC, prior to the Supreme Court’s decision in *Digital Realty Trust*, had tried to incentivise internal reporting, although critics said the Agency didn’t go far enough. While these attempts are now historical footnotes, it is worth noting the effort, because, if nothing else, it shows the SEC’s then belief in the SOX internal reporting system. Ironically, internal reporting up the corporate ladder is what business commentators advocated when the whistleblower rules

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\(^8\) See ftn. 3. The holding, citing to the clear language of the statute, stated quite precisely that Dodd-Frank defines a “whistleblower” as someone who provides “information relating to a violation of the securities laws to the Commission” 15 U.S.C. Section 78u -6 (a) (6). [Emphasis supplied.]
were first put out for comment, although, when Digital Realty Trust came up for argument before the Supreme Court, those same commentators filed amici briefs supporting the position that eventually prevailed – all of which create a disincentive to internal corporate reporting.

A second key issue in which the Courts have spoken is the issue of the extraterritorial effect of the Dodd-Frank whistleblower protections. In Liu Meng-Lin v Siemens AG, the Court held that, under the Supreme Court’s reasoning in Morrison v. National Australia Bank Ltd, there was no extraterritorial application of the Dodd-Frank whistleblower provisions: The rationale being that the statute is silent on the point and thus Congress expressed no extraterritorial intent – absent such intent, per Morrison, US laws do not apply to events in foreign jurisdictions.

IMPLEMENTATION

Both the SEC, and the CFTC have established whistleblower offices within their respective Agencies.

To be able to judge the impact of the SEC’s Whistleblower Program, the SEC, in its 2018 Annual Report on the Dodd-Frank Whistleblower Program (November, 2018), states that 5,282 (compared to 3,238 when the Program started in fiscal 2013) whistleblower tips were received at a steady pace during all months of the year. Tips were categorized by whistleblowers as relating most heavily to:

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10 130 S. Ct. 2869 (2010)
Corporate Disclosure and Financial 18.6%
Offering Fraud 19.9%
Manipulation 11.8%

All other categories, including Insider Trading, Trading and Pricing, FCPA, Unregistered Offerings, Market Event, and Municipal Securities and Public Pension comprised the remaining 49.7%.

Through November, 2018, the SEC has already paid out over $326 million in whistleblower claims and recovered over $1.5 billion from cases brought through whistleblower tips. The SEC Whistleblower program is funded at about $300 million. As of August, 2018, the CFTC has granted 9 awards and its whistleblower account is funded at over $100 million.

SEPARATION AGREEMENTS – CAN THEY VIOLATE DODD-FRANK?

The SEC brought four enforcement actions\(^\text{11}\) in 2016 against registrants that utilized blanket confidentiality or severance agreements wherein an employee or ex-employee is required to inform the company that he or she intends to provide information to a government agency, or, the company attempted to remove financial incentives (in the form of whistleblower bounties) to current employees or departed employees who decide to become whistleblowers. In each case, the offending company settled the action, paying a fine and essentially agreeing to recind the

\(^{11}\) In the Matter of KBR, Inc (April 1, 2015); In the Matter of Blue Linx Holdings (August 10, 2016); In the Matter of Health Net, Inc. (August 16, 2016); In the Matter of Anheuser Bush In Bev (September 28, 2016)
offending language and inserting new language making clear that nothing in the agreement
prohibits an employee or ex-employee from disclosing any issue to the SEC or other
governmental agencies, nor can or will the company interfere in the whistleblower’s ability to
receive a bounty for the whistleblowing activity.

The SEC based its enforcement cases on the language of Rule 21F 17:

“(a) No person may take any action to impede an individual from communicating
directly with the Commission staff about a possible securities law violation,
including enforcing, or threatening to enforce, a confidentiality agreement … with
respect to such communications”.

The SEC takes the position that any attempt to require an employee or ex-employee to disclose
that that person will make a disclosure to the SEC or other government agencies or that would
negate incentives for doing so “impedes” the potential whistleblower and is illegal.

Attorneys for SEC registered companies would be wise to review employment
agreements, codes of conduct, severances agreements, employee handbooks and similar
documents to insure that any offending language is removed and positive reinforcement of
whistleblower rights is expressly stated.
ETHICAL CONSIDERATION OF ABILITY OF A LAWYER TO BECOME A WHISTLEBLOWER AS A RESULT OF INFORMATION LEARNED IN HIS/HER CORPORATE REPRESENTATION CAPACITY.

The SEC will not consider information to be derived from the whistleblower’s own analysis or knowledge - a prerequisite for obtaining a whistleblower award - if it came from an attorney-client communication [§21F 4(b)(4)(i)] or from a client representation [§21F 4(b)(4)(ii)], unless, in either case, permitted by §205.3(d)(2) of the SEC Rules relating to attorney conduct.

§205.3(d)(2) permits (but does not require) an attorney appearing and practicing before the SEC in the representation of an issuer, without the consent of the issuer, to reveal confidential information to the SEC related to the representation to the extent the attorney reasonably believes necessary (a) to prevent the issuer from committing a material violation likely to cause substantial financial injury to the interests or property of the issuer or investors, (b) to rectify the consequences of such material violation on which the attorney services have been used, or (c) to prevent the issuer from committing or suborning perjury in an SEC proceeding.

Thus, attorneys who may permissively report violations to the SEC could, notwithstanding the SEC’s seeming attempt to exclude them from whistleblower status under the provisions of §21F 4(b)(4)(i) and (ii), actually became whistleblowers. What is the ethical propriety of an attorney, acting in the course of an engagement, providing confidential information to a regulatory body for his or her own personal gain? And, is the SEC encouraging attorneys to disclose client confidences by virtue of these rules?
One Bar Association has issued an Opinion\textsuperscript{12} that a New York lawyer would violate the New York Code of Professional Responsibility if the lawyer were to seek a bounty under the Dodd-Frank whistleblower provisions\textsuperscript{13}. The rationale is that lawyers would be disclosing confidential client information under SEC Rules which are permissive (not mandatory) to prevent ostensible wrongdoing, but that disclosure would be violative of New York client confidentiality rules under that State’s Code of Professional Responsibility. Moreover, the Opinion reasoned, the potential to receive a substantial bounty will, by its very nature, create for the lawyer an impermissible conflict of interests with his or her client.\textsuperscript{14}

The SEC would undoubtedly disagree and cite the provisions of Rule 205.1 which states that the SEC’s Attorney Conduct Rules prevail over inconsistent state ethic rules.\textsuperscript{15}

\textsuperscript{12} Formal Opinion 746 (October 7, 2013) New York County Lawyers Association Committee on Professional Ethics.
\textsuperscript{13} Id. at 9 “… preventing wrongdoing in not the same as collecting a bounty.”
\textsuperscript{14} Id. at 12. “Such large sums of money would tend to cloud lawyers professional judgement, influencing lawyers to report out a violation regardless of their clients’ interests.
\textsuperscript{15} SEC Rule 205.1:

“This part sets forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in the representation of an issuer …. Where the standards of a state or other United States jurisdiction where an attorney is admitted or practices conflict with this part, this part [including Rule 205.3 (d) (2)] shall govern.”

Application of the Attorney-Client Privilege to Compliance Officers

The question of whether the attorney-client privilege can attach to communications with a compliance officer is a perplexing one. As a threshold matter, we assume for purposes of this article that the compliance officer is an attorney, though that will not always be the case. With that assumption, the answer to the question can become even more difficult if the compliance officer is also part of a company’s legal department, or if the compliance officer “wears two hats,” (i.e., is both an attorney in a firm legal department and has compliance functions). And of course, the answer to the question depends on what precisely the compliance officer is doing. To take two examples on possibly opposite ends of the spectrum, the difference between the compliance officer preparing a compliance report for submission to a regulatory agency, as opposed to the compliance officer assisting a trader “in real time” on compliance with specific rules and restrictions (e.g., position limits). This article addresses these matters and essentially concludes that in some instances, the attorney-client privilege could attach to communications with a compliance officer, while in other instances it does not, but whether to assert the privilege in any given case often depends on who is requesting the information and for what purpose.

As is now well-understood, the Dodd-Frank Act amended sections of the Commodity Exchange Act to require registrants to designate an individual to serve as its Chief Compliance Officer. 

1 James Bernard, Francis Healy & Gilana Keller, Stroock & Stroock & Lavan LLP

Officer “CCO.” The board or senior officer must appoint, and may remove, the CCO. They are required to meet with the CCO annually and at the request of the CCO.

CCOs have several responsibilities, including “[a]dministering each of the registrant’s policies and procedures,” “taking reasonable steps to resolve material conflicts of interests,” “[t]aking reasonable steps to ensure compliance” in connection to the “registrant's business as a futures commission merchant, swap dealer or major swap participant” and “taking reasonable steps to ensure the registrant establishes, maintains, and reviews written policies and procedures reasonably designed to remediate noncompliance issues” that the CCO identifies through, for example, a “compliance office review.” As this list suggests, some of these functions seem more like business, or non-legal, functions (“administering each of the registrant’s policies and procedures” whereas some are more legal in nature (“taking reasonable steps to ensure compliance”).

The CCO is also tasked with preparing and signing an annual compliance report. The written report includes a description of “[t]he written policies and procedures” of the FCM, SD, or MSP, and provides an “assessment of [their] effectiveness.” The report delineates “areas for

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3 7 U.S.C. § 6d(d) and § 6s(k)(1).
4 17 C.F.R. § 3.3(a)(1) and (a)(2); 7 U.S.C. § 6sk. The CFTC amended regulations regarding certain duties of CCOs found in § 3.3, effective September 26, 2018.
5 17 C.F.R. § 3.3(d)(1).
6 Id. § 3.3(d)(2).
7 Id. § 3.3(d)(3).
8 Id. § 3.3(d)(4).
9 Id. § 3.3(e)(1) and (e)(2).
improvement” and recommends changes. Additionally, the report should describe the resources allocated for compliance and “[a]ny material noncompliance issues identified” and action taken. Before presenting the annual report to the Commission, the CCO delivers it to the board or senior officer for review.

The CCO has supervisory authority over employees acting at the CCO’s direction. Often, CCOs oversee desk compliance officers, who are available to advise traders on the floor. These compliance officers respond to questions that are related to both legal and business issues, although a compliance officer does not need to be an attorney. While some of their answers may be purely business related, they also respond to a mixture of legal and business questions.

There is a dearth of case law specifically applying attorney-client privilege law to compliance officers. But general principles from other contexts provide guidance on how such questions may get resolved.

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10 Id. § 3.3(e)(3).
11 Id. § 3.3(e)(4).
12 Id. § 3.3(e)(5).
13 Id. § 3.3(f)(1).
14 17 C.F.R. § 37.1501.
15 The privilege may still apply to communications to non-attorneys acting under the direction of attorneys in internal investigations. In re Kellogg Brown & Root, Inc., 756 F.3d 754, 758 (D.C. Cir. 2014). This article does not address the question of whether compliance officers who are not lawyers should be covered by attorney-client privilege.
16 The CCO “shall have the background and skills appropriate for fulfilling the responsibilities of the position.” 17 C.F.R. § 3.3(b).
In 2014, in a widely-discussed decision, the D.C. Circuit held that communications are privileged if providing legal advice was a “significant purpose” of the communication.\textsuperscript{17} In \textit{In re Kellogg Brown \& Root, Inc.}, plaintiff demanded documents during discovery that were created during defendant’s previous internal investigation, which was conducted “pursuant” to its Code of Business Conduct, and supervised by the company law department.\textsuperscript{18} The Court found that “[s]o long as obtaining or providing legal advice was one of the significant purposes of the internal investigation, the attorney privilege applies, even if there were also other purposes for the investigation and even if the investigation was mandated by regulation rather than simply an exercise of company discretion.”\textsuperscript{19} Further, the D.C. Circuit explicitly rejected the district court’s “but-for” analysis, finding that it would “eradicate the attorney-client privilege for internal investigations conducted by businesses that are required by law to maintain compliance programs, which is now the case in a significant swath of American industry.”\textsuperscript{20}

In June 2018, the D.C. Circuit reaffirmed its holding in \textit{Kellogg}, finding that if “a communication has multiple purposes—in particular, a legal purpose and a business purpose,” courts should apply the “primary purpose test” to ascertain whether providing or receiving “legal advice was one of the significant purposes of the attorney-client communication.”\textsuperscript{21} In \textit{Fed. Trade Comm'n}, “the communications [with the company’s general counsel] had a legal purpose: to help the company ensure compliance with the antitrust laws and negotiate a lawful settlement.

\begin{itemize}
\item \textsuperscript{17} \textit{In re Kellogg Brown \& Root, Inc.}, 756 F.3d 754, 759 (D.C. Cir. 2014).
\item \textsuperscript{18} \textit{Id.} at 756.
\item \textsuperscript{19} \textit{Id.} at 758–59.
\item \textsuperscript{20} \textit{Id.} at 759.
\item \textsuperscript{21} \textit{Fed. Trade Comm'n v. Boehringer Ingelheim Pharm., Inc.}, 892 F.3d 1264, 1267 (D.C. Cir. 2018) (internal citations and quotation marks omitted).
\end{itemize}
But the communications also had a business purpose: to help the company negotiate a settlement on favorable financial terms.”22

A New York district court, in addressing applicability of the privilege to an internal investigation, affirmed the “primary purpose test” from *Kellogg* and opined that “[r]are is the case that a troubled corporation will initiate an internal investigation solely for legal, rather than business, purposes… Accordingly, an attorney-client privilege that fails to account for the multiple and often-overlapping purposes of internal investigations would ‘threaten[ ] to limit the valuable efforts of corporate counsel to ensure their client's compliance with the law.’”23

In a New York Court of Appeals case concerning application of the common interest privilege, the court emphasized the overlapping business and legal responsibilities of lawyers working in corporations. The court opined that “in the corporate context, where corporate staff attorneys ‘may serve as company officers, with mixed business-legal responsibility; whether or not officers, their day-to-day involvement in their employers’ affairs may blur the line between legal and nonlegal communications.’”24

In contrast, some courts have found that communication between lawyers and clients would not be subject to privilege if the “the collection of information necessary to prepare those answers and the actual preparation of those answers was in the normal course of [the] business . . . and would have taken place with or without her involvement as an attorney.”25 Similarly, a

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22 Id. at 1267.


communication would not be privileged if it was not from a lawyer, and was not “information
gathered by corporate employees for transmission to corporate counsel for the rendering of legal
advice[.]”

Similar to in-house counsel, compliance officers often wear two hats, and the purpose for
which communications are made may determine whether the attorney-client privilege attaches.
For example, compliance officers on a trading floor often communicate with traders “in real
time” to ensure that transactions comply with specific rules and regulations, including, but not
limited to, applicable position limits, reporting of over-the-counter swap transactions, and pre-
trade disclosure of mid-market marks for certain swaps. Similarly, in performing their ordinary
duties and obligations, CCOs will often discuss compliance procedures, the annual report or
disclosure requirements with the board of directors or senior officers. Because such
communications are made within the capacity as a compliance officer, and not in any type of
"professional legal capacity" or at the direction of an attorney, a court may refuse to protect them
as attorney-client privileged or attorney work product because they are performing a business
function.

On the other hand, if a company decides to conduct an internal investigation concerning
certain trading practices at the request of the legal department, that same lower-level compliance
officer may interview those same traders concerning how certain transactions are executed or
reported and transcribe those interviews in notes. The CCO may then discuss the compliance
department’s findings with the board of directors or senior officers, including the general
counsel, and provide an oral or written recommendation on whether such findings should be

(M.D. Fla. Nov. 6, 2012).
reported to a regulator. Because the primary purpose for these communications is arguably more legal than business-related, as opposed to the annual compliance report submitted to the board, they may be more likely to be protected from disclosure as privileged. Such distinctions, however, may not always be clear cut.

A Tennessee district court found that “in-house counsel often performs more functions within a corporation than just providing legal advice, and ferreting out the particular “hat” in-house counsel may be wearing at a given moment can be very difficult…. [I]n-house counsel at issue in this case is also a compliance officer in the defendant's Compliance Department. There is likely overlap of legal and nonlegal duties in such a position.”27 Often, separating the legal and non-legal advice of compliance officers is extremely difficult, and therefore determining what is and is not privileged, or potentially privileged, is equally difficult.

The CFTC, in its rules, proposed rules and comments, has not taken a definitive position on the scope of the attorney-client privilege as applied to compliance officers. However, in commentary on a 2012 rule, the CFTC indicated that when furnishing the annual report, the privilege does not attach: “The Commission expects the CCO and registrant to articulate clearly the segregation of that individual’s CCO and non-CCO responsibilities. All reports required under sections 4d(d) and 4s(k) of the CEA, as well as the rules promulgated pursuant thereto, are meant to be made available to the Commission, and as such, they should not be subject to the attorney-client privilege, the work-product doctrine, or other similar protections.”28

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28 77 Fed. Reg. 20128, 20160-61. Additionally, in a 2017 Enforcement Advisory about evaluating cooperation during the agency’s investigations and enforcement actions, the CFTC declared that attorney-client privilege “protections can promote a client’s communications with counsel and thereby serve to promote the client’s compliance with the law. These rights are not intended to be eroded or heightened by this advisory.” See CFTC, Enforcement Advisory: Cooperation Factors in Enforcement Division Sanction Recommendations for Companies (Jan. 19 2017).
Additionally, in a 2013 comment to the proposed rule concerning chief compliance officers, a commenter “argued that it is unreasonable for the Commission to take the position that a CCO should not be able to receive privileged advice from counsel in an effort to comply with these new, complex, and uncertain rules.” The CFTC responded that the final rule did not change “existing Commission policies regarding the assertion of attorney-client privilege by registrants.”

In sum, whether the attorney-client privilege attaches to communications with a compliance officer is often confusing and such determinations will be fact specific. While neither the case law nor statutes and regulations directly address this question, it seems that in certain situations, where the “primary purpose” of such communications is to provide legal advice, the privilege may apply. However, where communications with a compliance officer are more business-focused, generated in the course of day-to-day transactions, such communications may not be protected if they were not also driven by a need for legal advice.


Self-Regulatory Organizations and the Constitutional Privilege against Self-Incrimination

By Julian E. Hammar¹

How does a self-regulatory organization (SRO), on the one hand, steer clear of being deemed a government actor (and subjects of SRO investigations thereby having Fifth Amendment protections) while, on the other hand, coordinating with a governmental authority enough to avoid duplication or disruption? The current state of the law is that a respondent has a fairly heavy burden to show that an SRO was in fact acting as a state actor, so that constitutional protections would apply to SRO investigations or disciplinary proceedings. Nonetheless, with the expansion of the jurisdiction (and disciplinary authority) of SROs to include market participants generally (i.e., members of the public who use their markets) and not just exchange members, the likelihood that a court might find an SRO to be a state actor may have increased. This is especially the case given the increase in coordinated actions by government regulators, the Department of Justice and the SROs over the same conduct.

In general, the U.S. Constitution only regulates government conduct, and not that of private actors, with certain exceptions.² Assertion of Constitutional privileges, such as the privilege against self-incrimination in the Fifth Amendment, can only be made against a private entity if the entity is properly considered a state actor. With respect to SROs, courts generally have not viewed them as governmental agencies or state actors and have not granted the targets of SRO investigations a right to assert their Fifth Amendment privilege.³ The justification for this treatment is that SROs are private membership organizations that police their members’

¹ Morrison & Foerster LLP.
² A handful of provisions in the Constitution, such as the 13th Amendment, apply to private entities.
conduct, and not governmental entities policing the general public. Nonetheless, an SRO can be subject to the Fifth Amendment if it engages in state action by becoming significantly involved with a government investigation. Significant involvement that would constitute state action only occurs when the nexus between the government and the challenged action by a private party is so close “that the seemingly private behavior may be fairly treated as that of the State itself.”

In determining whether such a close nexus exists, factors considered by courts include whether (1) the challenged activity results from the State’s exercise of coercive power; (2) the State provides significant encouragement, either overt or covert; or (3) a private actor operates as a willful participant in joint activity with the State or its agents. Moreover, the Supreme Court found in the Brentwood case that a private entity in charge of regulating and supervising interscholastic athletics in Tennessee was a State actor based on the government’s “entwinement” with its activities. The Court did not precisely define what constitutes “entwinement,” but simply emphasized the close relationship between the Tennessee Athletic Association and the government. After Brentwood, some courts have focused on whether “the state has so far insinuated itself into a position of interdependence with the private entity that it

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5 Id. at 296.

6 Id. at 298 (stating that “[t]he nominally private character of the Association is overborne by the pervasive entwinement of public institutions and public officials in its composition and workings, and there is no substantial reason to claim unfairness in applying constitutional standards to it.”).

7 For example, the Court cited that eighty-four percent of the association’s members were public schools, there was evidence that the state had traditionally delegated regulation of interscholastic athletics to the association; most of the association’s funding was derived from member public schools; most of its meetings were held on government property; and the government appointed non-voting members of the association’s committees. Id.
must be recognized as a joint participant in the challenged activity,”8 or whether “the particular actions challenged are inextricably intertwined with those of the government.”9

Specifically in the context of SROs, a leading case relied upon when a denial of the Fifth Amendment privilege is claimed is United States v. Solomon.10 The case involved testimony by an officer of an NYSE member firm in an NYSE investigation that was used to indict him. In the criminal case, the defendant argued that the NYSE had become an arm of the government, so that the Fifth Amendment should apply and his testimony in the NYSE investigation should be excluded. The Court of Appeals for the Second Circuit held that the actions of the NYSE were those of a private body and not the government, stating that “[t]his is but one of many instances where the government relied on self-policing by private organizations to effectuate the purposes underlying federal regulating statutes.”11

Similarly, it has been held that the National Futures Association (NFA) is not subject to the Fifth Amendment’s privilege against self-incrimination when it conducts investigations for violation of its own rules,12 and that NASD, the predecessor to FINRA--the SRO for broker-dealers--is not a government functionary.13 Moreover, the SEC has repeatedly held that FINRA Rule 8210’s requirement that persons associated with FINRA member firms provide information in response to FINRA’s requests does not impinge on the privilege against self-incrimination.14

9 Mathis v. PG&E, 75 F.3d 498, 503 (9th Cir. 1996).
10 509 F.2d 863 (2d Cir. 1975).
11 Id. at 869.
13 D.L. Cromwell Inv., Inc. v. NASD Regulation, Inc., 279 F.3d 155, 162 (2d Cir. 2002).
However, the SEC has recognized that an SRO may be acting as an agent for the government in some circumstances. In In re Fank P. Quattrone, the SEC reversed and remanded an NASD ban against Quattrone for refusing to testify on Fifth Amendment grounds, holding that Quattrone had the right to present evidence that NASD’s role in a joint investigation with the NYSE and SEC rendered its request for testimony state action. Evidence that suggested a joint investigation rendering NASD a state actor included, among other things, written statements from the NASD that its investigation was part of a joint investigation with the SEC and that any resolution of the matter would need to involve all three regulators (i.e., NYSE, the NASD, and SEC Enforcement). In addition, there was Congressional testimony by the then-Director of SEC Enforcement indicating that the investigations were conducted jointly.

In In re Ficken, the NASD barred Ficken from associating with any NASD member in any capacity based on his refusal to provide testimony, rejecting Ficken’s assertion that NASD was a state actor because its staff had forwarded documents to the SEC and Department of Justice that were also investigating him. The SEC reversed and remanded, giving Ficken the opportunity to conduct discovery to prove his allegations of joint action between the NASD and SEC, since NASD had not provided such an opportunity. However, the SEC noted that “cooperation between the Commission and NASD will rarely render NASD a state actor, and the mere fact of such cooperation is generally insufficient, standing alone, to demonstrate state action.”

17 Id. at 11. See also In re. Warren E. Turk, Exchange Act Release No. 55,942 (June 22, 2007)(a similar opportunity to prove state action in an NYSE proceeding where a specialist was barred for asserting the Fifth Amendment privilege).
While the SEC remanded these cases to allow the respondents to develop the record on whether the SRO was a state actor, the SEC has stated that the burden of demonstrating joint activities to render an SRO a state actor is “high,” and that burden “falls on the party asserting state action.” In order to meet this burden, a respondent must demonstrate “a nexus between the state and the specific conduct of which the [respondent] complains.”18 The SEC concluded that the respondent in In re Sassano failed to demonstrate such a nexus, rejecting his assertions that the close chronology of discovery requests by the NYSE and SEC demonstrated such a nexus because there was no evidence that the SEC guided the NYSE’s requests. The SEC found that the record merely showed that the investigations were conducted in parallel.19 Sharing of information from the NYSE to the SEC in the form of written testimony of another witness similarly did not establish state action.20

These and other cases show that there must be more than just circumstantial evidence of coordination, such as close in time information requests, or sharing of information with the government, in order for an SRO to be considered a state actor. Evidence that may be considered sufficient would include written statements such as those cited in Quattrone suggesting a joint investigation. However, so long as neither the SRO nor the government make statements that their investigations are coordinated or otherwise demonstrate a nexus between their investigations, it is unlikely that a court would find the SRO to be a state actor subject to the


19 See also D.L. Cromwell v. NASD Regulation, Inc., 279 F.3d 155, 162 (2d Cir. 2002)(declining to find that an NASD request for information constituted state action based on “the chronology of certain events” in simultaneous government and NASD investigations).

20 See also Scher v. NASD, 386 F. Supp. 2d 402, 408 (S.D.N.Y. 2005)(finding, where an NASD investigator shared information with the district attorney’s office with which he once worked approximately one year after plaintiffs testimony, that “such collaboration,” which ultimately led to the plaintiffs criminal prosecution, does not in itself demonstrate that a “close nexus” existed between the challenged conduct of the NASD and a state actor).
Fifth Amendment. In light of the cases, it can be anticipated that SROs and the government will attempt to avoid or minimize making such statements, since obtaining testimony from individuals in SRO investigations is critical to their regulatory enforcement programs.

That said, a number of commenters have suggested that the status of SROs as state actors needs to be reexamined by the courts.\(^21\) This seems particularly true in light of the expanded functions of SROs like FINRA and NFA, which perform a number of governmental functions delegated by the SEC and CFTC, respectively. While in the past justifications of denial of Fifth Amendment protections in the case of SROs often emphasized that SROs are self-regulatory and need to police their members, the authority of designated contract markets after the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act now extends far beyond policing their own members, but to members of the public who use their markets as well.\(^22\) They thus may be deemed to be more like governmental entities in their regulatory functions rather than self-regulatory organizations. To be sure, procedural protections for respondents, such as the right to counsel, are afforded under exchange rules and required by CFTC regulations,\(^23\) but they do not allow for the privilege against self-incrimination. Exchanges may contend that they have a right to effectively police their markets, and they should not in effect be penalized because the government has expanded their jurisdiction and made them appear more like governmental entities.

Even if despite these trends SROs may not be considered government actors, however, the increasing occurrence of contemporaneous investigations between SROs, regulators and the


\(^{22}\) See 17 CFR 38.151(a)(requiring that prior to granting any member or market participant access to its markets, a designated contract market must require that the member or market participant consent to its jurisdiction).

\(^{23}\) See 17 CFR Part 38, Subpart N.
Department of Justice and the fact that SROs will share information they obtain with the government, seems to argue in favor of Fifth Amendment protections applying in SRO proceedings, especially if there is a likelihood that the person may be criminally prosecuted. Since SRO sanctions may include a permanent ban from the industry for failure to testify in addition to penalties, a respondent may feel compelled to testify because of the impact on his or her livelihood and not attempt to assert Fifth Amendment rights. In a few cases, the SEC and the courts have found that a permanent ban may be too severe a sanction for failure to testify, but in general such permanent bars may be upheld. In practice, exchanges may decline to impose sanctions against a person who declines to testify if the exchange knows, for example, that a grand jury is investigating the same conduct, but they are not required to do so under the law.

In a related area not involving an SRO but a private entity, Gavin Black, a former Deutsche Bank trader, recently was convicted in October 2018 by a federal jury of wire fraud and conspiracy in connection with his alleged role in the manipulation of Libor rates. Absent from the government’s case were statements Black had made to attorneys engaged by Deutsche Bank to conduct an internal investigation that the government ultimately elected not to have admitted in evidence. At issue was the principle of the Supreme Court’s decision in Garrity v. New Jersey, which protects a public employee from being coerced by the threat of termination.

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24 See, e.g., PAZ Securities, Inc. v SEC, 494 F.3d 1059, 1062-63 (D.C. Cir. 2007) (remanding a case where the NASD had permanently barred an associated person for failing to respond to requests for information, where the SEC had affirmed the bar without addressing potentially mitigating factors, concluding that such a bar is the industry equivalent of capital punishment, and holding that the SEC was required to explain why such a severe sanction was remedial rather than punitive in light of mitigating evidence).


of employment to make incriminating statements during an investigation by his employer (the
government).

While Garrity involved a government employer, the principle has been extended to
coercion by private employers, when the coercion is “significantly encouraged” by the
government. In United States v. Stein,28 the court suppressed statements that KPMG employees
made to the Department of Justice (DOJ) on the basis that the government was responsible for
the pressure KPMG had put on its employees to talk with prosecutors (or be fired) such that their
statements to DOJ could be considered compelled for purposes of the Fifth Amendment.

In the Black case, Black, then a Deutsche Bank employee, was interviewed by the bank’s
attorneys who were conducting an internal investigation. Bank policy required employees to
either cooperate with the internal investigation or find new employment, and Black believed he
would be terminated if he did not agree to be interviewed. The interview was subsequently
disclosed to the government in cooperation with its contemporaneous criminal investigation.
Black moved to exclude the interview statements, maintaining that Deutsche Bank’s compulsion
of his statements should be attributed to the government because the bank regularly received
direction from DOJ in connection with interviewing bank employees, shared reports about what
occurred during the interviews and received guidance from DOJ on how to conduct the
interviews. Black also cited DOJ policy, which he argued pressured Deutsche Bank to conduct
and disclose employee interviews to DOJ in order to obtain cooperation credit and that, because
of this pressure, the government was responsible for compelling his statements. The court, while
evidently somewhat persuaded by Black’s arguments,29 did not rule on the admissibility of

29 See Shur and Nitz, supra n.26.
Black’s statements because the government ultimately decided not to submit them in evidence. Although the question of whether statements made to a nongovernmental investigator can be considered compelled for purposes of the Fifth Amendment was not decided, the case suggests that there may be avenues for defendants to pursue in that context, which presumably could be extended to the case of an SRO investigation as well.

Thus, while it is unlikely under the current state of the law that an SRO will be found to be a state actor, in light of changes to the nature of SROs in recent years to be more government like as opposed to being purely self-regulatory bodies, the increasing occurrence of parallel investigations between SROs and the government, and the sanctions imposed by SROs for failure to cooperate including permanent bars, it is possible that a defendant may successfully persuade a court to reconsider whether an SRO is a state actor in a particular case and assert the Fifth Amendment privilege.