Wall Street LAWYER
Securities in the Electronic Age

July 2014 ■ Volume 18 ■ Issue 7

City of Pontiac v. UBS AG The Continued Limitation of the Extraterritorial Application of U.S. Securities Laws

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City of Pontiac v. UBS AG,[1] decided by the U.S. Court of Appeals for the Second Circuit on May 6, addresses the issue of whether securities cross-listed on foreign and U.S. exchanges fall within the ambit of the Supreme Court's seminal *Morrison v. National Australia Bank Ltd.*[2] decision, restricting extra-territorial application of U.S. securities laws. The *City of Pontiac* Court held that under *Morrison*, cross-listed securities (when offered by a foreign defendant and purchased by a domestic plaintiff in a transaction that took place abroad) could not be governed by Section 10(b) of the Securities and Exchange Act of 1934 (Exchange Act). *City of Pontiac* is the first appellate ruling on this issue and the first major post-*Morrison* decision to emerge regarding so-called "foreign-squared" securities claims, involving a foreign issuer and foreign place of transaction.

City of Pontiac is significant as it further narrows *Morrison*'s holding to securities traded exclusively on U.S. exchanges, representing a continued trend seen in the courts in recent years. The Second Circuit decision also reinforces and potentially further narrows the definition of a "domestic transaction" under *Morrison*. As a result, it appears that foreign issuers and purchasers of securities outside of the U.S. have a clearer picture of the instances in

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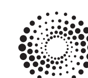
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One Year Subscription ■ 12 Issues ■ $867.96
(ISSN#: 1095-2985)

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From the EDITOR

Did the Second Circuit Tell Judge Rakoff that Facts Don't Matter?

More than 30 months after Judge Jed S. Rakoff of the U.S. District Court in Manhattan rejected a settlement deal between the Securities and Exchange Commission and Citigroup, a higher court has spoken.

A three-judge panel of the U.S. Court of Appeals for the Second Circuit ruled in early June that Judge Rakoff had abused his discretion and applied an incorrect legal standard to the case, remanding the case back to the district court.

The events stem from Judge Rakoff's ruling in November 2011 that rejected a deal that had Citigroup paying $285 million to settle a civil fraud case with the SEC, while neither admitting nor denying guilt. The SEC had accused the banking titan of selling investors complex mortgage-backed securities as the financial crisis was just about to hit.

Judge Rakoff called the fine "pocket change" for a bank of Citigroup's size, but more to the issue, he said he simply could not sign off on a deal in which almost no facts were presented for him to review. Judge Rakoff said that approving the deal and closing the book on it, would keep the country from "ever knowing the truth in a matter of obvious public importance."

At a time when Wall Street regulators were facing mounting pressure to bring some sort of prosecutorial strategy to bare on those whose behavior may have been partly responsible for the financial crisis, Judge Rakoff's refusal to play ball made him a sort of judiciary hero. It even forced the SEC to review how it applied its "neither admit/nor deny" standard.

Since Judge Rakoff's ruling, several other settlements have been held up or revised because of objections to that standard.

Such compromise wasn't to be in the Citigroup case. The Second Circuit—actually quoting Judge Rakoff's words back at him—ruled that it "is not within the district court's purview to demand 'cold, hard, solid facts.'" Instead, the Court suggested a sort of checklist for judges to use for such settlements, ticking off such items as basic legality, and whether collusion or corruption occurred.

In this way, according to the Second Circuit, judges would show the proper deference to settlements forged between parties, like the SEC and the Wall Street financial giants it oversees. "Absent a substantial basis in the record for concluding that the proposed consent decree does not meet these requirements, the district court is required to enter the order."

Of course, this legal dicta doesn't address Judge Rakoff's initial concern—that the *lack* of factual record presented by the parties made it difficult for him to meet what he saw as his other legal responsibility, that the settlement be "fair, reasonable, adequate and in the public interest."

The impact of the Second Circuit's ruling could be felt in a number of cases in which district judges questioned the wisdom of regulatory settlements where "neither admit/nor deny" was part of the package. Indeed, one such case—the SEC's proposed settlement of insider trading against SAC Capital Advisors—has been awaiting the outcome of this appeal.

The ruling also could have an impact on how the SEC approaches its settlements, given that—at Judge Rakoff's urging—the agency had been moving away from such problematic language. If the SEC feels its use of "neither admit/nor deny" has been vindicated, it could be emboldened to return to greater use of that phrase.

In this issue… The July issue of *Wall Street Lawyer* features author Lee Dunst of Gibson, Dunn & Crutcher LLP discussing another Second Circuit ruling, *City of Pontiac v. UBS AG*, that addressed whether securities cross-listed on foreign and U.S. exchanges fall under the Supreme Court's landmark *Morrison v. National Australia Bank Ltd* decision, which restricted extra-territorial application of U.S. securities laws.

—GREGG WIRTH

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which their transactions may fall under U.S. securities laws.

Citing *Morrison v. National Australia Bank*

Morrison, the Supreme Court's 2010 well-known decision restricting extraterritorial securities law claims, dealt with a so-called "foreign-cubed" situation, as both shareholder plaintiffs and defendant issuer were foreign and the transaction occurred outside of the U.S. The issuer, National Australia Bank (National), had American Depositary Receipts (ADRs), which represent a specified number of shares in a foreign stock, listed on the New York Stock Exchange, and National's shares were only directly listed on foreign exchanges. Plaintiffs were Australians who purchased National's shares prior to a write-down resulting in a decline in the value of its stock. Plaintiffs filed a lawsuit in the U.S. District for the Southern District of New York (S.D.N.Y.) under Exchange Act Section 10(b) and SEC Rule 10b-5 (in addition to control person liability under Section 20(a)), alleging they were misled by misrepresentations about the value of the mortgage-servicing rights of HomeSide Lending, a Florida-based company purchased by National and also listed as a defendant in the case.

Plaintiffs also claimed that National's officers were aware of these misrepresentations but failed to reveal this information to shareholders. In bringing the suit, plaintiffs stated that Section 10(b) applied outside of the U.S. and, even if it did not, defendants' misrepresentations were "domestic" because they originated in Florida.

The S.D.N.Y. court ruled in favor of defendants, dismissing the claim for lack of subject matter jurisdiction due to its predominately foreign nature. The Second Circuit later affirmed the District Court's ruling. The Supreme Court also ruled in favor of defendants, but instead dismissed the action for failure to state a claim under Federal Rule of Civil Procedure 12(b)(6). In doing so, the Court held that Section 10(b) does not provide a cause of action to foreign plaintiffs suing foreign and American defendants for misconduct linked to securities traded over foreign exchanges.

Writing for the Supreme Court, Justice Antonin Scalia emphasized that when interpreting U.S. law, courts must apply a presumption against extraterritorial application unless such international effect is clearly stated. In doing so, Justice Scalia rejected the long-standing "conducts and effects" test, applied to cases containing foreign elements. The Court found that since Section 10(b) does not clearly delineate its application outside of the U.S., Congress only intended for it to apply domestically.[3] Importantly, the Court rejected plaintiffs' arguments that defendants' Florida-based misrepresentations brought the case within Section 10(b), emphasizing that the Exchange Act is concerned with domestic transactions. The Court held that Section 10(b) only prohibited misrepresentations related to transactions in securities which are either listed on U.S. exchanges (so-called "prong one" of *Morrison*) or conducted domestically (prong two).

The Second Circuit's *City of Pontiac* Decision

In *City of Pontiac*, a group of foreign and domestic institutional investors—organizations such as hedge funds and mutual funds, which pool large sums of money to invest in securities and other assets—brought a class action under Section 10(b) (and Section 20(a) against control persons) against UBS AG (UBS) and a number of UBS officers and directors. Plaintiffs claimed that UBS overvalued its residential mortgage-backed securities (RMBS), a type of asset-backed security whose value is derived from a specified pool of mortgages. Plaintiffs also claimed that UBS overvalued its collateralized debt obligations (CDOs), which in the instant case were bonds secured by a pool of RMBS. One of the plaintiffs, Alaska Laborers-Employers Retirement Fund (Alaska Laborers), also brought a class action under Securities Act of 1933 sections 11, 12(a)(2), and 15 against UBS and a group of underwriters who participated in the issuance and distribution of certain securities issued in June 2008.

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The action was brought in S.D.N.Y., and the district court later dismissed the Section 10(b) claims of Plaintiffs who purchased the shares on foreign exchanges under *Morrison*, and dismissed the remaining claims for failure to adequately plead fraud and failure to allege a material misstatement under Section 12(a)(2). As expected, the plaintiffs opposed this dismissal.

Writing for the Supreme Court, Justice Antonin Scalia emphasized that when interpreting U.S. law, courts must apply a presumption against extraterritorial application unless such international effect is clearly stated.

The Second Circuit's eventual decision in May resulted in dismissal of Alaska Laborers' Securities Act claims related to UBS's alleged misrepresentations. The Court dismissed the remaining plaintiffs' Section 10(b) actions against UBS related to the domestic CDO/RMBS and other claims for failure to plead materiality or scienter.[4] The Court found that UBS's representations were too open-ended or subjective for plaintiffs to have relied on them in their purchasing decisions.

The significant part of the Court's decision related to plaintiffs' Section 10(b) claims arising out of the purchase of foreign-issued securities over a foreign exchange, to which the Court answered both of the following questions in the negative: Can a foreign (or American) plaintiff sue for alleged misrepresentations related to foreign-issued securities listed on both a U.S. and foreign exchange, where the transaction does not take place domestically? Can an American plaintiff sue under Section 10(b) for alleged misrepresentations related to foreign-issued securities purchased through a buy order initiated in the U.S.? The Court's answers to these questions can be broken down in terms of their significance to post-*Morrison* extraterritorial securities claims.

Rejection of Plaintiffs' "Listing Theory"

The Court first rejected plaintiffs' "listing theory," which claimed that the dual listing of securities on both a foreign and U.S. exchange automatically insulated the securities from *Morrison*'s restrictions, despite the fact that the relevant transaction took place abroad. Plaintiffs argued that under prong one of *Morrison* it did not matter where the securities transaction took place so long as the securities were listed on a national exchange in the U.S. The Second Circuit rejected this argument, noting that *Morrison* placed an emphasis on the domestic location of the securities transaction in both prongs one and two of its holding.[5] Any other reading, the Second Circuit held, would be irreconcilable with *Morrison* as a whole. The Court of Appeals also pointed out that in *Morrison*, the issuer's ADRs, which are also technically securities, were also listed on the NYSE, but that this domestic listing did not affect the Court's analysis in that case. The Second Circuit applied these arguments to both the foreign-cubed claims brought by foreign plaintiffs and foreign-squared claims brought by American plaintiffs.[6]

This analysis of plaintiffs' argument is in line with holdings of other courts post-*Morrison*, which have rejected the listing theory as contrary to the "spirit of *Morrison*" and have found that ADRs listed on national exchanges do not bring a plaintiff's claims within the purview of 10(b).[7] Many courts have grappled with the listing theory since *Morrison*. When making an argument in favor of this theory, plaintiffs have often relied on footnote 10 of the *Morrison* opinion, where Justice Scalia differentiated between securities registered on national exchanges from "other" unregistered securities, explaining that, although both were covered by Section 10(b), the latter only referred to domestically-traded securities.[8]

Plaintiffs often have relied on the fact that Justice Scalia made this differentiation only for unregistered securities (prong two) and not for securities registered on a U.S. exchange (prong one) when stating that these two categories were covered by the Exchange Act. However, courts

have rejected this argument. For example, in *In re Vivendi Universal*, the S.D.N.Y. found that such a reading would run contrary to the intent of *Morrison*, resulting in a more expansive extraterritorial application of the securities laws than even the previously accepted "conducts and effects" test would have allowed.[9] Furthermore, such a reading ignores the last sentence of Justice Scalia's footnote 10, which states in relevant part that,

> **[T]he only alternative to that reading [that only domestic transactions in unregistered securities are not allowed, rather than foreign and domestic unlisted transactions] makes nonsense of the phrase ["or any security not so registered"], causing it to cover *all* purchases and sales of *registered* securities, and *all* purchases and sales of *nonregistered* securities—a thought which, if intended, would surely have been expressed by the simpler phrase "all purchases and sales of securities."[10]**

Denial of Foreign-Squared Claims Involving Domestic Buy Orders

The Second Circuit next addressed the American plaintiff's claim that the U.S. initiation of its buy order, a request filed by investors with traders to purchase a security at a specified price, made its foreign-executed transaction sufficiently "domestic" under prong two of *Morrison*. The Court of Appeals rejected this assertion, relying on its previous decision in *Absolute Activist Value Master Fund Ltd. v. Ficeto*,[11] which held that when determining if a transaction is "domestic" under *Morrison*'s prong two, courts must look to the place where the parties either incurred irrevocable liability as per an agreement to buy and/or sell securities in the U.S., or where title to the securities or the securities themselves were transferred.[12] The Second Circuit held that, as the parties were not irrevocably liable to one another under the buy order, there was no domestic transaction. Also, the Court of Appeals pointed out that as per *Absolute Activist*, the purchaser's place of residency or citizenship did not have any bearing on the location of the transaction.[13]

The *Absolute Activist* decision defined "irrevocable liability" as the point where there is a "meeting of the minds" between the buyer and seller of the securities to become irrevocably bound to one another, even if the ultimate performance of the agreement is to occur at a later date.[14] In that case, decided by the Second Circuit in 2012, foreign hedge fund plaintiffs sued officers of an investment management company and its broker-dealer under Section 10(b). The securities at issue were not traded on a domestic exchange within prong one of *Morrison*, leading the Court of Appeals to analyze the transaction under *Morrison* prong two. Unlike *City of Pontiac*, however, *Absolute Activist* did not involve transactions that took place over a foreign exchange, but instead involved direct sales by U.S. companies to foreign funds. In *Absolute Activist*, the Second Circuit held that the plaintiffs did not adequately allege irrevocable liability or transfer of title in the U.S.

> ***This analysis of plaintiffs' argument is in line with holdings of other courts post-Morrison, which have rejected the listing theory as contrary to the "spirit of Morrison"…***

In determining how to define a domestic transaction, *Absolute Activist* looked to the Exchange Act's definition of "buy" and "sell," which includes a contract to buy or sell securities, respectively.[15] The Second Circuit found that these definitions suggest one "buys" or "sells" securities when they becomes irrevocably bound to perform the relevant transaction. The Court of Appeals found that a transaction was "domestic" under *Morrison* when a seller incurred irrevocable liability to deliver the securities or the purchaser became irrevocably bound to purchase and take ownership of the securities, in the U.S. The Second Circuit also relied on the standard definition of "sale," which is "the transfer of property or title for a price,"[16] and therefore found that a transaction could also be "domestic" if title to the securities was transferred in the U.S.

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The Scope of Domestic Transaction after *City of Pontiac*

Absolute Activist's interpretation of "domestic transaction" has been relied upon by courts in several circuits, and no court has flatly rejected its application to Section 10(b) violations.[17] Courts have called into question its applicability in certain situations, such as over-the-counter transactions, which several district courts in the Second and Ninth Circuits have held fall under prong one of *Morrison* and therefore escape *Absolute Activist*'s analysis.[18]

It also is unclear if courts will apply *Absolute Activist* and *City of Pontiac* to securities swap transactions, which involve the exchange of one security for another. District courts in the Second and Ninth Circuits have held previously that securities swaps are not domestic transactions under *Morrison* where only the purchaser is located in the U.S. or when the transactions take place over a foreign exchange.[19] It is difficult to apply *Absolute Activist* to security swap agreements, which are distinct from the securities-based transactions dealt with in *Morrison* and its progeny, as no title or ownership passes between the parties involved.

It is possible that City of Pontiac has further narrowed the holding of Absolute Activist, making it more difficult to apply U.S. securities laws extraterritorially than was previously the case.

It is possible that *City of Pontiac* has further narrowed the holding of *Absolute Activist*, making it more difficult to apply U.S. securities laws extraterritorially than was previously the case. For example, the *City of Pontiac* decision reiterated the main aspects of the *Absolute Activist* holding, but failed to restate its holding that the nature of the issues or issuer in themselves do not matter when analyzing a Section 10(b) action under prong two of *Morrison*.

More fundamentally, the *City of Pontiac* decision stands in the face of *Absolute Activist*'s claim that facts such as the "place of purchase order" can be taken into consideration when considering whether irrevocable liability has been established domestically.[20] In *City of Pontiac*, the Second Circuit distinguished *Absolute Activist*, by pointing to the fact that the transaction at issue took place over a foreign exchange, which was not the case in *Absolute Activist*. The Court of Appeals also pointed to the fact that *Absolute Activist* never stated that a purchase order *alone* could establish irrevocable liability. However, *City of Pontiac* does not make it clear whether the absence of irrevocable liability is related to the nature of a buy order in itself, as distinct from a purchase order, which usually involves a contract. The Court also does not provide guidance as to what facts must be pleaded by plaintiffs regarding irrevocable liability in order for their claims to survive a motion to dismiss.

Potential Narrowing of *Morrison* in the Face of Dodd-Frank

One issue not addressed in *City of Pontiac* but discussed in several courts since *Morrison*, is Section 929P(b) of the Dodd-Frank Act, which has the potential to expand the extraterritorial application of Section 10(b) actions brought by the Securities and Exchange Commission (SEC) and the Department of Justice (DOJ). Congress passed Section 929P(b), "Extraterritorial Jurisdiction of Antifraud Provisions of the Federal Securities Laws,"[21] shortly after the *Morrison* decision. Although discussed in a number of cases, one decision in the U.S. District Court for the Northern District of Illinois from 2013 gives a considerable amount of legitimacy to Section 929's "conducts and effects" test, casting possible doubt on *Morrison*'s continued applicability to SEC and DOJ-initiated 10(b) actions. The case, *U.S. SEC v. A Chicago Convention Center LLC*, highlights the difficulties that courts have faced with interpreting the meaning of Section 929P(b) in light of *Morrison*.[22] For the most part, this difficulty has boiled down to an interpretation of this Dodd-Frank provision as either jurisdictional, and thus potentially superfluous to current provisions which give the SEC and DOJ extraterritorial

enforcement authority for Section 10(b) claims, or substantive, potentially trumping *Morrison*. Despite providing possible arguments for either interpretation, the *Convention Center* decision did not ultimately address the matter as the plaintiffs' complaint did not pass either the *Morrison* transactional test or Dodd-Frank's conducts and effects test.

The Future of *Morrison*

In general, it is clear that *Morrison's* holding prohibiting Section 10(b) actions involving foreign plaintiffs and defendants *and* a foreign place of transaction still limits a greater number of foreign-based claims than existed previously under the former "conduct and effects" test. With the Second Circuit's recent rulings in *City of Pontiac* and *Absolute Activist*, the prohibition against extraterritorial application of U.S. securities laws appears to have the potential of further foreclosing the filing of additional foreign-based securities claims.

NOTES

1. *See City of Pontiac Policemen's and Firemen's Ret. Sys. v. UBS AG*, No. 12-4355-cv, 2014 WL 1778041 (2d Cir. May 6, 2014).
2. *See Morrison v. Nat'l Austl. Bank Ltd.*, 561 U.S. 247, 130 S. Ct. 2869, 177 L. Ed. 2d 535 (2010).
3. *See Morrison*, 561 U.S. at 265.
4. *See City of Pontiac*, 2014 WL 1778041, at *6-8.
5. *See City of Pontiac*, 2014 WL 1778041, at *3.
6. *See City of Pontiac*, 2014 WL 1778041, at *3-4.
7. *See, e.g., In re Royal Bank of Scot. Grp. PLC Securities Litigation*, 765 F. Supp. 2d 327, 336 (S.D.N.Y. 2011); *In re Infineon Tech. AG Sec. Litig.*, No. C 04–04156 JW, 2011 WL 7121006, at *3 (N.D. Cal. Mar. 17, 2011); *In re Alstom SA Sec. Litig.*, 741 F. Supp. 2d 469, 471–73 (S.D.N.Y. 2010) (finding the listing theory contrary to *Morrison*).
8. *Morrison*, 561 U.S. 247, 282 n.10.
9. *In re Vivendi Universal, S.A. Sec. Litig.*, 765 F. Supp. 2d 512, 530-31 (S.D.N.Y. 2011).
10. *Morrison*, 561 U.S. at 282 n.10 (emph. added).
11. *See Absolute Activist Master Fund Ltd. v. Ficeto*, 677 F.3d 60, 68 (2d Cir. 2012).
12. *See City of Pontiac*, No. 12-4355-cv, 2014 WL 1778041, at *4; *see also Absolute Activist*, 677 F.3d at 67-68.
13. *See City of Pontiac*, 2014 WL 1778041, at *4; see also Absolute Activist, 677 F.3d at 69.
14. *See Absolute Activist*, 677 F.3d at 68.
15. *See* 15 U.S.C. § 78c(a)(14).
16. *See Absolute Activist*, 677 F.3d at 68.
17. *See, e.g., Arco Capital Corp. Ltd. v. Deutsche Bank AG*, 949 F.Supp.2d 532, 541-42 (S.D.N.Y. 2013); *MVP Asset Mgmt. (USA) LLC v. Vestbirk*, No. 2:10–cv–02483–GEB–CKD, 2013 WL 1726359, at *2 (E.D. Cal. Mar. 22, 2013); *U.S. S.E.C. v. Benger*, No. 09 C 676, 2013 WL 593952, at *9 (Feb. 15, 2013).
18. *See, e.g., S.E.C. v. Ficeto*, No. CV 11–1637–GHK (RZx), 2013 WL 1196356, at *2 (C.D. Cal. Feb. 7, 2013); *Pope Invs. II, LLC v. Deheng Law Firm*, No. 10 Civ. 6608(LLS), 2012 WL 3526621, at *6-8 (S.D.N.Y. Aug. 15, 2012).
19. *Elliott Assocs. v. Porsche Auto. Holding SE*, 759 F. Supp. 2d 469, 476 (S.D.N.Y. 2010); *Stackhouse v. Toyota Motor Co.*, No. CV 10-0922 DSF (AJWx), 2010 WL 3377409, at *1 (C.D. Cal. July 16, 2010).
20. *See City of Pontiac*, No. 12-4355-cv, 2014 WL 1778041, at *4 n.33.
21. 15 U.S.C. § 78aa(27); 15 U.S.C. § 77v(22).
22. *See U.S. SEC v. A Chi. Convention Ctr.*, LLC, 961 F. Supp. 2d 905 (N.D. Ill. 2013).

The Expanding Presence of the U.S. Commodity Futures Trading Commission

BY BENTLEY J. ANDERSON

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The U.S. Commodity Futures Trading Commission (CFTC), and the National Futures Association (NFA), a self-regulatory organization supervised by the CFTC, are the principal regulators of the futures and commodities markets in the U.S. Historically, the public's awareness of the roles of these agencies was limited by the agencies' relatively constrained authority and jurisdic-

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tion, and obscured by the much higher regulatory profile of the U.S. Securities and Exchange Commission (SEC) (particularly given the SEC's aggressive enforcement docket over the last several years). However, as a result of material changes to the U.S. regulatory architecture following the passage of the Dodd-Frank financial reform legislation, which resulted in, among other things, an increase in the CFTC's authority and jurisdiction, and the significant number of enforcement matters brought by the CFTC following the market turmoil which started in 2007, the CFTC has established a considerably more visible and dynamic regulatory presence in the markets.

…[A]s a result of material changes to the U.S. regulatory architecture following the passage of the Dodd-Frank financial reform legislation, which resulted in, among other things, an increase in the CFTC's authority and jurisdiction…

This presence may be especially notable for broker-dealers and investment advisers who are registered with the CFTC as commodity pool operators (CPOs), commodity trading advisers (CTAs), or in other capacities. A large number of these firms had limited, if any, substantive interactions with the CFTC or NFA prior to 2010. But several recent CFTC and NFA rule proposals, the CFTC's increasingly aggressive enforcement agenda, and the consistent growth in the amounts recovered by the CFTC in enforcement cases, now suggest strongly that SEC-registered broker-dealers and investment advisers should not expect "business as usual" from the CFTC—instead, these firms should assure that they have developed and implemented robust policies, procedures, and programs, supported by investments in professional staffing and technology, to comply with the agencies' requirements.

Privacy "Best Practices"

One area in which the CFTC has recently made an important announcement regarding broadening regulatory obligations is privacy. As background, Title V of the Gramm-Leach-Bliley Act (GLBA), passed in 1999, imposed requirements on "covered financial institutions" to protect the non-public personal information of their customers. Under the GLBA, federal financial regulators, including the CFTC, were required to adopt rules to carry out the GLBA's objectives. The CFTC adopted the required rules in 2001. However, earlier this year, in its Staff Advisory No. 14-21 (Staff Advisory), the CFTC communicated a series of "recommended best practices" that the agency expects covered financial institutions, including CPOs and CTAs, to comply with.[1] While not, on its face, having the force of a regulation that has been adopted following notice-and-comment rule-making procedures, the Staff Advisory makes clear that the standards referenced in the document reflect the CFTC's interpretations of the privacy rules adopted in 2001. Accordingly, CFTC registrants should be able to demonstrate that their privacy and information-security policies and practices incorporate the CFTC's "best practices."

In summary form, the CFTC's "best practices" relate to the "security safeguards" that the agency expects registrants to erect. The agency explained that under Part 160 of the CFTC's regulations, agency registrants (which include not just CPOs and CTAs, but also futures commission merchants, swap dealers, major swap participants, and retail foreign exchange dealers) are required to "adopt policies and procedures that address administrative, technical and physical safeguards for the protection of customer records and information." A registrant's policies and procedures must therefore "insure the security and confidentiality of customer records and information;" "protect against any anticipated threats" to the "security or integrity" of records containing confidential information; and protect against "unauthorized access to or use of such records or information which could result in substantial harm or inconvenience to any customer."

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One area in which the CFTC has recently made an important announcement regarding broadening regulatory obligations is privacy.

With these broadly-stated requirements as context, the CFTC articulated its view that each registrant should develop and implement a written security and information privacy program (Privacy Program) customized to the registrant's business, that specifically takes into account the nature of the registrant's market activities and the risks that those activities create. Moreover, the Privacy Program should designate a particular employee of the registrant who is responsible for managing the program, periodically reviewing and assessing the program, and reporting to senior management regarding the performance of the program. The Staff Advisory also states that the Privacy Program should be based on a written assessment of "all reasonably foreseeable internal and external risks" to the "security, confidentiality, and integrity of personal information and systems processing personal information." The agency further expects that each registrant will train relevant staff regarding the requirements imposed on the firm under the CFTC's privacy rules and the terms of the Privacy Program, and "regularly test or otherwise monitor" the effectiveness of the program. As part of the latter requirement, the Staff Advisory states that "at least once every two years" the registrant should contract with "an independent party" to test the effectiveness of the Privacy Program, and that appropriate written records relating to that testing be retained by the registrant. The CFTC expects that each registrant, as part of the maintenance of its Privacy Program, will at least annually report to the registrant's board of directors regarding the outcome of any assessment of the program, and any "instances during the year of unauthorized access or disclosure of personal information." Finally, the agency noted that it expects to enhance, where necessary, its internal examination standards to ensure that the CFTC's and NFA's staff are trained to detect instances in which a registrant is not, or has not been, in compliance with the privacy "best practices" referenced in the Staff Advisory.

Proposed Capital-Related/ "Customer-Protection" Requirements

In the first quarter of 2014, the NFA proposed a number of potential new capital and customer-protection measures applicable to CPOs and CTAs. Each of the concepts announced by the agency included a brief description of its objective, followed by a series of questions to which market-participants were solicited to reply with guidance and comments. The deadline to respond to those questions passed recently, and the agency is currently considering the responses that it received from the industry.

To begin with, the NFA indicated that it is considering a capital-adequacy requirement to be imposed on CPOs and CTAs. As the NFA acknowledged, currently there is no requirement that a CPO or CTA maintain a minimum amount of capital (unlike, for example, SEC-registered broker-dealers, which are required to have a minimum amount of regulatory capital and to regularly report that figure, as adjusted, to the SEC). However, the NFA also noted that CPOs and CTAs are fiduciaries with respect to the customer assets that they manage, and, consequently, they should be required to maintain "adequate funds to operate and ensure that they are a going concern." On this basis, the NFA asked market-participants, for example, what the minimum dollar amount of the capital requirement should be; how the capital figure reported by registrants should be calculated; how (that is, through what mechanism or technology) a registrant's capital should be reported to the agency; and how frequently the minimum capital figure should be reported to the NFA. The NFA also solicited comments from the industry on whether there exist practical alternatives to the minimum capital requirement which it is considering.

In addition, the NFA proposed certain measures that the agency views as protecting custom-

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ers of CPOs and CTAs. As a threshold point, the agency noted the relatively large number of recent enforcement matters that involved CPOs or CTAs misstating or misrepresenting pool or account performance information or asset valuations, or misusing customer funds. The agency then noted its customer-protection initiatives. Among others, the NFA stated that it is considering whether to require that a third-party, retained by each CPO and CTA, review and authorize any disbursement by the CPO or CTA of assets from a pool or account. The agency also stated that it is considering whether to require that each CPO and CTA retain a third-party to prepare or verify the monthly or quarterly performance and asset-valuation figures reported by the registrants. Finally, the NFA stated that it is considering the development of a system by which pool assets would be verified on a much more frequent basis – including possibly daily – through the collection of pool-asset information directly from registrants; those data would then be reviewed and reconciled with pool- or account-related data provided to the agency by custodians and depositaries (such as banks) retained by the registrants.

Enforcement

Perhaps in no other area has the CFTC so clearly articulated its intention to be a more aggressive regulator than in the enforcement arena. Strictly in numerical terms, since approximately the end of 2009, the CFTC has brought an increasingly larger number of enforcement actions, and has imposed an increasingly larger aggregate amount of financial sanctions. Consider, for example, that in 2009, the CFTC filed 50 enforcement cases, and imposed $636 million in financial sanctions, and that in 2013 the CFTC brought 82 actions and imposed $1.7 billion in financial sanctions (as a further benchmark, consider the relevant 2006 data: 33 enforcement actions and $446 million in financial sanctions, respectively). Indeed, the aggregate number of enforcement actions filed in 2011 and 2012 was almost as large as the number of all such actions filed in the previous five years combined. But the agency has gone beyond relying on its enforcement data, and has unambiguously communicated its intentions: the CFTC's chairman and senior staff have made clear that "Dodd-Frank expand[ed] the CFTC's arsenal of enforcement tools," and that the agency would use those "tools to be a more effective cop on the beat,"[2] as it strives to live up to its "unwavering commitment to hold those who seek to undermine the integrity of the U.S. financial markets responsible for their actions."[3] On a less colorful but more practical level, the agency has communicated that it will continue to allocate more staff and other resources to investigations and other pre-enforcement and enforcement matters, and that it will carefully investigate individual managers at firms suspected of wrong-doing to determine whether a failure to "diligently supervise" has occurred, and whether one or more individual managers, alone or in addition to the firm, should be personally charged.

Conclusion

Prior to the enactment of the Dodd-Frank reform legislation, a significant number of broker-dealers and investment advisers subject to SEC jurisdiction were able to avoid any requirement that they be registered with the CFTC, in any capacity. With the passage of Dodd-Frank, however, and the promulgation of new rules by the CFTC, the exemptions from the agency's registration requirements were greatly narrowed or eliminated. As the agency's jurisdiction expanded, these firms became subject to requirements with which they were entirely unfamiliar. For these broker-dealers and investment advisers, already subject to the jurisdiction of the SEC, the CFTC's expanded jurisdiction means new and substantive reporting, trading, testing, and investor-protection requirements (among others), and more rigorous levels of regulatory scrutiny. In other words, it means new and significant types of regulatory risks that, if not mitigated through the adoption and implementation of appropriate policies and procedures, directed and managed by experienced staff and supported by relevant technology, could result in potentially material financial and reputational damages as the CFTC continues to pursue an aggressive enforcement agenda.

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NOTES

1. Staff Advisory No. 14-21, U.S. Commodities Futures Trading Commission (February 26, 2014), http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-21.pdf.
2. "Enhanced Oversight after the Financial Crisis, The Wall Street Reform Act at One Year: Hearing before the Senate Committee on Banking, Housing and Urban Affairs, 112th Congress, (2011) (statement of CFTC Chairman Gary Gensler), *available at* http://www.cftc.gov/pressroom/speechestestimony/opagensler-87.
3. "CFTC Charges RP Martin Holdings Limited and its Subsidiary, Martin Brokers (UK) Limited, with Manipulation and Attempted Manipulation of Yen Libor," U.S. Commodities Futures Trading Commission, CFTC Release PR6930-14 (May 15, 2014) (Statement of Gretchen Lowe, Acting Director of the Division of Enforcement), *available at* http://www.cftc.gov/PressRoom/PressReleases/pr6930-14.

Conflicts at Fund Adviser Yields First SEC Whistleblower Retaliatory Action

BY THOMAS O. GORMAN

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The Securities and Exchange Commission (SEC) brought its first action involving the anti-retaliation provisions of the Dodd-Frank Act. The case, *In the Matter of Paradigm Capital Management, Inc.*,[1] centers on an investment adviser, a broker dealer, conflicts and retaliation against a firm employee who reported the misconduct to the SEC and later informed his employer of that report.

The Conduct

The proceeding names as Respondents, Paradigm Capital Management, a registered investment adviser, and Candace King Weir, its founder, director, president and Chief Investment Officer. Ms. Weir also owns about 74% of C.L. King & Associates, Inc., a registered broker-dealer. Paradigm advises a hedge fund.

Beginning in 2009, and continuing for the next two years, Paradigm sought to reduce the tax liability of Fund investors. A plan was implemented under which securities with unrealized losses were either sold into the open market or to a trading account at C.L. King. The trading losses were then used to offset realized gains.

During the period Paradigm engaged in at least 83 principal transactions with the broker dealer. Ms. Weir, acting as portfolio manager, made the trading decisions. According to the SEC, Ms. Weir would evaluate the security, and if she thought it might be repurchased, the shares would be sold to the trading account at the broker dealer. Approximately 47 of the transactions were with C.L. King, and about 36 of the positions were repurchased. The others were sold into the open market.

Since all of the transactions between Paradigm and C.L. King were principal transactions, written disclosure was required to be made to the Fund and its investors. However, the Fund did not have a board of directors to receive the disclosures and consent. Accordingly, a Conflicts Committee was established to review the transactions. It was composed of Paradigm's COO and CFO. Paradigm's CFO also served as the CFO of C. L. King. The Conflicts Committee itself thus had a conflict. This was underscored by the fact that each time the broker-dealer purchased securities from the Fund, the transaction had a negative impact on its net capital.

The SEC claimed that Paradigm failed to provide effective notice of the conflicts because disclosure could not be made to the Fund, and the Conflicts Committee was ineffective because of conflicts. The firm's Form ADV Part 2A was rendered materially misleading since it failed to disclosure the CFO's conflict.

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The Whistleblower

Pardigm's former head trader voluntarily made a whistleblower submission to the SEC in March 2012 regarding the principal transactions. He continued at the firm as head trader until mid-July 2012. He then notified Ms. Weir and the COO of the broker-dealer of his whistleblower report.

The SEC claimed that Paradigm failed to provide effective notice of the conflicts because disclosure could not be made to the Fund, and the Conflicts Committee was ineffective because of conflicts.

Subsequently, the head trader was reassigned to investigate the trades that were the subject of his report to the Commission. The report was prepared while working at home, an arrangement sanctioned by the firm. During that period the head trader was denied access to the firm's trading and account systems. The report was complete and submitted to the firm at the end of July.

After completion of the report, Paradigm informed counsel to the head trader that the employment relationship was "irreparably damaged." The parties tried, but failed, to work out a severance package.

In early August 2012, the head trader was directed to return to work. He was assured that his compensation would remain the same. Paradigm refused to specify his exact duties, although it was clear that he would no longer serve as head trader. Eventually he was directed to determine if the firm had engaged in any other wrongful conduct. This review was to be conducted by analyzing 1,900 pages of trading data. A request to review the electronic reports was denied. Subsequently, the head trader was tasked with consolidating multiple trading procedure manuals into one comprehensive document and proposing revisions to enhance the firm's procedures. That assignment was the outgrowth of the head traders' statement that firm procedures were inadequate.

Additional disputes regarding his duties and the manner in which his assignments were to be conduct followed. The head trader resigned on August 17, 2012. There was no legitimate reason for removing him from the position of head trader, according to the SEC's Adminstrative Order.[2] The Order alleges violations of Exchange Act Section 21F(h), and Sections 206(3) and 207 of the Advisers Act.

The SEC's Settlement

To resolve the proceeding, Respondents agreed to implement a series of undertakings. Those include an obligation to distribute $1.7 million to compensate certain investors in the Fund for administrative fees paid in connection with the principal transactions. Paradigm will also retain an Independent Compliance Consultant who will review and analyze firm policies and make recommendations which will be adopted.

Paradigm informed counsel to the head trader that the employment relationship was "irreparably damaged." The parties tried, but failed, to work out a severance package.

Paradigm consented to the entry of a cease and desist order based on the Sections cited in the Order. Ms Weir consented to the entry of a similar order, but based on Section 206(3) of the Advisers Act. Respondents also agreed to pay, jointly and severally, disgorgement of $1.7 million, prejudgment interest and a civil penalty of $300,000. The $1.7 million payment will be deemed satisfied by the distribution to investors in the undertakings.

NOTES

1. *In the Matter of Paradigm Capital Management, Inc.*, Adm. Proc. File No. 3-15930 (June 16, 2014).
2. *See* the SEC's Administrative Order, *available at* https://www.sec.gov/litigation/admin/2014/34-72393.pdf.

Securities in the Electronic Age:

SEC Looking at Rules for High Frequency Trading & Dark Pools

SPEECH BY SEC CHAIR MARY JO WHITE

Mary Jo White, Chairwoman of the Securities and Exchange Commission spoke before Sandler O'Neill & Partners, L.P.'s Global Exchange and Brokerage Conference in New York City on June 5 about the SEC's potential rulemaking in the area of High Frequency Trading and Dark Pools. The following is a partial text of her remarks.

[…] During my first year as Chair, not surprisingly, I have heard a wide range of perspectives on equity market structure, reflecting its inherent complexity, the relationships among many core issues, as well as the different business models of market participants. To frame the SEC's review of these issues, I set out last fall certain fundamentals for addressing market structure policy. One of those is the importance of data and empirically based decision-making. At that time, we launched an interactive public website devoted to market structure data and analysis drawn from a range of sources. The website has grown to include work by SEC staff on important market structure topics, including the nature of trading in dark venues, market fragmentation, and high-frequency trading.

Through this initiative and others, we have taken important steps to further strengthen the investing environment. And today, as we move forward in the next phase of our efforts to enhance our market structure, I am recommending additional measures to further promote market stability and fairness, [and] enhance market transparency and disclosures. I am also recommending to the Commission the creation of a new Market Structure Advisory Committee of experts to review specific initiatives and rule proposals. Your input also remains essential to help us ensure that our markets continue to operate openly, fairly, and efficiently to benefit investors and promote capital formation. […]

Market Structure Today

Equity markets are, of course, now dominated by computer algorithms, which generate orders at a volume and speed that have transformed the nature of trading. Importantly, these algorithms are used not only by high-frequency traders, but also by or on behalf of investors.

Empirical evidence shows that investors are doing better in today's algorithmic marketplace than they did in the old manual markets.

For institutional investors, the costs of executing large orders, measured in terms of price, were more than 10 percent lower in 2013 than in 2006.[1] This is true even though fundamental volatility—which in general is positively correlated with such costs—was slightly higher in 2013 than it was in 2006.[2]

> ***Equity markets are, of course, now dominated by computer algorithms, which generate orders at a volume and speed that have transformed the nature of trading.***

The level of intraday volatility also has returned to low levels after spiking during the financial crisis. Intraday volatility of the S&P 500 Index was nearly the same in 2013 as it was in 2006—for both average and maximum volatility.[3]

The spreads between bid and ask prices for the broader market also are as narrow as they have ever been.[4] These narrower spreads are particularly important for retail investors because they reflect the cost of trading immediately at the best prices, which is generally the objective of retail investors.

All of these market quality metrics show that the current market structure is not fundamen-

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tally broken, let alone rigged. To the contrary, the equity markets are strong and generally continue to serve well the interests of both retail and institutional investors. The largely positive data on broad market quality does not mean, however, that the current market structure is without issues.

Some potential additional benefits for investors from improved technology may have been diverted by excessive intermediation, and broad market quality would perhaps be even better if different rules were in place.

And not all segments of the equity markets have equally shared the benefits from the positive market trends, and that disparity may have increased in recent years. For example, key costs for institutional investors in small-cap stocks appear to have remained relatively high since the financial crisis, in contrast to the large declines in such costs for the broader market.

As a general matter, many market structure rules and industry practices were developed with manual markets in mind. They cannot be expected to optimally address all of today's market practices.

Enhancing Market Structure Today and Tomorrow

Addressing the issues of our current market structure demands a continuous and comprehensive review that integrates targeted enhancements with an expansive consideration of broader changes. But we must not ignore the largely positive evidence of market quality. That reality demands careful study and deliberate action when considering fundamental changes. As we evaluate the merits of broader changes, we will also continue to assess and address specific elements of today's market structure that work against the interests of investors and public companies.

Let me now outline the initiatives we are advancing across five broad sets of issues: market instability, high frequency trading, fragmentation, broker conflicts, and the quality of markets for smaller companies.

Preventing Market Instability

First, as I have said from the day I took office, one of the most serious concerns about today's equity markets is the risk of instability and disruption. Technology can and has greatly increased the efficiency of our markets, but it can also allow severe problems to develop very quickly—just consider some of the systems events of the last few years at exchanges and brokers.

And not all segments of the equity markets have equally shared the benefits from the positive market trends, and that disparity may have increased in recent years.

The SEC and the securities industry have already undertaken a series of responsive initiatives. "Limit up-limit down," for example, is now fully implemented and moderating price volatility in individual securities.[5] Market-wide circuit breakers are in place to address volatility across the equities, options, and futures markets.[6]

And the SEC has taken additional steps to require market participants to address their technology risks. We adopted—and are vigorously enforcing—the Market Access Rule, which requires brokers to implement better risk controls.[7] And last March, the Commission proposed Regulation SCI to put in place stricter requirements relating to the technology used by exchanges, large alternative trading systems, clearing agencies, and securities information processors—the SIPs.[8] The staff is now completing a recommendation for final rules.

We also have closely focused on certain market infrastructure systems that are "single points of failure" that can halt or severely disrupt trading when a problem occurs. Last fall, I met with the leaders of the equities and options exchanges to address strengthening these systems. Among other measures, the exchanges have responded with technology audits of the SIPs and a series of specific enhancements to improve SIP robustness and resilience. In addition, the exchanges have developed more robust SIP backup capabilities,

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and they expect to implement a new "hot-warm" backup, with a ten-minute recovery standard, by the end of this month.

We have made considerable progress in addressing the risk of market instability, and I look forward to the completion of these ongoing efforts in the coming months. But there is more to be done, and there is never room for complacency.

Addressing High Frequency Trading and Promoting Fairness

Recently, a lot of lively debate has centered on high frequency trading, speed, and fairness. These have been important issues for some time. Algorithmic traders, which include high frequency trading firms and a large percentage of institutional trading, likely represent well over a majority of trading volume.[9]

These traders use a variety of low-latency tools, including co-located servers in trading data facilities and direct data feeds from trading venues rather than the slower consolidated data feeds of the SIPs.[10] Much of the recent public focus has been on high frequency trading firms, but it is important to remember that many brokers use the same tools on behalf of their customers.

The SEC should not roll back the technology clock or prohibit algorithmic trading, but we are assessing the extent to which specific elements of the computer-driven trading environment may be working against investors rather than for them.

An area of particular focus is the use of aggressive, destabilizing trading strategies in vulnerable market conditions, when they could most seriously exacerbate price volatility.[11] While the volatility moderators already put in place impose outside limits on price moves,[12] even moves within those limits can be damaging. Instability arising during a broad market event may simultaneously affect hundreds or thousands of stocks, triggering many trading pauses and reopenings over a short period of time.

To address this risk, I have directed the staff to develop a recommendation to the Commission for an anti-disruptive trading rule. Such a rule will need to be carefully tailored to apply to active proprietary traders in short time periods when liquidity is most vulnerable and the risk of price disruption caused by aggressive short-term trading strategies is highest.

We also are focused on using our core regulatory tools of registration and firm oversight. I have asked the SEC staff to prepare two recommendations for the Commission: the first, a rule to clarify the status of unregistered active proprietary traders to subject them to our rules as dealers; and second, a rule eliminating an exception from FINRA membership requirements for dealers that trade in off-exchange venues. Dealer registration and FINRA membership should significantly strengthen regulatory oversight over active proprietary trading firms and the strategies they use.

I have further instructed the staff to prepare recommendations for the Commission to improve firms' risk management of trading algorithms and to enhance regulatory oversight over their use. Given the overwhelming dominance of trading algorithms, it is time that our regulatory regime is updated to take better account of the risks when they are poorly designed or operated.

Another important concern raised by algorithmic trading is fairness for investors. Do low-latency tools, even though they are available to investors through brokers, tend to advantage certain types of proprietary trading strategies that may detract from the interests of investors? Some of the research suggests this may be the case.[13] And a related fairness concern is the latency difference between the direct data feeds and the consolidated feeds.

As initial steps to address these issues, we will continue to focus the efforts of the exchanges and FINRA in minimizing consolidated data latency. The exchanges and FINRA have an obligation to provide data to the SIPs in a way that is not unreasonably discriminatory. They are not allowed to transmit data to direct customers any sooner than they transmit data to the SIP, and the technology used for transmitting data to the SIP must be on a par with what is used for transmitting data to direct feeds.

I am also asking the exchanges and FINRA to consider including a time stamp in the consolidated data feeds that indicates when a trading venue,

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for example, processed the display of an order or execution of a trade. With this information, users of the consolidated feeds would be able to better monitor the latency of those feeds and assess whether such feeds meet their trading and other requirements.

Given the overwhelming dominance of trading algorithms, it is time that our regulatory regime is updated to take better account of the risks when they are poorly designed or operated.

And I am asking the exchanges to develop proposed rule changes to disclose how — and for what purpose — they are using data feeds. For example, which data feeds are used to execute and route orders? And which feeds are used to comply with regulatory requirements, such as trade-through rules? Brokers and investors could use the enhanced transparency to better assess the quality of an exchange's execution and routing services.

Each of these measures target specific elements of today's technology-driven market that may work against, or at least not optimally for, the interests of investors and companies. We also are evaluating whether the evidence supports broader measures that would further advance those interests without creating unintended adverse consequences.

We must consider, for example, whether the increasingly expensive search for speed has passed the point of diminishing returns. I am personally wary of prescriptive regulation that attempts to identify an optimal trading speed, but I am receptive to more flexible, competitive solutions that could be adopted by trading venues. These could include frequent batch auctions or other mechanisms designed to minimize speed advantages. They could also include affirmative or negative trading obligations for high-frequency trading firms that employ the fastest, most sophisticated trading tools.

Such obligations would be analogous to the ones that historically applied to the proprietary traders with time and place advantages on manual trading floors.

A key question is whether trading venues have sufficient opportunity and flexibility to innovate successfully with initiatives that seek to deemphasize speed as a key to trading success in order to further serve the interests of investors.[14] If not, we must reconsider the SEC rules and market practices that stand in the way.

Enhancing Market Transparency and Examining Trading Venue Regulation

Another market structure concern is fragmentation. Order flow in exchange-listed equities is divided among many trading venues — 11 exchanges, more than 40 alternative trading systems, and more than 250 broker-dealers.[15] The competition for order flow among these venues is intense, and it benefits investors by encouraging services that meet particular trading needs and by keeping trading fees low. Having multiple trading venues also can help avoid trading disruptions if one venue has an isolated problem — order flow often can be immediately shifted to other venues.

This proliferation of venues, however, also raises issues. One is their interconnectedness — the potential for one or more systems to malfunction and disrupt other systems, or to interact with other systems in unexpected ways. Another is the increase in the percentage of order flow that is handled and executed by dark trading venues.[16] The percentage of trading volume executed in dark venues increased from approximately 25% in 2009 to approximately 35% today.[17]

Dark trading venues generally reference the quoted prices displayed by the lit exchanges and do not publicly display quotes or otherwise provide pre-trade transparency of the prices at which they will execute orders. And the consensus of the research is that the current extent of dark trading can sometimes detract from market quality, including the informational efficiency of prices.[18]

Dark venues lack transparency in other important respects. Although the trades of dark venues are reported in real time, the identity of

participants in the dark venue is not disclosed to the public. And dark venues generally only provide limited information about how they operate. ATSs, for example, file a form with the SEC on some aspects of their operations, but the forms are not publicly available under current rules.

The percentage of trading volume executed in dark venues increased from approximately 25% in 2009 to approximately 35% today.

Transparency has long been a hallmark of the U.S. securities markets, and I am concerned by the lack of it in these dark venues. Transparency is one of the primary tools used by investors to protect their own interests, yet investors know very little about many trading venues that handle their orders.

Just this week, FINRA began disseminating aggregate information on trading volume of ATSs.[19] This is a useful first step, but ATSs represent less than half of dark venue volume. To remedy this gap, I fully support FINRA in considering an expansion of its trading volume disclosure regime to off-exchange market makers and other broker-dealers.

I also have asked the SEC staff to prepare a recommendation to the Commission to expand the information about ATS operations submitted to us and to make the information available to the public. As you have seen in the recent media, some operators of dark venues began offering greater transparency to their operations this week, but a broader effort is needed.

While this expanded information will be an important tool for investors, we must continue to examine whether dark trading volume is approaching a level that risks seriously undermining the quality of price discovery provided by lit venues.

We also are continuing to consider whether more fundamental changes are needed to bring our regulatory structure in line with the significant market changes of the last decade. Importantly, we will be considering whether the SEC's own rules, such as the trade-through rule of Regulation NMS, have contributed to excessive fragmentation across all types of venues.

We also will be considering whether the current regulatory model for exchanges and other trading venues makes sense for today's markets.

The SEC last comprehensively considered trading venues in the 1990s, which led to the adoption of Regulation ATS. The 1990s approach draws a sharp distinction between exchanges and other trading venues, a distinction that has been blurred considerably over the last 20 years. A core focus of our comprehensive review will be whether and how the SEC's regulatory approach for trading venues should be changed to reflect significantly changed conditions. […]

Looking Ahead

I expect that the specific measures I have identified today to be considered by the Commission in the coming months. While our review in each of these five areas has already resulted in discrete actions targeting specific issues, the more fundamental policy questions demand — and are receiving — close attention at the SEC. While we do not require perfect solutions, our regulatory changes must be informed by clear-eyed, unbiased, and fact-based assessments of the likely impacts — positive and negative — on market quality for investors and issuers. Continued engagement by all market participants on these issues is critical.

To facilitate this engagement, the SEC staff will populate our market structure website with summaries of key issues that provide a framework for further analysis, identifying areas that the staff is focused on and where public perspectives are essential. I am also recommending to the Commission that the SEC establish a new Market Structure Advisory Committee comprised of experts with a diversity of backgrounds and viewpoints. The new committee will serve as an additional forum and resource for reviewing specific, clearly articulated initiatives or rule proposals.

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Transparency has long been a hallmark of the U.S. securities markets, and I am concerned by the lack of it in these dark venues.

We will continue the disciplined, data-driven approach to market structure that has marked the last year. Our comprehensive review and follow-up actions will ensure that our equity markets continue to operate fairly and efficiently, and in a manner that both optimally protects investors and promotes capital formation.

NOTES

1. Investment Technology Group, Inc. (ITG) maintains a large database of investor information and periodically generates statistical reports on institutional trading costs *available at* http://www.itg.com/thought-leadership/reports. Collectively, the ITG reports indicate that U.S. implementation shortfall costs declined from 63 basis points in Q3 2003 to 44 basis points in Q1 2006 to 36 basis points in Q3 2013. The ITG reports are consistent with other analyses of costs for institutional investors in the U.S. equity markets. *See, e.g.,* Angel, James J., Lawrence E. Harris and Chester S. Spatt, "Equity Trading in the 21st Century: An Update," at 23-24 (June 21, 2013) (Angel, Harris and Spatt (2013)), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1584026.
2. *See* Chicago Board Options Exchange (CBOE), "Volatility Indexes at CBOE," at 1 (January 2014), *available at* http://www.cboe.com/micro/VIX/pdf/CBOE30c7-VOLindex_QRG.pdf.
3. SEC Staff analysis. Average intraday volatility was calculated on a quarterly basis as the average difference between the daily high and the daily low in the S&P 500 Index, divided by the closing price. Maximum volatility was calculated the maximum difference between the daily high and daily low, divided by the closing price.
4. *See, e.g.*, Angel, Harris and Spatt (2013) at 5.
5. SEC Press Release No. 2012-107, "SEC Approves Proposals to Address Extraordinary Volatility in Individual Stocks and Broader Stock Market" (June 1, 2012).
6. *Id.*
7. SEC Press Release No. 2010-210, "SEC Adopts New Rule Preventing Unfiltered Market Access" (November 3, 2010). One market access risk is the potential for erroneously submitting a single large order or a flood of small orders that disrupt trading. See SEC Press Release 2013-222, "SEC Charges Knight Capital With Violations of Market Access Rule" (October 16, 2013).
8. SEC Press Release No. 2013-35, "SEC Proposes Rules to Improve Systems Compliance and Integrity" (March 7, 2013).
9. Calculating the percentage of algorithmic trading in U.S. equities is challenging due to the lack of data identifying all orders that are submitted algorithmically. *See* Staff of the Division of Trading and Markets, U.S. Securities and Exchange Commission, "Equity Market Structure Literature Review, Part II: High Frequency Trading," at 5 (October 7, 2013) (HFT Literature Review), *available at* http://www.sec.gov/marketstructure/research/hft_lit_review_march_2014.pdf. Estimates of high frequency trading volume—a large subset, but by no means all, of algorithmic trading—are over 50% of total volume. *Id.* at 4-5.
10. The consolidated feeds necessarily are slower because of the extra step required for data to move from various trading venues to the SIP and the time required for the SIP to consolidate that data. The average time required for SIPs to consolidate data was approximately 1 second at the end of 2006, but currently has declined to approximately 1 millisecond. *See, e.g.,* Consolidated Tape Association, "Notice of Filing and Immediate Effectiveness of the Nineteenth Charges Amendment to the Second Restatement of the CTA Plan and Eleventh Charges Amendment to the Restated CQ Plan," Securities Exchange Act Release No. 70010, 78 FR 44984, 44992 (July 25, 2013).
11. As the SEC staff has reviewed and posted on the market structure website, the economic literature on high frequency trading suggests that at least some HFT firms employ aggressive strategies that are associated with increased transitory price volatility. HFT Literature Review at 25-28, 31-33. *See also* Kirilenko, Andrei, Albert S. Kyle, Mehrdad Samadi and Tugkan Tuzun, 2014, "The Flash Crash: The Impact of High Frequency Trading on an Electronic Market," working paper, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1686004.
12. For more liquid securities, the limit is a 5% price move in five minutes; for most other listed securities, the limit is 10% price move in five minutes. The percentages are doubled during the opening and closing periods. When the limits are reached and persist, a temporary trading pause is triggered to facilitate a more deliberate price discovery process. *See* SEC Press Release 2012-107, "SEC Approves Proposals to Address Extraordinary Volatility in Indi-

vidual Stocks and Broader Stock Market" (June 1, 2012).

13. *See* HFT Literature Review at 30-33.
14. In 2010, for example, the NASDAQ OMX Philadelphia exchange launched a trading model that gave priority to the size of orders rather than speed. The Nasdaq OMX Group, Inc., "NASDAQ OMX Launches First U.S. Equity Price-Size Exchange" (September 20, 2010), *available at* http://ir.nasdaqomx.com/releasedetail.cfm?ReleaseID=508731.
15. *See* Tuttle, Laura, 2014, "OTC Trading: Description of Non-ATS OTC Trading in National Market System Stocks," at 7-8 (Tuttle (2014)), *available at* http://www.sec.gov/marketstructure/research/otc_trading_march_2014.pdf.
16. *See* Tuttle (2014) at 8-9; Tuttle, Laura, 2013, Alternative Trading Systems: Description of ATS Trading in National Market System Stocks, at 5-6 (Tuttle (2013)), *available at* http://www.sec.gov/marketstructure/research/alternative-trading-systems-march-2014.pdf.
17. Staff of the Division of Trading and Markets, U.S. Securities and Exchange Commission, "Equity Market Structure Literature Review, Part I: Market Fragmentation," at 7 (October 7, 2013) (Fragmentation Literature Review), *available at* http://www.sec.gov/marketstructure/research/fragmentation-lit-review-100713.pdf.
18. Fragmentation Literature Review at 10-12.
19. FINRA makes the ATS trading volume data *available at* http://www.finra.org/Industry/Compliance/MarketTransparency/ATS.

SEC/SRO Update:

Commissioner Aguilar Shares His Views on Directors' Oversight of Cyber-Risk Management; New Revenue Recognition Standard Adopted; PCAOB Adopts New Auditing Standard No. 18, Related Parties

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Commissioner Aguilar Shares His Views on Directors' Oversight of Cyber-Risk Management

On June 10, Commissioner Luis A. Aguilar of the Securities and Exchange Commission spoke at a NYSE conference, "Cyber Risks and the Boardroom,"[1] about what boards of directors should do to ensure that their companies are appropriately considering and addressing cyber threats.

Commissioner Aguilar was concerned that "there may be a gap that exists between the magnitude of the exposure presented by cyber-risks and the steps, or lack thereof, that many corporate boards have taken to address these risks."

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Commissioner Aguilar stressed that boards should, among other matters:

- review annual budgets for privacy and IT security programs;
- assign roles and responsibilities for privacy and security; and
- receive regular reports on breaches and IT risks.

Boards should also:

- have a clear understanding of who at the company has primary responsibility for cybersecurity risk oversight and for ensuring the adequacy of the company's cyber-risk management practices; and
- put time and resources into making sure that management has developed a well-constructed response plan that is consistent with best practices for a company in the same industry (including a consideration of whether and how cyber-attacks should be disclosed to customers and to investors).

Commissioner Aguilar suggested that one conceptual roadmap boards should consider is the Framework for Improving Critical Infrastructure Cybersecurity,[2] released by the National Institute of Standards and Technology (NIST) in February 2014. The NIST Cybersecurity Framework provides companies with a high-level, strategic view of the lifecycle of an organization's management of cybersecurity risk consisting of five concurrent and continuous functions:

- *identify* known cybersecurity risks to the company's infrastructure;
- develop safeguards to *protect* the delivery and maintenance of infrastructure services;
- implement methods to *detect* the occurrence of a cybersecurity event;
- develop methods to *respond* to a detected cybersecurity event; and
- develop plans to *recover* and restore the company's capabilities that were impaired as a result of a cybersecurity event.

Boards should work with management to assess their corporate policies to ensure how they measure up to the Framework's guideline.

Commissioner Aguilar emphasized that cyber-risk is part of a board of director's overall risk oversight responsibilities, in addition to liquidity and operational risks facing the company. Generally, the board's risk oversight function lies either with the full board or is delegated to the board's audit committee. But the board's audit committee may not have the expertise, support, or skills necessary to add oversight of a company's cyber-risk management to its agenda. Some boards create a separate enterprise risk committee. There is obviously no "one-size-fits-all" way to address cybersecurity issues at the board level and each company should evaluate its board composition and determine what would be the most effective way for its board to oversee cyber-risk management.

New Revenue Recognition Standard Adopted

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued jointly written revenue recognition standards on May 28.[3] The new guidance standardizes how companies should recognize revenue in financial statements under both U.S. generally accepted accounting principles (GAAP) and international financial reporting standards (IFRS). This new revenue recognition standard will replace most of the current revenue recognition guidance, including much of the industry-specific guidance that exists under GAAP today.

The new guidance aims to:

- Remove inconsistencies and weaknesses in revenue requirements.
- Provide a more robust framework for addressing revenue issues.
- Improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets.

- Provide more useful information to users of financial statements through improved disclosure requirements.

- Simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer.

The core principle of the new guidance is that "an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services." The guidance contains the following five step process:

Step 1: Identify the contract(s) with a customer.

Step 2: Identify the performance obligations in the contract.

Step 3: Determine the transaction price.

Step 4: Allocate the transaction price to the performance obligations in the contract.

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation.

Public companies using GAAP will be required to apply the new revenue recognition standard for annual reporting periods beginning after December 15, 2016, including interim reporting periods therein. Public companies are not permitted to apply this new standard early.

PCAOB Adopts New Auditing Standard No. 18, *Related Parties*

On June 10, the Public Company Accounting Oversight Board (PCAOB) adopted "Auditing Standard No. 18, *Related Parties*",[4] as well as amendments to certain PCAOB auditing standards regarding significant unusual transactions and other related amendments to PCAOB auditing standards. Auditing Standard No. 18 superseded the PCAOB's "Auditing Standard AU Sec. 334, *Related Parties*", which was issued in 1983. The new auditing standard and amendments will be effective, subject to approval by the SEC, for audits of financial statements for fiscal years beginning on or after December 15, 2014.

Generally, under the new standard, auditors will be required to engage in a detailed analysis of transactions with related parties and inquire of management regarding:

a) the names of the company's related parties during the period under audit, including changes from the prior period;
b) background information concerning the related parties (for example, physical location, industry, size, and extent of operations);
c) the nature of any relationships, including ownership structure, between the company and its related parties;
d) the transactions entered into, modified or terminated, with its related parties during the period under audit and the terms and business purposes (or the lack thereof) of such transactions;
e) the business purpose for entering into a transaction with a related party versus an unrelated party;
f) any related party transactions that have not been authorized and approved in accordance with the company's established policies or procedures regarding the authorization and approval of transactions with related parties; and
g) any related party transactions for which exceptions to the company's established policies or procedures were granted and the reasons for granting those exceptions.

In addition to obtaining information regarding related party transactions from management, auditors will be required to inquire of others within the company regarding their knowledge of the foregoing matters. The auditor is expected to identify others within the company to whom inquiries should be directed, and determine the extent of such inquires, by considering whether such individuals are likely to have knowledge regarding such matters as:

- the company's related parties or relationships or transactions with related parties;

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- the company's controls over relationships or transactions with related parties; and
- the existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor.

The audit committee, or its chair, will also be questioned by the auditor regarding:

- the audit committee's understanding of the company's relationships and transactions with related parties that are significant to the company; and
- whether any member of the audit committee has concerns regarding relationships or transactions with related parties and, if so, the substance of those concerns.

The auditor will be required to communicate to the audit committee the results of the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties, as well as other significant matters arising from the audit regarding the company's relationships and transactions with related parties including, but not limited to:

- the identification of related parties or relationships or transactions with related parties that were previously undisclosed to the auditor;
- the identification of significant related party transactions that have not been authorized or approved in accordance with the company's established policies or procedures;
- the identification of significant related party transactions for which exceptions to the company's established policies or procedures were granted;
- the inclusion of a statement in the financial statements that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction and the evidence obtained by the auditor to support or contradict such an assertion; and
- the identification of significant related party transactions that appear to the auditor to lack a business purpose.

NOTES

1. For a full text of the speech, *see* http://www.sec.gov/News/Speech/Detail/Speech/ 1370542057946.
2. *Framework for Improving Critical Infrastructure Cybersecurity*; the National Institute of Standards and Technology (NIST); February 2014. *See* http://www.nist.gov/cyberframework/upload/cybersecurity-framework-021214.pdf.
3. FASB Accounting Standards Update No. 2014-09 - Revenue from Contracts with Customers (Topic 606).
4. Auditing Standard No. 18, *Related Parties*; PCAOB, *See* http://pcaobus.org/Rules/Rulemaking/Pages/Docket038.aspx.

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