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In This Issue

SEC Seeks to 'Modernize' Its Internal Courts through Proposed Rule Amendments 2

FINRA Examination Review Provides Guidance to Identify, Mitigate and Manage Compensation Conflicts 3

Delaware Supreme Court Clarifies When a Friendship Could Compromise a Director's Independence 4

OCIE Identifies Focus Areas for Second Round of Cybersecurity Sweep Exams 6

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SEC Seeks to 'Modernize' Its Internal Courts through Proposed Rule Amendments

by Rebecca L. Dandy

With its internal administrative courts under continuous scrutiny by both the courts and the defense bar, the Securities and Exchange Commission (the "SEC") voted to propose amendments to the current rules governing its administrative proceedings.

SEC Chair Mary Jo White stated that "[t]he proposed amendments seek to modernize our rules of practice for administrative proceedings, including provisions for additional time and prescribed discovery for the parties."[1]

The SEC will take comments for 60 days from the date the proposed amendments are published in the Federal Register, but the proposed changes will not become effective until the SEC votes to approve any final rules.

Perhaps of most interest to the defense bar, the proposed amendments seek to permit parties to take depositions as part of the discovery process, something that parties may currently do only if the witness is unavailable for hearing. The proposed amendment would permit three depositions per side in single-respondent proceedings and, collectively, five depositions per side in multiple-respondent cases.

In addition, the proposed amendments seek to lighten the burden of the so-called "300-day rule" by extending the deadline for the filing of an administrative law judge's initial decision from the time that the post-hearing or dispositive motion briefing is complete rather than the date of service of the Order Instituting Proceedings ("OIP"). For some, this could mean as many as 120 days after completion of the post-hearing briefing. The proposed amendments also provide for a longer period of time before which the hearing must begin—in some instances, up to eight months after service of the OIP. The amendments also create a procedure for extending the initial decision deadline for an additional 30 days.

Certain of the other proposed amendments attempt to bring the somewhat lax evidentiary standards applicable to administrative proceedings more in line with the Federal Rules of Evidence, including (i) exempting from disclosure draft expert reports and communications between a party's attorney and the party's expert witness and (ii) clarifying that hearsay may be admitted if it is relative and material and bears satisfactory indicia of reliability such that its use is fair.

The proposed amendments also seek to simplify the appeals process, proposing to eliminate the requirement that the petitioner set forth all the specific findings and conclusions of the initial decision and to eliminate the provision stating that if an exception is not listed, it may be deemed waived. Instead, the proposed amendments provide that the petitioner is required to set forth only a summary statement of the issues limited to three pages.

[1] *See* September 24, 2015 SEC Press Release, available at http://www.sec.gov/news/pressrelease/2015-209.html

While the proposed amendments are a step in the right direction, many within the defense bar are wondering whether the proposals are really enough to "level the playing field" for clients who are forced to defend against claims brought in the SEC's in-house courts.

Indeed, a five-deposition limit in complex cases is still not sufficient, in particular when those five must be spread among multiple respondents, while the SEC still has the benefit of testimony it took during its investigation—in addition to five depositions of its own. Moreover, while the proposed amendments nearly double the length of time preceding the hearing deadline, some question whether even eight months is sufficient to adequately prepare for trial. Also, the proposed amendments are still not in line with the Federal Rules of Evidence, although they have come closer.

Perhaps most notably, the proposed amendments do not propose any changes to address the perceived constitutional flaws with the SEC's in-house tribunals. It remains to be seen whether the SEC will ever be forced to address the constitutional challenges in-house proceedings face, but these proposed amendments are, at the very least, a positive step forward.

FINRA Examination Review Provides Guidance to Identify, Mitigate and Manage Compensation Conflicts

by David M. Cummings

In recent years, the Financial Industry Regulatory Authority ("FINRA") has focused on conflicts of interest in the brokerage industry. FINRA, which regulates member exchange markets and brokerage firms, published a report on conflicts of interest in October 2013 that offered extensive guidance on how firms should handle conflicts.[1]

Although compensation-based conflicts represented only a portion of FINRA's October 2013 report,[2] these conflicts have become a major focus of FINRA largely due to the role that compensation can play when brokers make recommendations to their clients. In August of this year, FINRA published an examination letter that it sent to approximately one dozen retail brokerage firms.[3] The letter was designed to procure substantial information about a broad range of compensation practices. As FINRA stated in the letter, "the intent of this review it [sic] to continue our assessment of the efforts employed by firms to identify, mitigate and manage conflicts of interest, specifically with respect to compensation practices."[4]

FINRA agrees that the August 2015 letter operates as a means of evaluating areas of concern and measured improvement since the October 2013 report. "Hopefully in the two years since that report, we see firms having really strong policies in that given area. It's critical to investor protection to identify conflicts of

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[1] *See generally* FINANCIAL INDUSTRY REGULATORY AUTHORITY, REPORT ON CONFLICTS OF INTEREST (Oct. 2013) ("FINRA OCTOBER 2013 REPORT").

[2] *See id. at 26–36.*

[3] *See* FINANCIAL INDUSTRY REGULATORY AUTHORITY, *Conflicts of Interest Review - Compensation and Oversight* (Aug. 2015), www.finra.org/industry/conflicts-interest-review-compensation-and-oversight#sthash.BZ0qTMYQ.dpuf ("Conflicts of Interest Review").

[4] *Id.*

interest and either mitigate them or eliminate them," says Michael Rufino, head of FINRA Member Regulation's sales practice program.[5]

Although the letter was sent to select brokerage firms, FINRA's decision to make it publicly available online presents a unique opportunity for brokerage firms to test the adequacy of their own processes by providing a helpful roadmap for identifying, mitigating and managing potential compensation conflicts.

FINRA's letter contains a list of 19 requests that ask not only about compensation structure, but also about specific efforts to identify, manage and eliminate compensation conflicts.[6] For example, the letter asks firms to "[i]dentify and describe the composition of the departments or committees that are responsible for reviewing and approving compensation policies for the firm's registered representatives." In another item, the letter asks recipients to "[i]dentify and describe surveillance efforts or supervisory processes that have been implemented to assess whether potential compensation-related conflicts of interest are materializing in your firm's retail brokerage business."[7]

The letter also attempts to assess how brokerage firms have responded to FINRA's increasing focus, and extensive guidance, on compensation conflicts over the past few years. For example, the letter asks: "If changes to compensation structures were made during the period of August 2014 through July 2015, summarize each change and identify the strategic goal of each change."[8] Fortunately, with the online publication of the August 2015 letter, FINRA has given brokerage firms a tool to "do something about it"—an excellent guidepost to assess their processes and take proactive steps.

Delaware Supreme Court Clarifies When a Friendship Could Compromise a Director's Independence

by Brian W. Ledebuhr

When can a close personal friendship potentially interfere with a director's independence? The Supreme Court of Delaware recently addressed the issue in *Delaware County Employees Retirement Fund, et al. v. Sanchez.* The *Sanchez* case involved a complicated transaction between Sanchez Resources, LLC, a private company that is wholly owned by the family of A.R. Sanchez, Jr. (the "Private Sanchez Company"), and Sanchez Energy Company, a public company in which the Sanchez family is the largest shareholder and which depends upon the Private Sanchez Company for its management services (the "Public Sanchez Company"). Among other matters, the transaction included significant cash payments from the Public Sanchez Company to the Private Sanchez Company in exchange for the purchase of certain properties.

[5] Ed Beeson, *FINRA Exam Gives Handy Map To Spot Conflicts In Broker Pay, Law360* (Aug. 24, 2015, 6:38 PM), www.law360.com/articles/693861/finra-exam-gives-handy-map-to-spot-conflicts-in-broker-pay.

[6] *See* Conflicts of Interest Review, *supra* note 3.

[7] *Id.*

[8] *Id.*

Without first making a demand upon the Board, certain shareholders initiated a derivative action alleging that the Public Sanchez Company grossly overpaid and unfairly benefited the Private Sanchez Company. The shareholders also claimed that demand was excused because a majority of the Board's directors were not sufficiently independent and disinterested to evaluate a demand. The parties stipulated that, of the five members on the Public Sanchez Company's board of directors (the "Board"), Mr. Sanchez and his son were not disinterested board members. The parties disagreed, however, as to whether a third director, Alan Jackson, was independent from Mr. Sanchez.

According to the plaintiffs, Mr. Jackson was not an independent and disinterested director because:

- Mr. Jackson was a close personal friend of Mr. Sanchez for over 50 years. To that end, Mr. Jackson personally donated $12,500 to Mr. Sanchez's gubernatorial campaign in 2012;
- Mr. Jackson and his brother are executives at an insurance agency at which they are responsible for the Private Sanchez Company and Public Sanchez Company accounts. Moreover, the insurance company employing Mr. Jackson and his brother is wholly owned by a company in which Mr. Sanchez is the largest stockholder and a non-independent director.
- The $165,000 paid to Mr. Jackson for his role as a director of the Public Sanchez Company represented approximately 30-40% of his total income in 2012.

Upon the defendants' motion, the Court of Chancery dismissed the shareholders' complaint, finding that the plaintiffs' allegations did not rebut the presumption that Mr. Jackson was an independent and disinterested director. As a result, the court held that the plaintiffs did not sufficiently plead demand futility under *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).

The Supreme Court of Delaware reversed the Court of Chancery's dismissal, holding that the lower court improperly considered Mr. Jackson's close friendship with Mr. Sanchez separate and apart from Mr. Jackson's business and financial ties to Mr. Sanchez. The Court held that, when considered in their totality and in a light most favorable to the plaintiffs, the plaintiffs' allegations supported a pleading inference that Mr. Jackson could not act independently of Mr. Sanchez. As such, the Court held that the plaintiffs sufficiently alleged that the majority of the Board lacked independence.

In its ruling, the Delaware Supreme Court noted that it can be a close and difficult decision when determining "whether a plaintiff has pled facts supporting an inference that a director cannot act independently of an interested director for purposes of demand excusal." In this respect, the Court was careful to note the distinction between allegations of a long-term friendship and those of a more casual, undeveloped relationship. Ultimately, the totality of the plaintiffs' allegations—including the substantial payments to the Private Sanchez Company, Mr. Jackson's considerable business and financial ties to Mr. Sanchez

and his longstanding and continued friendship with Mr. Sanchez, tilted the scale in favor of the plaintiffs. Notwithstanding the unique facts alleged in this case, shareholders will likely rely on the *Sanchez* decision in support of future derivative actions in which a director has any personal relationship with an insider.

OCIE Identifies Focus Areas for Second Round of Cybersecurity Sweep Exams

by Nathaniel Segal and Cody J. Vitello

On September 15, 2015, the SEC's Office of Compliance Inspections and Examinations ("OCIE") issued a Risk Alert to provide additional information on the focus areas for OCIE's second round of cybersecurity examinations of registered broker-dealers and investment advisers. The Risk Alert is the latest publication by the SEC staff concerning cybersecurity compliance and controls, which OCIE included among its 2015 examination priorities.

In April 2014, OCIE announced the first round of sweep examinations intended to identify cybersecurity risks and assess cybersecurity preparedness in the securities industry. In February 2015, OCIE issued a Risk Alert providing summary observations derived from the first round of examinations, which included interviews with key personnel and evaluation of materials from 57 registered broker-dealers and 49 registered investment advisers relating to the firms' practices for: identifying cybersecurity-related risks; establishing cybersecurity governance, including policies, procedures and oversight processes; identifying and responding to risks relating to service providers, vendors and other third parties; safeguarding network infrastructure and information; identifying and managing risks associated with remote access to client information and funds transfer requests; and uncovering unauthorized activity.

In the recently released Risk Alert, OCIE indicated that the second round of sweep examinations will involve more testing to assess implementation of firm procedures and controls. In this connection, OCIE identified several key focus areas, including:

- Governance and Risk Assessment: Examiners may assess whether firms: (i) have cybersecurity governance and risk assessment processes related to the other key areas of focus described below; (ii) are periodically evaluating cybersecurity risks and whether their controls and risk assessment processes are tailored to their business; and (iii) are involving senior management/boards of directors and to what extent.

- Access Rights and Controls: Examiners may review how firms control access to various systems and data via management of user credentials, authentication, and authorization methods. This review may include a review of controls associated with remote access, customer logins, passwords, firm protocols to address customer login problems, network segmentation, and tiered access.
- Data Loss Prevention: Examiners may assess how firms: (i) monitor the volume of content transferred outside of the firm by their employees or through third parties (e.g., by email attachments or uploads); (ii) monitor for potentially unauthorized data transfers; and (iii) verify the authenticity of a customer request to transfer funds.
- Vendor Management: Examiners may assess: (i) firm practices and controls related to vendor management (e.g., due diligence with regard to vendor selection, monitoring and oversight of vendors, and contract terms); (ii) how vendor relationships are considered as part of the firm's ongoing risk assessment process; and (iii) how the firm determines the appropriate level of due diligence to conduct on a vendor.
- Training: Examiners may assess: (i) how training is tailored to specific job functions and is designed to encourage responsible employee and vendor behavior; and (ii) how procedures for responding to cyber incidents under an incident response plan are integrated into regular personnel and vendor training.
- Incident Response: Examiners may assess whether firms have established policies, assigned roles, assessed system vulnerabilities, and developed plans to address possible future events (including determining which firm data, assets, and services warrant the most protection to help prevent attacks from causing significant harm).

In connection with "OCIE's efforts to promote compliance and to share with the industry where it sees cybersecurity-related risks," OCIE included with the Risk Alert a sample request for information and documents to be used in the second round of sweep examinations. The Risk Alert, including the sample information request, is available at: http://www.sec.gov/ocie/announcement/ocie-2015-cybersecurity-examination-initiative.pdf.

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