Debevoise & Plimpton

Spring 2016 Debevoise & Plimpton's UK, US and Hong Kong Banking Litigation, Regulatory and Competition LawUpdate

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Contents

Welcome to Debevoise & Plimpton's Spring 2016 edition of its Banking Litigation, Regulatory and Competition Law Update.

How to Use This Update
Section A of this Update includes a bite sized overview of banking litigation cases and regulatory developments in the UK, US and Hong Kong. More detailed analysis is found in Sections B to F.

In this Update, we pick out some recent cases involving financial institutions in the UK, US, Hong Kong and an interesting case from the Indian Supreme Court. We also round-up some financial regulatory developments in the UK, US and Hong Kong. We also take a look at the new competition law regime which has recently come into force in Hong Kong and the potential application of EU law on UK financial institutions as a result of Brexit.

Please click here for:

Please let us know if you would like further information on any of the legal issues or practical points discussed in this Update.

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Section A: Brief Overview Of Recent Developments

1. UK banking litigation and white collar

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KEY POINTS

In this section we summarise the key points from recent banking litigation cases in the English courts, and we look at how the new Financial List in the Commercial Court has developed since its introduction in September 2015.

Privilege

In a potentially helpful judgment for banks subject to a regulatory investigation, the High Court has confirmed that legal advice privilege applies, under English law, to client-lawyer communications where such communications consist of memoranda summarising the status and coordination of regulatory investigations.

See page 19 for more detail.

Contractual interpretation

We consider three recent cases which apply the Supreme Court's re-affirmation of the principles of contractual interpretation in *Arnold v Britton* [2015] UKSC 36. In short, English courts will continue to interpret contracts according to their ordinary and natural meaning. It is only when the language is ambiguous that the Court may have regard to commercial common sense as an aid to interpretation.

See page 21 for more detail.

Statutory and Common Law Duties of Financial Institutions

A number of recent cases in the English courts have considered whether the general law duties of financial institutions (in tort or contract) might have expanded in the light of the regulatory requirements instituted by various iterations of the Financial Services and Markets Act 2000 ("**FSMA**") and the Conduct of Business Sourcebook rules ("**COBS Rules**"). Many of these cases have arisen out of transactions entered into around the time of the financial crisis.

See page 30 for more detail.

Financial List

The Financial List was introduced in October 2015 as a specialist list set up to handle claims related to the financial markets. We review three recent decisions of the court which provide indications of the types of matters likely to be resolved in the List.

See page 42 for more detail.

Right to challenge notice obligations of UK Financial Conduct Authority

When the UK Financial Conduct Authority prejudicially identifies a firm or individual in a notice, the Authority must provide that third party with a copy of it and afford them reasonable time make representations on its contents. A stream of litigation has, however, thrown this ostensibly simple obligation under the spotlight and useful guidance has emerged from the UK courts for both the FCA when drafting its notices and those who feel their rights may have been breached.

The most recent case was brought by Mr. Ashton, former Global Head of G10 Voice Spot FX at Barclays in London and member of the now notorious "Cartel" chat room that allegedly conspired to rig FX markets. His claim that the FCA had breached its obligations to him failed, however, with the Upper Tribunal finding that two enforcement notices linked to the FX market manipulation scandal did not identify him.

Nevertheless, the Upper Tribunal's analysis gives greater substance to the legal tests established by previous challenges and brings increasing clarity to what is a fast evolving area of law. That said, the situation remains far from settled with the Supreme Court due to hear the FCA's appeal in the leading case Macris later this year.

See page 47 for more detail.

2. US banking litigation and white collar update

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KEY POINTS

In this section of the Update we discuss some important recent banking and other financial services litigation cases in United States courts as well as discuss significant regulatory developments.

FCPA Liability, Foreign Officials and the Meaning of a "Thing of Value"

In August 2015, the Securities and Exchange Commission ("SEC") announced a settled Cease-and-Desist Order ("Order") against the Bank of New York Mellon Corporation ("BNYM"). The SEC had alleged that a subsidiary of BNYM had acquiesced to the request from two officials employed by a Middle Eastern sovereign wealth fund that BNYM hire three individuals for internships. The Order noted that providing the internships was seen "by certain relevant BNY Mellon employees as a way to influence the [sovereign wealth fund] officials' decision."

Although one of the internships was unpaid, and even though the practice of hiring relatives of well-connected individuals had been well known for years without the SEC taking action, the SEC charged BNYM with violating the FCPA's anti-bribery provisions "by corruptly providing valuable internships to relatives of foreign officials from the Middle Eastern Sovereign Wealth Fund in order to assist BNY Mellon in retaining and obtaining business," as well as with failing to "maintain a system of internal accounting controls sufficient to provide reasonable assurances that its employees were not bribing foreign officials."

This Order highlights the importance of companies taking steps to reduce the risk of facing similar allegations.

See page 51 for more detail.

Liability for Statements of Opinion in Registration Statements
The Supreme Court resolved a disagreement among lower courts as to when a statement of opinion in a registration statement constitutes an untrue statement of fact giving rise to liability under Section 11 of the Securities Act of 1933.

In *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, the Court held that a statement of opinion gives rise to liability either if the issuer does not genuinely believe the opinion expressed, or if the issuer omits a material fact regarding the basis for the opinion expressed that renders the opinion misleading to a reasonable person. This articulation is narrower than the more expansive approach adopted by some lower courts, which allowed a genuinely believed statement of opinion to give rise to liability if that opinion turned out to be incorrect. The Court also provided guidance as to when liability arises from a failure to disclose material facts about inquiry into or knowledge concerning a statement of opinion.

Following *Omnicare*, it will likely be more difficult for plaintiffs to assert a claim premised on a statement of opinion that turned out to be incorrect. Still, issuers should be careful to include only statements of opinion that they actually believe and not to omit material facts related to the formation of an opinion.

See page 55 for more detail.

Dodd-Frank Anti-Retaliation Provision Circuit Split

Conflicting appellate and district court opinions have created uncertainty as to the scope of Dodd-Frank's protection for whistleblowers. Under a narrow reading of Dodd-Frank espoused by some courts, including the Fifth Circuit Court of Appeals, the protection only extends to whistleblowers who report externally to the SEC. Recently, the Second Circuit Court of Appeals disagreed and held that Dodd-Frank applies more broadly and does not require external reporting.

It is still unclear which interpretation of Dodd-Frank's whistleblower protection provisions will prevail. In the last few months two district courts sided with the Fifth Circuit's narrower reading of the provision. Nevertheless, the legal uncertainty prevails and the whistleblower protection provisions remain an area of focus for both the SEC and private litigants.

Companies should regularly monitor and test the effectiveness of their whistleblower policies and procedures in order to mitigate risks associated with potential whistleblower retaliation claims.

See page 57 for more detail.

Evidentiary Obstacles in Prosecutions Against Individual Defendants

The SEC and the Department of Justice ("DOJ") were recently handed losses in two high-profile appeals involving professionals in the fixed-income industry. Both of these opinions, one by the First Circuit Court of Appeals and the other by the Second Circuit Court of Appeals, focused on the government's materiality arguments.

- The First Circuit reversed an SEC Order that had fined two former State Street Global Advisors employees, holding that the Commission's findings did not meet the burden of demonstrating substantial evidence of culpability.
- In overturning Jesse Litvak's 2014 conviction for fraud against the United States, the Second Circuit held that the evidence at trial did not show that Litvak's statements influenced any government decisions and was insufficient to support a jury finding that those statements were material under the relevant statute. The court proceeded to vacate Litvak's conviction as to ten counts of securities fraud, finding that the trial court had improperly excluded testimony that went to the question of materiality.

These rulings reinforce the challenges of bringing individual prosecutions and demonstrate that federal courts will continue to closely analyze the government's evidentiary showings of materiality and scienter.

See page 60 for more detail.

Iran Sanctions Relief

On January 16, 2016, the International Atomic Energy Agency announced that Iran had completed the necessary preparatory steps to mark "Implementation Day" under the Joint Comprehensive Plan of Action ("JCPOA"). As a consequence, US Secretary of State John

Kerry confirmed that US sanctions relief under the JCPOA was now in effect.

The new sanctions relief covers:

- Ceasing application of most US "secondary" sanctions;
- Authorizing non-US persons owned or controlled by US persons to engage in most Iran-related transactions;
- Removing a number of Iranian entities from the US sanctions list; and
- Authorizing US persons to engage in civilian aircraft sales and support and import of Iranian-origin carpets and foodstuffs.

This relief gives effect to the specific commitments already outlined in the JCPOA, and the details of the sanctions relief are largely as expected. Primary US sanctions that generally prohibit persons in the United States and US companies and individuals anywhere in the world from dealing with Iran largely remain in effect. In particular, transactions with Iran that involve the US banking system remain strictly prohibited. Nevertheless, the new authorization for non-US entities owned or controlled by US persons is arguably broader than anticipated in one respect, permitting a wider range of Iran-related activities, including certain actions by US persons, than may have been expected.

See page 63 for more detail.

Post*-Newman *Insider Trading Liability

In October 2015, the US Supreme Court denied certiorari in *United States v. Newman*, leaving the Second Circuit's insider trading decision undisturbed. In *Newman*, the Second Circuit developed a two-prong standard for establishing a tippee's insider trading liability. Under the decision, the government must prove that a tippee knew both: 1) that the tipper breached a fiduciary duty by disclosing material, non-public information and 2) that the tipper received a personal benefit by disclosing the information.

While the sweeping nature of the *Newman* holding led many to foresee a seismic shift in insider trading liability, *Newman*'s progeny suggests that, although significant, the prediction that *Newman* would severely limit insider trading investigations and prosecutions may have been overstated.

See page 69 for more detail.

SEC Sanctions for Failure to Adopt Cybersecurity Protections
Evidencing its stated commitment to focus on cybersecurity, in September 2015, the Securities and Exchange Commission ("SEC") found registered investment adviser R.T. Jones Capital Equities Management liable for failing to adopt written policies and procedures to safeguard customer records and information. In 2013, the investment adviser experienced a breach of the database where it stored the personally identifiable information of its clients, and while it took prompt remedial steps, it did not have written cybersecurity policies or an incident response plan in place at the time.

The case provides a valuable reminder that registered investment advisers and broker-dealers should carefully consider how to adopt the prevention, detection and response measures recommended by the SEC's Division of Investment Management in April 2015. Several steps firms should take to come into compliance with SEC regulations are detailed on page 75 of this update.

FINRA Rule 13200, Arbitration and Waiver

The Second Circuit recently upheld Credit Suisse's Employment Dispute Resolution Program ("EDRP"), which requires arbitration of claims in a non-FINRA forum. In so holding, it rejected the contention that Rule 13200 created a non-waivable requirement that arbitration occur in a FINRA forum. To the contrary, the court found that FINRA's arbitration provisions are default rules that parties can override with more specific contractual terms.

However, the court noted that its holding was not without limits. It distinguished the EDRP from a provision that waived arbitration completely and acknowledged that in a previous case it had found that such a provision was not enforceable.

See page 78 for more detail.

Disclosure-Only Settlements and the Delaware Chancery Court

In *In re Trulia, Inc.*, the Delaware Chancery Court recently rejected a disclosure-only settlement, finding that the terms of the settlement were neither fair nor reasonable.

This decision is notable because the court discussed in detail its skepticism that disclosure-only settlements provided benefits to stockholders and signaled that Delaware courts would continue to examine vigilantly such settlements before approving them. The court further expressed its view that disclosure claims should be advanced in an adversarial setting and in a manner that does not incentivize defendants to settle. This opinion could have broad ramifications on the volume of deal litigation as well as the jurisdiction in which that litigation is brought.

See page 79 for more detail.

3. Hong Kong and India banking and white collar litigation

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Bank not negligent for failing to discover Madoff fraud

In *Li Kwok Heem John v Standard Chartered International (USA) Ltd [2016] HKEC 7* an investor failed in his claim that a Bank had been negligent for failing to discover that the fund it had recommended was connected to the Madoff Ponzi scheme. Given that the Madoff fraud was undetected for years by the fund's auditors, administrators and regulators, this result was perhaps unsurprising – particularly as the alternative result would potentially impose an impossibly onerous duty on banks to verify the veracity of its investment recommendations. However, the case is an interesting illustration of the limitation of the effectiveness of so-called "basis" clauses.

In the past few years, banks have been highly successful in defending claims by customers who allege that the bank provided negligent investment advice causing loss. A key defensive weapon for financial institutions has been contractual "basis" clauses which typically provide that no advice is given and the customer is not entitled to rely on any representations made by the bank. The controversial effect of such clauses is that, when applicable, customers are estopped from bring claims even if negligent advice has been given.

The question for the Courts in such circumstances is whether the basis clause reflects the reality of the agreed bargain or the relationship with the customer. The courts are generally slow to strike down the terms of a freely negotiated commercial contract. However, as is illustrated in this case, basis clause will not be upheld in circumstances where they attempt to rewrite history of the agreed bargain for the purposes of circumventing statutory controls on the exclusion of liability.

See page 83 for more detail.

Officers and Employees of Private Sector Banks Deemed "Public Servants" under India's Anti-Corruption Law

Corruption is prolific in India's banking sector, yet India's anti-corruption regime contains no express offences in relation to private sector corruption and bribery.

However, in a landmark judgment handed down on 23 February 2016[1], India's Supreme Court ruled that officers and employees of banks are "public servants" for the purposes of prosecution under the Prevention of Corruption Act 1988 (the "PCA"). In order to reach this decision, the Court adopted a highly purposive approach to legislative interpretation in order to remedy "unintended omissions" in relation to the application of the PCA to officers and employees of a bank. The decision is another important example of judicial activism to tackle India's corruption issues.

See page 89 for more detail.

"No consent" regime in relation to Suspicious Transaction Reports not unconstitutional or Wednesbury unreasonable

Interush Ltd v Commissioner of Police [2015] HKEC 1589 is an interesting insight into the practical operation of the "no consent"

[1] Central Bureau of Investigation v. Gelli, India Supreme Court (February 23 2016)

regime in relation to suspicious transaction reports filed under 25A(2)(a) of the Organized and Serious Crimes Ordinance.

In this case, the Court rejected a claim that the regime was unconstitutional in that it offended property rights under the Basic Law. The Court held Section 25A(2)(a) of OSCO does not operate to withhold the accounts or property of a suspect. It only creates a defence for further dealings with the property after disclosure. Accordingly, the Basic law did not come into operation.

Further, on the facts of the case and in light of internal police guidelines on withholding consent, the Court found that the Police had not been irrational or unreasonable (in a *Wednesbury* sense) for withholding consent to deal and that the Court will be slow to interfere in an on-going criminal investigation.

See page 92 for more detail.

Inside Information Disclosure Regime: No Exception for NEDs and INEDs

On 11 March 2016, the Securities and Futures Commission (SFC) commenced proceedings in the Market Misconduct Tribunal (MMT) against Mayer Holdings Limited (Mayer), and ten of its current and former senior executives (Senior Executives), in connection with Mayer's failure to disclose inside information[2] under Part XIVA of the Securities and Futures Ordinance (SFO). This is the second set of MMT proceedings brought by the SFC under Part XIVA of the SFO since it became effective on 1 January 2013.

[2] Pursuant to section 307A of the SFO, inside information is information that is specific, not generally known to the segment of the market which deals or would likely deal in the listed company's securities, and if so known, would be likely to have a material effect on the price of the listed securities.

See page 96 for more detail.

Being Kept Sweet: Court of Appeal Rules on Rafael Hui Appeal
On 16 February 2016, the Court of Appeal handed down its ruling dismissing the appeals of former Chief Secretary Rafael Hui, Thomas Kwok and others.[3] The bulk of the judgment by Vice President Lunn (and the entirety of a shorter opinion by Vice President Yeung) dealt with the question of whether a prosecution for conspiracy to commit the common law offense of misconduct in public office could be made out merely based on an agreement by Rafael Hui "to be or remain favourably disposed to" Sun Hung Kai Properties ("SHKP"). In other words, the court found that a "general sweetener" could be the basis of a misconduct in public office offence, even in the absence of a specific act of misconduct or *quid pro quo*.

See page 100 for more detail.

SFO Section 300 used by the Hong Kong SFC to combat insider dealing in respect of securities listed overseas
The Court of First Instance (made an important decision on 15 January 2016 in relation to the judicial interpretation of section 300 of the Securities and Futures Ordinance (the "SFO"), which prohibits the use of fraudulent or deceptive schemes in transactions involving securities.

The insider dealing provisions in the SFO, i.e., sections 270 and 291, are subject to a jurisdictional limitation, i.e., their applications are limited to securities listed on the Hong Kong Stock Exchange. This decision sends a clear message to all market participants that the

[3] *HKSAR v. Hui Rafael Junion and others*, CACC 444 of 2014 (16 February 2016).

Securities and Futures Commission may now investigate and prosecute insider dealings in respect of shares listed overseas.

See page 102 for more detail.

4. Brexit: potential application of EU law for UK financial institutions

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If the UK votes to leave the European Union ("EU") in the referendum on 23 June 2016, the future application of EU-based legislation to the banking and financial services industry is uncertain. Ultimately much will depend on how the UK re-negotiates its relationship with the EU. In this update we look at some of the issues facing financial institutions in the event of Brexit.

See page 105 for more detail.

5. Hong Kong introduces new competition law regime

The Competition Ordinance ("CO") came into full force on 14 December 2015. Hong Kong's competition law regime, is conceptually similar to the EU competition law regime. In particular, the CO prohibits restrictions on competition in Hong Kong through three competition rules:

- The First Conduct Rule prohibits anti-competitive agreements;
- The Second Conduct Rule prohibits abuse of market power;
- The Merger Rule prohibits anti-competitive mergers and acquisitions.

The First Conduct Rule and the Second Conduct Rule apply to all sectors of the Hong Kong economy. At present, the Merger Rule only applies to mergers involving carrier licence holders within the meaning of the Telecommunications Ordinance (Cap 106).

The CO contains exceptions for conduct which increases competition and *de minimis* thresholds apply to conduct captured by the First and Second Conduct Rule.

See page 111 for more detail.

Section B: UK Banking and White Collar Litigation Update

PRIVILEGE

Documents produced by external lawyers in the context of a regulatory investigation are capable of attracting privilege

Background

In *Property Alliance Group Limited v The Royal Bank of Scotland plc* [2015] EWHC 3187 (Ch), the issue was whether documents created in the context of a regulatory investigation were privileged. Please see our UK, US and Hong Kong Banking Litigation, Regulatory and Competition Law Update of August 2015 for a discussion of the prior decision in this case which was concerned with whether without prejudice communications applied in a regulatory context. The case provided helpful clarification that firstly, privileged material could be disclosed to a regulator on a confidential "no waiver basis"; and secondly, that the without prejudice rule applied to communications between a regulator and a firm which form part of genuine settlement discussions.

The claimant ("**PAG**") alleged that RBS induced it to enter into four interest rate swaps between 2004 and 2008. PAG claimed that by proposing such swaps, RBS implicitly misrepresented that it was not rigging the relevant LIBOR rate. As is well-known, RBS has admitted that it was involved in rigging the Japanese Yen and Swiss Franc LIBOR rates and has paid substantial fines. However, RBS has denied misconduct in relation to the setting of any GBP LIBOR rates.

It was in this context that RBS was ordered to disclose "high level" internal reports, reviews and summaries relating to the allegations of LIBOR misconduct, including documents produced for the Executive Steering Group ("**ESG**") which was set up to oversee a series of regulatory investigations across various jurisdictions against RBS. RBS claimed privilege over these documents.

Issue

The issue to be decided was whether RBS had correctly claimed legal advice privilege. These documents were all produced by a law firm for the ESG and were all marked "privileged and confidential". They can be classified as:

1. Confidential memoranda in the form of tables prepared by a law firm, which informed and updated the ESG on the progress, status and issues arising in the regulatory investigations brought against RBS; or

2. Confidential notes and/or summaries drafted by a law firm concerning the discussions between the ESG and its legal advisors.

Decision

The Court held that all of these documents were privileged. In coming to this decision, the Judge referred to the well-known test for legal advice privilege as set out in *Three Rivers District Council v Bank of England* (No. 6) [2004] UKHL 48. The Judge also applied the test in *Balabel v Air India* [1988] 1 Ch 317, and agreed that these documents formed a continuum of communication, the purpose of which was to keep the client informed so that advice may be sought and given as required.

Takeaway

This case is important in providing guidance as to the circumstances in which a document will attract legal advice privilege in the context of regulatory investigations.

In particular, the Court recognised that the public policy considerations underlying legal professional privilege also apply in the context of regulatory investigations. These considerations were that:

1. it encourages candid disclosure by a client to his lawyer; and

2. it removes any hesitation on the part of the lawyer about committing matters to paper which he would be unlikely to do if concerned his communications may be discloseable, with the inevitable risk of misunderstandings of the facts, and legal advice given.

However, this case (like all privilege disputes) turned very much on its particular facts. It should not been seen as a green light for allowing all communications from external lawyers to be protected by the cloak of privilege. The Court considered some instances in which documents may not be privileged, for example minutes of a business meeting taken by lawyers. These minutes would not be privileged simply on the basis they were taken by a lawyer: the lawyer has to be acting as a lawyer to provide legal advice. For a lawyer simply to take the minutes because it was convenient for him to do so would not attract privilege. Accordingly, care must be taken when producing documents ion the context of a regulatory investigation and if there is any area of doubt, clients should seek legal advice.

CONTRACTUAL INTERPRETATION

Three recent banking cases before the High Court and the Court of Appeal have considered the approach to contractual interpretation following the decision of the Supreme Court in *Arnold v Britton* [2015] UKSC 36. In particular, they considered the interplay between the ordinary and natural meaning of a contract, and the relevance of "commercial common sense" in the process of contractual interpretation.

Indemnity clause should be given its plain meaning, even if this is uncommercial for one party

Background

In *Wood v Sureterm Direct Ltd* [2015] EWCA Civ 839, the parties had entered into a sale and purchase agreement ("**SPA**") by which the seller indemnified the buyer "*against all actions, proceedings, losses, claims, damages, costs, charges, expenses and liabilities suffered or incurred, and all fines, compensation or remedial action or payments imposed on or required to be made by the Company <u>following and arising out of claims or complaints registered</u> with the FSA, the Financial Services Ombudsman or any other Authority against the Company, the Sellers or any Relevant Person and which relate to the period prior to the Completion Date pertaining to any mis-selling or suspected mis-selling of any insurance or insurance related product or service*".

Shortly after the sale of the Company was completed, the Company became aware of concerns regarding potential mis-selling practices while under previous ownership. Following an internal investigation, the Company and the buyer were obliged to, and did, inform the FSA of their findings. The Company and the buyer under the SPA thereby became liable to pay large amount in compensation to customers as the alleged victims of the mis-selling, which the buyer sought to claim from the seller under the indemnity contained in the SPA.

Issue

At issue was whether the indemnity extended to compensation paid as a result of self-reporting by the Company, as opposed to claims or complaints registered with the FSA.

Decision

The Court of Appeal re-stated the principles in *Arnold v Britton* [2015] UKSC 36 and decided that the ordinary and natural meaning of the indemnity precluded claiming for self-reporting. The Court accepted that the indemnity "*bears some of the hallmarks of a clause which has grown in the course of drafting and contains a combination of phrases which are not wholly easy to parse*" (para [12]). However, grammatically and linguistically there was no real basis to give the indemnity any other meaning.

The Court rejected an argument that this would lead to an uncommercial result for the buyer, since it made no commercial sense in precluding a claim under the indemnity for self-reporting. While this approach had "*some attractions*", it was not the role of the Court to re-write a poor deal.

Takeaway

This decision makes it clear the first step is always to look at the wording of the contract, rather than any underlying commercial intentions. The Court emphasised that business people make bad bargains all the time for any number of reasons, such as a weak negotiating position, poor negotiation skills, or bad advice. It is not for the Court to reject the natural meaning of a provision simply to improve what it perceives might be an uncommercial deal.

Whilst the ultimate decision may not have reflected the commercial expectations of the buyer, it is difficult to argue with the reasoning of the Court. The terms of the contract were relatively clear. This case acts as a stark warning to practitioners of the need for clear and unambiguous drafting at the outset.

Commercial common sense approach applied to interpretation of "principal" and "interest" in the context of a commercial

mortgage backed securities structure, where the terms were undefined and ambiguous

Background

In *CBRE Loan Servicing Limited v Gemini (Eclipse 2006-3) plc & Ors* [2015] EWHC 2769 (Ch), CBRE acted as master servicer and special servicer of a securitised bank loan of £918,862,500 (the "**Loan**") advanced to a number of Guernsey-registered limited partnerships by Barclays. In November 2006, Gemini (the "**Issuer**") purchased the Loan and related security by issuing secured floating-rate notes of equivalent value, divided into classes A to E (the "**Notes**").

Following a significant fall in value of the underlying commercial property portfolio and failure by the borrowers to keep making interest payments, CBRE exercised its right to accelerate the Loan in August 2012. Following the acceleration of the Loan, administrators were appointed over the general partners of the borrowers and receivers over the properties. The administrators and receivers collect the rental income and pay it over to CBRE after deducting costs and expenses.

Issue

The central question was how CBRE should carry out its role of characterising three categories of receipts from the properties – rental income, sale proceeds and lease surrender premiums – for the purpose of a clause in the 'Cash Management Agreement', the document which governs how those funds would then be allocated. The clause required CBRE to identify the funds paid as "principal" and "interest" in accordance with the respective interests of certain parties, but these terms were undefined.

It was accepted that rental income constituted "interest", but the classification of sale proceeds and surrender premiums remained disputed. The classification was important as the money would be paid out to different classes of noteholders under different waterfall provisions.

Decision

The Court concluded that it was clear from the wording of the clause that the focus of the inquiry was on the Loan and related security rather than the rights of the noteholders and the priorities of payments flowing from the securitisation. The Court found that the absence of defined terms for "principal" and "interest" suggested that the parties envisaged the classification to be relatively routine and to be applied in a common sense way, without requiring any legal sophistication.

The Court therefore found it "*tolerably clear*" that receipts should be characterised depending on their source and the role they play in the context of the Loan and its security, viewed as a matter of commercial common sense.

In doing so the Court applied the key principles of contractual interpretation as set out in *Rainy Sky SA v Kookmin Bank* [2011] UKSC 50 and *Re Sigma Finance Corporation* [2009] UKSC 2. Where the original drafting is ambiguous and there are two possible meanings the Court should ascertain what a reasonable person with a reasonable level of background knowledge would have understood the parties to have meant, having regard to all the relevant surrounding circumstances. If there are two possible constructions, the Court is entitled to prefer the one that accords with business common sense.

The Court also had regard to *Arnold v Britton* [2015] UKSC 36, where the Supreme Court considered that reliance on "*commercial common sense and surrounding circumstances*" should not "*undervalue the* *importance of the language*", and that ascertaining the meaning that a reasonable person would have understood can be gleaned "*most obviously*" from the words themselves, over which the parties have control.

On the facts the Court held that the proceeds of sale and surrender premiums should be characterised as principal since they represented, respectively, the realised capital value of the property as security for the Loan, and the capitalised value to the landlord of the remaining term of the lease.

Testing this conclusion within the context of the overall structure of the transaction documents the Court found it to be consistent with the parties' reasonable expectations, the way in which such funds were treated under the Loan before it was in default, and the prioritisation of certain noteholders over others.

Takeaway
This decision provides helpful guidance on how to apply sale proceeds in mortgage-backed loan transactions where the terms "principal" and "interest" are undefined.

More broadly, this case is of interest as an early consideration of *Arnold v Britton* and the commercial common sense approach to contractual interpretation where the language did not have a natural meaning and was ambiguous. However, the authorities are not yet settled and the case turned on the facts. The judge distinguished, for example, interpretation of a clause relating to receipts of capital or income for tax purposes, noting that this would require close legal analysis rather than merely a commercial common sense approach.

Court of Appeal confirms approach to rectification of mistakes in a contract and takes into account changes in the capital

regulatory regime as part of the commercial context for the purpose of contractual interpretation

In *LBG Capital No. 1 plc v BNY Mellon Corporate Trustee Services Limited* [2015] EWCA Civ 1257, the Court of Appeal overturned the decision of the High Court and held that a series of contingent convertible capital notes, or "CoCos", issued by companies in the Lloyds Banking Group ("**LBG**"), could be redeemed early on account of the fact that these Enhanced Capital Notes ("**ECNs**") had ceased to assist LBG in passing the PRA's capital stress tests.

Background
The case concerned some £3.3 billion worth of outstanding ECNs carrying a coupon of around 10.33%. The purpose of the ECNs was to increase LBG's core tier 1 capital after it was found to have a shortfall. Pursuant to the terms of the ECNs, early redemption could take place if a Capital Disqualification Event ("**CDE**") had occurred and was continuing.

The definition of CDE included where the ECNs "*cease to be taken into account… for the purposes of any "stress test" applied by the FSA in respect of the Consolidated Core Tier 1 Ratio*". The issuers, LBG, contended that this had occurred when the PRA did not take the ECNs into account in its stress test carried out in December 2014.

There were two issues: first, whether there was a mistake in the contract sufficient to invoke rectification principles; and second, contractual interpretation.

Decision: correcting a mistake in the contract through rectification
As a preliminary issue, the Court determined that the drafting of the definition of a CDE was "*obviously wrong*" as, literally interpreted, it would make ECNs capable of redemption only during a narrow

window in which the FSA conducted stress tests based on the definition of "Core Tier 1" capital as of 1 May 2009 (a historical term by December 2014).

In doing so, the Court confirmed the legal principle concerning rectification of mistakes in *Chartbrook Ltd v Persimmom Homes Ltd* [2009] UKHL 38 that "*it should be clear that something has gone wrong with the language" and "clear what a reasonable person would have understood the parties to have meant*".

- As to whether something has gone wrong with the language, the Court found the definition of CDE "*wholly inapt*" for a number of reasons, including that failing to allow for changes in the regulatory environment (which were widely expected and anticipated at the time) made no commercial sense.
- As to what a reasonable person would have understood the parties to have meant, the Court noted that the offer memorandum clearly set out that the decision to invest should only be taken after informed and detailed consideration. Accordingly, the Court held that a reasonable addressee would be someone with an informed understanding of the working of the financial markets, the regulatory background, the use of stress tests and the intended function of the ECNs. The fact that many of the investors were retail investors was deemed irrelevant to the question.

The Court therefore corrected the mistake by continuing to refer to "*the relevant ratio*" rather than "*the Consolidated Core Tier 1 Ratio*".

Decision: reading down the clause
The main issue before the Court of Appeal was whether the High Court was correct to conclude that "*cease to be taken into account*" did not require looking at the actual performance of LBG in any

particular stress test, but that instead, relying in particular on the fact that the clause concerned "*disqualification*", the wording connoted a requirement for a complete disallowance of the use of ECNs for stress testing purposes for the foreseeable future.

The Court of Appeal, applying *Arnold v Britton*, rejected this approach and looked to the actual language and the natural meaning of the clause, which focuses on whether the ECNs have ceased to be taken into account "*for the purpose of any stress test applied by the FSA in respect of the [relevant ratio]*". The appeal was allowed because, due to a change in the regulatory environment, LBG was no longer able to use the ECNs to pass the relevant ratio for the purposes of the stress test. Accordingly, LBG was entitled to redeem the ECNs.

Comment
As to the law in relation to mistake, this case reaffirms the position *in Chartbrook v Persimmom Homes* that the court may, as a matter of interpretation, correct "obvious mistakes". In taking a purposive approach the Court found that failing to allow for changes in the regulatory environment in the drafting made no commercial sense. It is worth noting here that the Court was not sympathetic to the argument that retail investors would not have understood the "obvious" drafting error.

As to contractual interpretation, the Court of Appeal emphasised once again the primacy of the actual language of the clause and its natural and ordinary meaning. This clearly demonstrates the continued importance of clear, unambiguous and forward-looking drafting in complex financial transactions.

Appeal to the Supreme Court
In a one-day hearing which took place on 21 March 2016, the Supreme Court heard BNY Mellon's appeal, which was brought on

the ground that the Court of Appeal incorrectly relied on "*technical and specialist information as part of the factual matrix*".

On the main construction issue in relation to reading down the CDE clause, BNY Mellon submitted that the words "*in respect of the [relevant ratio]*" did not import an idea of passing or failing a stress test. It was submitted that the significance of the link between the conversion trigger of the ECNs and the threshold requirement for the capital stress test could not be assumed to have been apparent to all investors, whether retail or institutional. That, he submitted, would require detailed knowledge of regulatory information which had not been given any prominence in the large volume of documentation provided to investors in this case.

Shorter submissions were heard on the question of "*mistake*". BNY Mellon submitted that there was no mistake, but that if there was, it was not obvious.

LBG commenced buying back the bonds in January, and has stated that it will compensate investors for any losses caused by the early redemption if the Supreme Court should decide against it.

STATUTORY AND COMMON LAW DUTIES OF FINANCIAL INSTITUTIONS

Whether an advisory relationship arises, and whether there is a common law duty to provide information regarding break costs

Background
In *Thornbridge Limited v Barclays Bank plc* [2015] EWHC 3430 (QB), Thornbridge Limited ("**Thornbridge**") entered into a loan agreement with Barclays Bank plc (the "**Bank**") in April 2008. As a condition of that loan, in May 2008 Thornbridge entered into an interest rate swap agreement with a term of five years and a notional

amount for £5.652 million. Pursuant to the swap, Thornbridge was obliged to pay the Bank an amount each month calculated by reference to a fixed rate of 5.65 per cent. In May 2008, the Bank of England base rate was 5 per cent. By March 2009, the Bank of England base rate had fallen to 0.5 per cent.

The interaction between Thornbridge and the Bank before Thornbridge entered into the swap consisted of three telephone conversations and certain email exchanges during one of which a presentation style document entitled "Interest Rate Risk Management Strategy" was provided by the Bank's representative to Thornbridge.

Thornbridge alleged that the Bank failed to provide sufficient information before it entered into the swap regarding break costs in the event of early termination, including by failing to give examples of break costs when interest rates were very low, and by failing to set out the comparative advantages and disadvantages of hedging products other than the swap.

Issue

The key issues were (a) whether the Bank had assumed an advisory duty; (b) whether, if that was the case, Thornbridge was estopped from asserting that the Bank had done so by a representation made by Thornbridge in the written agreement between the parties that it did not rely on the Bank's communications as investment advice, or whether such representations did not raise an estoppel; and alternatively whether that representation was an unenforceable exclusion clause; (c) the relevant duties if the court found that the relationship was not an advisory relationship; and (d) whether the claims had been established as a matter of fact.

Decision
The claim failed on all counts.

First, the Court held that the Bank had not recommended the swap. The Court held that even if the Bank had given advice during the conversations its representatives had with Thornbridge, the Bank had not assumed an advisory duty. The Court, applying *JP Morgan Bank v Springwell Navigation Corp* [2008] EWHC 1186 (Comm), ruled that one had to consider all aspects of the parties' relationship in deciding whether an advisory duty had been assumed.

Second, applying *Springwell* and *Titan Steel Wheels v Royal Bank of Scotland* [2010] EWHC 211 (Comm), [2010] 2 Lloyd's Rep 92, the Court found that the test for whether a clause was an exclusion clause was whether the clause defined the basis on which the parties transacted business or whether it was inserted as a means of evading liability. The relevant clause in the written agreement between Thornbridge and the Bank was, therefore, a basis clause and not an exclusion clause with the result that even if advice had been given by the Bank, Thornbridge was contractually estopped from asserting that the Bank had advised it to enter into the swap agreement.

Third, in the absence of an advisory relationship, there was no broad duty to provide information (*Hedley Byrne v Heller* [1964] A.C. 465). In addition, the written agreement between the parties did not incorporate the relevant regulatory rules. Furthermore, applying *Titan Steel Wheels*, there was no direct right of action by Thornbridge for breaches of the relevant regulatory rules as Thornbridge fell outside the relevant definition (which provides that a contravention of the relevant rules is actionable at the suit of any person who is not an individual only where that person does not suffer the loss in question in the course of carrying on business of any kind).

Fourth, the Court held that the applicable common law duty of care was limited to a duty not to misstate information and did not extend to a positive duty to provide information. It followed that the Bank could not be criticised for failing to give illustrations of break costs which took account of greater falls in interest rates; and the swap agreement was not unsuitable as it did what it was supposed to do (i.e. limit Thornbridge's exposure to increases in the underlying interest rate).

Takeaway

In a decision that will be welcomed by banks, this is an illustration of claimants seeking to utilise the stringent regulatory regime to extricate themselves out of fairly standard financial instruments. As the Court observed, "*This is in my view a case based on hindsight and…it is not a case of a claimant being advised to enter, or being misled into entering, into a swap which in the circumstances was unsuitable*."

It further re-affirms the English court's strict approach to speculative claims. However, this was a case that depended on its facts. The Court did not decide as a matter of principle that claimants cannot ever recover in such cases. Whether an advisory relationship arises, and the extent to which that gives rise to a duty of care, is a question that remains outstanding and will of course depend on a case-by-case analysis.

Whether a suit is directly actionable by a company as a "private person" under section 138D of FSMA

MTR Bailey Trading Ltd v Barclays Bank [2015] EWCA Civ 667 concerned an application by the claimant for permission to appeal to the Court of Appeal against a decision of the High Court to refuse the claimant's application for permission to amend its particulars of claim and to grant the defendant's application for summary judgment.

Background

Mr Bailey is a director and the sole shareholder of MTR Bailey Trading Ltd (the "**Company**"), a car dealership. Both Mr Bailey and the Company were customers of Barclays Bank plc (the "**Bank**").

In 2007, Mr Bailey entered into an interest rate swap agreement with the Bank. In 2011, the swap was transferred from Mr Bailey to the Company. The Company subsequently commenced legal proceedings against the Bank seeking a declaration that the swap agreement was unenforceable, plus rescission of the swap agreement and damages. The Bank made an application for summary judgment and the Company made an application for permission to amend its claim. The High Court held that the Company's claim (even with the proposed amendments) had no prospect of success and it, therefore, granted the Bank's application for summary judgment. The Company sought permission to appeal that decision. The application for permission to appeal was heard by a single Court of Appeal judge.

Grant of permission to appeal

Many of the claims which were either originally pleaded or were the subject of the Company's unsuccessful application for permission to amend were either not pursued at all at the permission to appeal stage or were dropped at the hearing of the application for permission to appeal. The key points in respect of which the Court of Appeal granted permission to appeal were as follows:

1. First, the Company persuaded the judge hearing the application for permission to appeal that the High Court had, at least arguably, fallen into error when assess the relationship between the Bank, on

the one hand, and Mr Bailey and the Company, on the other hand, for the purposes of COBS 2.1.1R and accordingly granted permission to appeal in respect of the Company's claim pursuant to COBS 2.1.1R. The COBS rules are the Conduct of Business Sourcebook rules promulgated by the Financial Conduct Authority. COBS 2.1.1R requires firms to act honestly, fairly and professionally in accordance with the best interests of the client.

2. Secondly, whether the Company has a cause of action against the Bank in respect of its alleged breach of the COBS Rules. Section 150 (now section 138D) of FSMA provides that a contravention by an authorised person of a rule (including the COBS Rules) is actionable at the suit of a private person who suffers loss as a result of the contravention. A "private person" is defined to include a person who is not an individual "*unless he suffers the loss in question in the course of carrying out business of any kind*", which the existing case law states should be given a wide meaning (see *Titan Steel Wheels v Royal Bank of Scotland* [2010] EWHC 211 (Comm) and *Camerata Property v Credit Suisse Securities (Europe) Ltd* [2012] EWHC 7 (Comm)). If those words are given a wide meaning, the Company's argument that it did not enter into the transaction in the course of business in any relevant sense because its usual business was dealing in cars and not in financial products fails. The Company argued that the existing case law was wrong, and permission to appeal was granted in order to allow the Court of Appeal the opportunity to consider the correctness of that case law.

3. Thirdly, even if the Company has no statutory right of action under section 150 of FSMA, whether the applicable COBS Rules were incorporated into the contract between the Company and the Bank, thus providing the Company with a claim for breach of contract against the Bank.

4. Finally, whether the relationship between the Bank and the Company was more than a commercial banking relationship such that the Bank had, in substance, taken on the role of a professional intermediary in relation to the transaction and so the Company was entitled to assume that the Bank had fiduciary obligations to act in the Company's best interests.

Takeaway

The full appeal on the points in relation to which the Company was granted permission to appeal will take place in July 2016. The points which will be aired during the course of the appeal are of importance to the banking industry generally. The second question regarding the correctness of the *Titan Steel Wheels* line of cases regarding the meaning of a "private person" is particularly important: depending on the outcome of the appeal, it might well lead to legislative intervention to clarify the meaning of this expression.

Common law duty of care in addition to the existing statutory duties under FSMA and the COB Rules

Background

In *David Anderson v Openwork Limited* [2015] EW Misc B14, Mr Anderson sued his financial adviser for losses arising out of his investment in a bond. Mr Anderson claimed that he was advised to purchase the bond by the financial adviser when it was not in fact suitable for his needs. Mr Anderson argued that the financial adviser had made negligent misstatements relating to the bond, that the advice given by the financial adviser had breached the relevant statutory rules (in this case the then COB Rules) and that the financial adviser had breached its common law duty of care owed to the respondent by failing to take reasonable steps to ensure that the bond was suitable for his needs.

Following a trial in Slough County Court it was held that:

- There had been no negligent misstatement in respect of the bond.
- The COB Rules did not directly apply to the bond (on the basis that the bond came within the definition of a "structured deposit" rather than a "designated investment" for the purposes of those rules).
- In considering the extent of the financial adviser's duty of care, consideration should be given to the standards imposed by the COB Rules.
- The financial adviser had satisfied its duty to ensure that the relevant information about the bond was known to Mr Anderson.
- The financial adviser had <u>not</u> satisfied its duty to take reasonable steps to ensure that Mr Anderson understood the risks associated with the bond.

Issues and Decision

There were three key issues before the Circuit Court judge:

1. Whether a common law duty of care is capable of existing where there is a statutory duty of care which covers more complicated investments (in this instance the COB Rules). The Circuit Court judge held that previous cases do not exclude a common law duty of care in these circumstances.

2. Whether the standards set out in the COB Rules (specifically COB 5.2.5R, 5.3.5R and 5.4.3R) should be taken into account when assessing the standard of the common law duty of care that applied in relation to this case. The financial adviser argued that this approach was incorrect as it imposed a wider obligation on financial advisers than the applicable regulatory regime and extended standards intended for complex financial products to more basic products such as the bond purchased in this case by Mr Anderson.

The Circuit Court judge held that the first instance judge had not used the COB Rules to define the standard of the common law duty of care that applied in this case. Rather, the first instance judge "*simply and understandably made reference to them in considering the duty to be applied*", which was an entirely proper approach.

3. Whether there was in fact a breach of the common law duty of care in this case. However the Circuit Court judge found that the first instance judge was entitled to find that the financial adviser had breached its common law duty of care by not taking reasonable care to ensure that the respondent understood the nature of the risks involved relating to the bond.

Takeaway

This case is consistent with a line of authorities imposing a common law duty of care in addition to the statutory duty of care. While the statutory duty of care is not co-extensive with the common law duty of care, the content of the regulatory regime can be taken into account in considering the scope of the common law duty. In other words, if a court finds that a common law duty of care exists in circumstances where there is no directly applicable regulatory regime, that court may look to an analogous regulatory regime for guidance as to the scope of that common law duty.

Potential duty in tort on financial institutions to conduct FCA review process properly and as agreed with the FCA

In *Suremime Limited v Barclays Bank plc* [2015] EWHC 2277 (QB), the Court considered whether a bank owed private law duties in contract and/or tort to the alleged victim of a mis-sold interest rate swap, as a consequence of the bank making an offer of redress as part of a review agreed with the FCA.

Background

In 2012, the FSA (as it then was) agreed with a number of banks that they must review all sales of interest rate swaps since December 2001 and, if made to "non-sophisticated" customers, where appropriate, provide redress for mis-sold swaps on the basis of what is fair and reasonable in the circumstances.

Barclays was one of the banks that entered into this agreement. Having conducted a review, in July 2013 Barclays wrote to the claimant, Suremime Limited, saying that it was "automatically eligible for redress", and inviting it to take part in a fact finding process with its solicitors, which would be overseen by an independent reviewer.

The claimant participated in the fact finding process but was not satisfied with the formal offer of redress that was ultimately made by Barclays, on the basis that the offer allegedly contravened the principles for assessing redress as agreed between Barclays (and other banks) and the FCA.

Initially, the claimant asserted rights pursuant to the *Contracts (Rights of Third Parties) Act 1999* as a third party beneficiary of the contract with the FCA. However, this claim was abandoned as the agreement with the FCA stated expressly that third parties would have no such right.

Issue

The issue that remained was whether in making an offer of redress, Barclays owed the claimant a duty in <u>contract</u> and/or in <u>tort</u> to conduct the review in accordance with its agreement with the FCA. Barclays argued that neither claim had any real prospect of success, such that they should not be allowed to proceed.

Decision

The Court rejected the claim in contract, as there was no consideration between the claimant and Barclays. Barclays had not agreed with its customers, but with the FCA, to conduct the review of interest rate swaps. At most, Barclays had promised the claimant that it would take into account any information the claimant might provide if it participated in the fact finding review process. There was no contention that Barclays did not take this information into account, and so there was no basis to found a claim in contract.

However, the Court decided that there was a possible basis for a claim in tort. While there are possibly other public law and statutory remedies available to certain aggrieved customers (for example, through an application for judicial review or through a statutory right of action under section 138D of FSMA), such remedies do not preclude the existence of a duty in tort. In any event, the Court said that in a matter of such public importance, it was better to have the factual matrix properly ventilated at a full trial, instead of rejecting the claim at an interlocutory stage.

Takeaway

This case is important as it imposes on banks a possible duty in tort to conduct reviews properly and in a manner agreed with the FCA. In so doing, it exposes banks to additional scrutiny in the form of satellite litigation regarding the manner in which such reviews should be conducted, and allows customers of interest rate swaps another route to ventilate their concerns with the way in which their bank has conducted its review process.

Limited scope for a contractual duty to correct incorrect investment advice

In *Worthing v Lloyds Bank plc* [2015] EWHC 2836 (QB), the Court considered whether a financial institution had any continuing contractual duties following bad initial investment advice.

Background
In January 2007, just prior to the financial crisis, the Worthings made substantial investments in a managed portfolio service provided by Lloyds Bank. At a review meeting in March 2008, the Worthings maintained their investment upon the advice of Lloyds. They ultimately suffered significant losses.

The Worthings commenced a claim against Lloyds Bank, asserting negligence, breach of contract, and breach of statutory duties under FSMA and under the COBS Rules.

Decision
The Court rejected the claim, largely on the basis of factual findings that the Worthings sufficiently understood the nature of, and risk posed by, the investment. The Worthings' risk profile had not changed by the March 2008 review meeting, and Lloyds' advice to maintain the investment at that time did not contravene any common law or statutory duties.

Takeaway
The case is interesting because of what the Court did not decide, as opposed to what it decided.

The Worthings were unable to claim in respect of the initial investment advice as the limitation period has expired. They instead claimed in respect of (1) alleged negligent advice given at the March

2008 review meeting; and (2) breaches of an alleged continuing duty to correct the initial investment advice. It was in this context that the Court had to examine the initial investment advice.

Having examined the factual matrix, the Court decided that there was no initial breach of duties with regard to the initial investment advice.

However, the Court went on to decide that even if that initial advice was wrong, Lloyds was under no continuing duty to correct that initial advice. The statutory obligations to conduct investment reviews with reasonable skill and care, in accordance with the COBS Rules did not give rise to a continuing obligation in contract or in tort to correct the initial advice. Nor was there a duty to conduct a new risk assessment: all that was required was to see whether the objective and subjective circumstances had changed so as to make the investment no longer suitable for the investors.

FINANCIAL LIST

Better, Faster? The Financial List – five months on

Three recent cases transferred into the newly established Financial List demonstrate that the alacrity with which the Financial List was implemented has possibly been matched by the enthusiasm from its potential users.

These decisions together provide helpful indications of the profile of potential users of the Financial List, the types of cases that are likely to be transferred and (in due course) started in it, and the way in which such cases are likely to be managed.

Cases decided in the Financial List

Case 1: The very first case to be heard in the List was *Banco Santander Totta v Transport Companies* [2016] EWHC 465 (Comm), one of many interest rate swap cases that have made their way before the English Commercial Court over the years.

Like others before it (*Dexia Crediop Spa v Crotone, Dexia Crediop Spa v Comune di Prato*), this case concerned interest rate swaps entered into by quasi-public bodies (in this case Portuguese state-owned transport companies) under ISDA Master Agreements subject to English law and jurisdiction. At a time when interest rates were less than 1%, the transport companies were paying interest at fixed rates of up to 40% to Banco Santander. The transport companies stopped making payments in 2013 and the bank brought proceedings against them to recover payments due.

This was plainly a case for the Financial List, given that the amount in dispute totalled almost €275 million. The proceedings were transferred into the List on the application of both parties. Blair J was, however, careful to emphasise the added significance for the financial markets. Prior to his decision, there had been no decisions in any court of law on the effect of the 'snowball swaps' in issue which contained cumulative leveraged features that magnified changes in interest rates.

In a detailed and carefully structured judgment delivered a few months after the end of the trial, Blair J ultimately found for Banco Santander, emphasising the need for certainty in financial contracts. He held that the international market and standard documentation used by the parties guaranteed that the parties' choice of law prevailed over local law and that the transport companies could not deploy local law defences including lack of capacity and change of circumstances.

Whilst it is possible that a similar judgment may have been arrived at outside of the List, the precedent-setting effect and potential litigation risks for banks and financial institutions made it beneficial to have a case of this size and impact heard by a judge with particular expertise and experience in the financial markets and whose decision was likely to carry significant weight.

Case 2: *GSO v Barclays Bank* [2016] EWHC 146 (Comm) is the second case to be heard in the Financial List. This also involved issues with widespread market repercussions, concerning the contractual interpretation of standard form documents published by the Loan Market Association (the "**LMA**") governed by English law.

This is not the first time that the LMA's terms have come before the English court. The LMA's terms reached the Supreme Court in 2015 in relation to the consideration of payment premiums in *Tael One Partners v Morgan Stanley Co* [2015] UKSC 12. The LMA had publicly disagreed with the Supreme Court's interpretation of the provision in question and updated its documentation after the decision was published. The impact on the market was significant, driving home the need for these and similar matters to be dealt with by specialist judges.

On this occasion, the court was asked to consider the meaning of key terms that were universally used for loan and debt trades in the LMA's Standard Terms and Conditions for distressed transactions. The case was transferred to the Financial List at the request of all parties on the basis of its generally accepted significance for the financial markets. Interestingly, the court requested that the parties notify the LMA of the fact that the dispute involved its documentation. The relatively short judgment of Knowles J, which ultimately found for GSO, involved detailed and careful consideration of the specifics of the trades and the meaning of the disputed terms.

Case 3: The final decision, *PAG v Royal Bank of Scotland* [2016] EWHC 207, concerned an opposed application for an order that a case be transferred into the Financial List. The decision considers in some detail the matters that are likely to be taken into account when assessing the suitability of cases to be heard in the List.

This case involved, *inter alia*, claims in relation to the mis-selling of interest rate swaps by PAG against the Royal Bank of Scotland. PAG argued that the sale and recommendation of such swaps breached implied terms in certain customer agreements and/or involved actionable representations including in relation to LIBOR rates. The total value of the claim was approximately £29 million, some £21 million less than the threshold of £50 million set out in the Civil Procedure Rules. Lawyers for PAG argued, however, that the case required financial market expertise and raised issues of general market importance such that it was still suitable to be transferred.

Etherton J set out a number of factors that would be of significance when deciding to accede to applications to transfer existing proceedings in the List. These included:

- whether the case involved issues of market significance and the relative importance of those issues;
- whether the case had already been assigned to a specific judge and the extent of involvement of that judge;
- the length of time for which the proceedings have been afoot;
- the proximity to the trial date, and whether the trial timetable would be disrupted by a transfer.

Etherton J was ultimately persuaded by the fact that the misselling claims and the allegations against RBS in relation to the fixing of LIBOR raised important issues of market significance that were being litigated or likely to be litigated in future and ordered that the case be transferred into the List even though it had previously been assigned a dedicated judge in the Commercial Court.

Takeaway

It is too early to say whether the Financial List will achieve all of the stated objectives enumerated by Lord Thomas in his speech of 8 July 2015. It is no coincidence, however, that the three cases in which judgments have been delivered thus far have involved financial institutions; they are the natural users of the List and will likely be providing most of its work.

The types of cases that seem to be coming into the List are (rightly) less likely to be straightforward commercial or contractual matters (even when involving significant sums) and more often cases with wider international and market implications. As Etherton J said in *PAG v Barclays Bank*, the judges of the Commercial Court and Chancery Division are capable of handling general financial and business disputes of all kinds and even though a case might fall within the wide definition of a Financial List claim, it will not always be necessary or appropriate to hear every such claim in the List. This decision has also shown that there is willingness to exercise discretion so that cases can be admitted into the List that do not meet the financial threshold, provided that issues of wider market significance are at play.

Interestingly, there have not yet been reported decisions involving international litigants (one of the key anticipated target audiences of the List). We have also not yet seen users of the most salient feature of the Financial List – the Financial Markets Test Case Scheme. It will be interesting to see in the upcoming months whether and the extent to which this is utilised, how it is likely to work alongside market reviews and investigations by regulatory entities, and whether financial institutions are likely to refer questions to the List before entering into settlements with regulators or agreeing to voluntary agreements for redress.

UK UPPER TRIBUNAL CLARIFIES THIRD PARTY RIGHTS TO CHALLENGE FCA NOTICES

Firms and individuals prejudicially identified by a UK Financial Conduct Authority notice have the right to receive a copy of it and have reasonable time to make representations to the Authority on its contents.[4] The FCA has, however, recently fallen foul of these relatively simple obligations in a number of cases.[5]

Nevertheless, the recent decision in *Ashton v. FCA*,[6] bucked the trend when the Upper Tribunal dismissed Mr. Ashton's applications, concluding that two enforcement notices linked to the FX market manipulation scandal did not identify him and, therefore, that the FCA did not breach its statutory obligation to allow Mr. Ashton to contest its findings.

While a blow for Mr. Ashton, the decision gives useful guidance to firms and individuals considering challenging potentially prejudicial FCA notices. However, how long the guidance in *Ashton* is instructive remains to be seen with the Supreme Court due to decide

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4 *See*, Financial Services and Markets Act 2000, Section 393.

5 *See*, *Christian Bittar v. The Financial Conduct Authority* [2015] UKUT 602 (TCC) and *The Financial Conduct Authority v. Macris* [2015] EWCA Civ 490.

6 *Christopher Ashton v. The Financial Conduct Authority* [2016] UKUT 0005 (TCC)

the FCA's appeal in the leading case in this area, *Macris*,[7] this Autumn.

That said, the FCA's recent fine against Mr. Macris for almost £800,000[8] for his involvement in the London Whale case may have diminished his desire to fight the Authority's appeal. In any event, *Ashton* is instructive in the meantime.

Mr. Ashton's Claim

In November 2014 and May 2015 the FCA fined UBS and Barclays £234 million and £284 million respectively for serious failings linked to attempts to manipulate FX markets. During the period of misconduct, Mr. Ashton was Global Head of G10 Voice Spot FX at Barclays in London and a member of the now notorious "Cartel" chat room that allegedly conspired to rig FX markets.

Having read the notices against the two banks, Mr. Ashton recognised that they reproduced chat logs containing his words, albeit attributed to "Firm A" in the UBS notice and "Barclays" in its notice.

Given his previous role at Barclays and widespread media reports that he was a member of prominent chat rooms linked to FX manipulation, Mr. Ashton argued that readers would reasonably conclude that the references to "Firm A" and "Barclays" were in fact references to him personally and prejudicial to his reputation.

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7 *The Financial Conduct Authority v. Macris* [2015] EWCA Civ 490

8 *See*, http://www.fca.org.uk/news/former-jp-morgan-cio-international-head-fined

Accordingly, Mr. Ashton argued that the FCA failed to meet its statutory obligation[9] to give him:

1. a copy of the notice; and

2. reasonable time to make representations to the Authority regarding its contents.

The Upper Tribunal's Finding
In deciding Mr. Ashton's application, the Upper Tribunal applied the Court of Appeal's test from *Macris*, a similar and successful claim brought by a senior JP Morgan banker arising out of the FCA's enforcement notice in the London Whale case.

The Tribunal applied the two stage Macris test and asked whether the relevant portion of the notices:

1. identified a third party other than the banks themselves; and

2. would reasonably lead persons acquainted with Mr. Ashton or who worked in his areas of expertise, to believe that he was the person referenced.

The Upper Tribunal easily disposed of the first question, finding that references to "Firm A" and "Barclays" in the chat logs necessarily referred to a specific individual participant.

The Upper Tribunal, however, rejected Mr. Ashton's case at the second stage, finding that, notwithstanding Mr. Ashton's prominent position in the FX industry, there was nothing in the notices that would enable a relevant third party to identify him.

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[9] *See*, Financial Services and Markets Act 2000, Section 393.

Takeaway

Nevertheless, the Upper Tribunal gave important guidance on the second limb of the *Macris* test.

First, while the second stage should be answered by reference to information in the public domain, knowledge that "can only be obtained by extensive investigation" will not be relevant. The test does not assume any sort of "extensive forensic exercise" and the test is not satisfied just because it is "logically possible" to identify the third party from public information.

Second, a relevant "acquaintance" is not someone who was involved in the conduct in question, or has intimate knowledge of the events or of the individual identified. For example, someone who sat next to the individual in the office is not a relevant person for the test. However, a counterpart at another bank working in the same area would be.

Third, while far from determinative given the objective nature of the test, evidence from individuals who have managed to identify the person from the notice may be helpful to an applicant's case and applicants should adduce it where possible.

Fourth, as a matter of good practice, the applicant themselves should provide a witness statement to assist the Tribunal or Court (which Mr. Ashton did not do).

Those who feel they have been prejudicially identified by an FCA notice and not received their proper protections should keep all of these points in mind when deciding whether to challenge the FCA. However, until and if the Supreme Court decides *Macris* this Autumn, anyone considering a challenge should remember that the state of play is far from settled.

Section C: US Banking and White Collar Litigation Update

FCPA LIABILITY, FOREIGN OFFICIALS AND THE MEANING OF A "THING OF VALUE"

Since August 2013, the legal community has debated whether and how the US Securities and Exchange Commission ("SEC") and the US Department of Justice ("DOJ") would address the hiring by a number of US-based financial institutions of relatives of foreign officials for prestigious jobs and internships in connection with efforts to win or retain business.

This debate was resolved in part with the August 2015 announcement by the SEC of a settled Cease-and-Desist Order ("Order") against Bank of New York Mellon Corporation ("BNYM"). The SEC alleged, and BNYM neither admitted nor denied, charges related to the bank's hiring of three interns who were related to officials employed by a Middle Eastern sovereign wealth fund (the "Sovereign Wealth Fund") that placed assets for management with the bank. The SEC put forward an expansive view of how the Foreign Corrupt Practices Act ("FCPA") applies in this context, particularly with respect to the definition of "thing of value" and how a benefit provided to a foreign official's relative could qualify as conferring a thing of value.

The BNYM case concerned certain subsidiaries of BNYM's global investment management division (the "BNYM subsidiaries") that had a long relationship with the Sovereign Wealth Fund. The Order alleges that, in about February 2010, two officials employed by the Sovereign Wealth Fund, who had discretion over whether to maintain or place new assets for management with the BNYM subsidiaries, asked BNYM to hire three individuals for internships, and that the bank granted the requests. As the Order notes, "delivering the internships as requested was seen by certain relevant BNY Mellon employees as a way to influence the officials' decisions."

The first official, "Official X," requested internships for his son and his nephew, allegedly calling the requests an "opportunity" for the BNYM subsidiaries and suggesting that, alternatively, he could "secure internships for his family members from a competitor of BNY Mellon." BNYM sought to accommodate the requests, despite their "personal" nature, allegedly believing that "by not allowing the internships to take place, we potentially jeopardize our mandate" with the Sovereign Wealth Fund. One employee allegedly expressed a desire to obtain "more money for this," given that the bank was "doing [Official X] a favor."

At about the same time, the second official, "Official Y," sought an internship at BNYM for his son. The relevant BNYM relationship manager allegedly explained to more senior officers at BNYM that granting the request was likely to "influence any future decisions taken within the [Sovereign Wealth Fund]," and that if BNYM did not hire the official's son as an intern, one of its competitors would, potentially resulting in BNYM's loss of market share. The relationship manager allegedly expressed a belief that it is "silly things like this that help influence who ends up with more assets / retaining dominant position," and that granting the official's request was the "only way" to increase BNYM's market share with the Sovereign Wealth Fund.

The bank ultimately hired the three interns, allegedly with the "support" and "blessing" of "senior BNY Mellon employees." Two of the internships were in Boston, and the third was in London; one was unpaid. The Order alleges that the candidates did not have the necessary qualifications to be hired through BNYM's ordinary internship hiring process and were not hired through that process, that the internships were "customized one-of-a-kind training programs" that lasted longer than BNYM's standard summer internships and that these bespoke internships, unlike the other internships, were not expected to lead to full-time employment. The Order alleges that the interns proved to be "less than exemplary." It also alleges that BNYM coordinated obtaining visas for the interns and that BNYM paid the associated legal costs.

The Sovereign Wealth Fund remained a client of the BNYM subsidiaries, placing an additional $689,000 with BNYM shortly before the internships began. This additional placement made up only a small portion of the approximately $55 billion in Sovereign Wealth Fund assets held by BNYM during the relevant period.

The SEC charged BNYM with violating the FCPA's anti-bribery provisions "by corruptly providing valuable internships to relatives of foreign officials from the Middle Eastern Sovereign Wealth Fund in order to assist BNY Mellon in retaining and obtaining business," as well as with failing to "maintain a system of internal accounting controls sufficient to provide reasonable assurances that its employees were not bribing foreign officials." Although the practice of hiring relatives of well-connected individuals had been well known for years without the SEC taking action, and even though in 2010 very few compliance programs had specific controls related to hiring relatives of foreign officials, the SEC found fault with BNYM's compliance program.

As noted in the Order, although the bank had "a specific FCPA policy" in place during the relevant period, the SEC faulted BNYM for not providing employees with tailored training and guidance regarding hiring-related risks. The SEC did commend BNYM for "enhancing its anti-corruption compliance program," even before the SEC's investigation began, and noted the bank's remediation. BNYM paid disgorgement of $8.3 million, prejudgment interest of $1.5 million and a penalty of $5 million.

The SEC did not explain how experience provided to an official's adult relative constituted a benefit to the official absent the official's legal obligation to support that relative. Instead, the SEC stated that "[t]he internships were valuable work experience, and the requesting officials derived significant personal value in being able to confer this benefit on their family members." The BNYM Order, moreover, did not articulate any tie to a concrete business opportunity and did not identify the rationale for the $8.3 million disgorgement amount, given that the investment associated with the internships was less than $1 million. Although the SEC appears to have followed the "quid pro quo lite" theory from criminal domestic bribery prosecutions, the case does little to lessen the opacity of the way US agencies approach the task of settling the terms of FCPA resolutions.

Takeaway

By also including allegations of internal controls failures, the BNYM Order likely will be viewed as putting other FCPA-covered companies that are exposed to similar risks on notice that the SEC views targeted training efforts and other controls as required elements of an adequate system of internal controls. Based on the order, a list of steps companies can take to reduce risk in this arena includes:

- Developing anti-corruption policies and training programs that explicitly address the hiring of government officials' relatives;
- Routing applications for employment (full-time or internship) through a centralized human resources process;
- Requiring employees to certify (on an annual or other periodic basis) that they have not circumvented or made hires outside of that centralized process;

- Requiring candidates for employment to indicate as a standard process step whether they are related or closely associated with a current or recent government official; and
- For cases involving a connection to a foreign official, requiring that the application be reviewed by the company's anti-corruption compliance group.

STATEMENTS OF OPINION UNDER SECTION 11 OF THE SECURITIES ACT

In *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, 135 S. Ct. 1318 (2015), the US Supreme Court resolved a circuit split and clarified a key issue in securities litigation—namely, the circumstances under which a statement of opinion in a registration statement constitutes an untrue statement of fact such that it gives rise to liability under Section 11 of the Securities Act of 1933. Section 11 provides that issuers of securities and other associated persons may be held liable if a registration statement either contains "an untrue statement of material fact" or "omits to state a material fact required to be stated therein or necessary to make the statements therein not misleading." The opinion has already had an observable effect on fraud-based securities litigation.

The Court held that a statement of opinion in a registration statement does not constitute an untrue statement of fact giving rise to liability under Section 11 of the Securities Act of 1933 simply because it ultimately proves to be incorrect. Instead, a statement of opinion constitutes an "untrue statement of material fact" for the purposes of Section 11 only if the issuer does not genuinely believe the opinion and gives rise to liability for "omit[ting] to state a material fact" only if the issuer omits a material fact regarding the basis for its opinion that renders the opinion misleading to a reasonable person.

The Court took issue with the Sixth Circuit's expansive approach to Section 11 liability, which enabled a genuinely believed statement of opinion to be treated as an "untrue statement of a material fact" simply because it ultimately proved to be incorrect. It rejected that approach as contrary to statutory language and as conflating the difference between statements of fact and statements of opinion. A statement of opinion, the Supreme Court explained, explicitly affirms only that "the speaker actually holds the stated belief." Therefore, a statement of opinion is an untrue statement of fact only if the speaker does not genuinely believe the opinion expressed.

As to the question of when an omission can render an opinion misleading, the Court noted that a statement of opinion may imply that certain steps were taken in forming the expressed opinion. Accordingly, the Court held that an issuer may be liable, even for a genuinely held opinion, under Section 11 "if a registration statement omits material facts about the issuer's inquiry into or knowledge concerning a statement of opinion, . . . if those [omitted] facts conflict with what a reasonable investor would take from the statement itself." The Court emphasized that whether an omission renders a statement of opinion misleading must be determined by taking into account factors that a reasonable investor would consider (such as the customs and practices of the relevant industry) and in the context of the registration statement as a whole, including "hedges, disclaimers and apparently conflicting information."

Following *Omnicare*, pleading a Section 11 claim with respect to a statement of opinion based on omitted facts will require a higher level of specificity: "a plaintiff must identify particular (and material) facts going to the basis for the issuer's opinion . . . whose omission makes the opinion statement at issue misleading." The Court also instructed that to avoid liability, issuers can divulge the bases of an opinion or otherwise make clear that the opinion is tentative in nature.

Takeaway

Since being decided, *Omnicare* has been cited in over forty lower court orders and decisions. Lower courts have permitted plaintiffs to amend their complaints and invited litigants to submit supplemental briefings focused on plaintiff's pleadings in light of *Omnicare*.

It seems clear from the *Omnicare* opinion that issuers face a diminished risk of incurring securities fraud liability for stating an untrue fact when disclosing statements of opinion formed with a reasonable basis. However, even if an issuer *actually believes* an opinion statement, the omission of facts that go to the reasonableness of the basis for that statement may nevertheless subject it to Section 11 liability.

DODD-FRANK ANTI-RETALIATION PROVISION CIRCUIT SPLIT

Recent federal appellate and district court decisions have created increasing legal uncertainty around the question of who is a protected whistleblower under Dodd-Frank's anti-retaliation provision. The Second and Fifth Circuits have come to opposite conclusions on the issue, and the Sixth Circuit is set to hear an appeal on the question.

Under Dodd-Frank, whistleblowers are protected from any manner of discrimination in the terms and conditions of their employment because of their lawful acts. However, who exactly is entitled to such protections is unclear. Section 21F(a)(6) of the Act defines "whistleblower" as someone who "provides … information … *to the Commission*" (i.e. the Securities Exchange Commission ("SEC")). Another provision of the Act, Section 21F(h)(1)(A)(iii), states that whistleblowers who make disclosures required or protected by various laws and rules, including Sarbanes-Oxley, are protected. Several Sarbanes-Oxley provisions require *internal* reporting of securities law violations or improper practices. The Securities Exchange Commission ("SEC") argues that the two sections—one requiring external reporting and the other seemingly only internal reporting—are in tension, and therefore ambiguous. In its 2011 rules implementing the whistleblower provisions of the Act, the SEC took a broad view of who qualifies as a "whistleblower" and the rules do not require external reporting to the SEC.

The Fifth Circuit, in *Asadi v. G.E. Energy (USA), LLC*, 720 F.3d 620 (5th Cir. 2013), considered the propriety of the SEC's 2011 rules. It expressly "reject[ed] the SEC's expansive interpretation of the term 'whistleblower' for purposes of the anti-retaliation provision" and held that the plain language of the statute provides protection only to whistleblowers who provide information to the SEC. After all, it noted, 21F(a) defines whistleblower as an individual who reports to the Commission. It observed that 21(F)(h) does not purport to define the term "whistleblower." Instead, it provides a list of activities that are protected when engaged in by someone meeting the definition of whistleblower set forth in 21(F)(a). The court held that its reading of the statute does not render 21F(h)(1)(A)(iii) superfluous because that provision would still protect an individual who simultaneously reported internally and externally.

In September 2015, a divided panel of the Second Circuit Court of Appeals came to the opposite conclusion. In *Berman v. Neo@Ogilvy LLC*, 801 F.3d 145 (2d Cir. 2015), the court held that 21F(h)(1)(A)(iii) and 21(F)(a) were in sufficient tension that the SEC's implementing rules were entitled to deference, and that therefore internal reporting of alleged wrongdoing is sufficient to trigger protection under Dodd-Frank's anti-retaliation provision. The appellate court found that the Fifth Circuit's reading of

21F(h)(1)(A)(iii) would so significantly limit the scope of that provision that the provision would be left virtually meaningless. It provided two rationales for its conclusion: *first*, few whistleblowers are likely to report wrongdoing to the government simultaneously with an internal report; and *second*, several Sarbanes-Oxley provisions prohibit auditors and attorneys from reporting wrongdoing to the SEC until after they have reported the wrongdoing to their employer. Because adopting the Fifth Circuit's reading would render 21F(h)(1)(A)(iii) essentially meaningless, and because the court did not think it clear that the conferees who adopted 21F(h)(1)(A)(iii) intended for that provision to be rendered meaningless, the Second Circuit found the provision sufficiently ambiguous that the SEC's implementing rules were entitled to deference.

Two federal district courts—one in the Fourth Circuit and one in the Sixth Circuit—have subsequently issued decisions on this question. In both *Verble v. Morgan Stanley Smith Barney, LLC*, No. 3:14-CV-74, 2015 WL 8328561 (E.D. Tenn. Dec. 8, 2015) and *Puffenbarger v. Engility Corp.*, No. 1:15-cv-1888, 2015 WL 9686978 (E.D. Va. Dec. 31, 2015), the courts sided with the Fifth Circuit. The *Verble* case has already been appealed to the Sixth Circuit Court of Appeals.

Takeaway

These recent decisions highlight the legal uncertainty around the question of who is a protected whistleblower under Dodd-Frank's anti-retaliation provision. They also underscore the importance of ensuring robust policies and procedures relating to internal reporting of violations. Since the implementation of Dodd-Frank, there has been a rise in the number of whistleblower complaints received by the SEC each year. This is an area of particular focus for the SEC as well as private litigants. Companies should regularly monitor and test the effectiveness of their whistleblower policies and procedures in order to mitigate risks associated with potential whistleblower retaliation claims.

EVIDENTIARY OBSTACLES TO PROSECUTIONS OF INDIVIDUAL DEFENDANTS

The SEC and the DOJ were recently handed losses in two high-profile appeals involving professionals in the fixed-income industry. On December 8, 2015, in *Flannery v. SEC and Hopkins v. SEC*, 810 F.3d 1 (1st Cir. 2015),[10] the First Circuit reversed an SEC Order that had fined two former State Street Global Advisors employees for allegedly providing misleading information regarding a bond fund during the 2007 subprime mortgage crisis. On the same day, the Second Circuit issued a decision in *United States v. Litvak*, 808 F.3d 160 (2d Cir. 2015), vacating former Jefferies Group trader Jesse Litvak's criminal conviction in the District of Connecticut for securities fraud. The opinions underscore evidentiary obstacles that the government faces in actions against individual defendants, particularly in proving materiality and scienter.

The two First Circuit cases were originally brought in 2011 as an administrative proceeding against John Flannery and James Hopkins for allegedly failing to adequately disclose the exposures of a bond fund that was largely invested in subprime mortgage-backed securities. After an 11-day hearing, the SEC's Chief Administrative Law Judge ("ALJ") dismissed the proceeding, but a divided panel of SEC Commissioners subsequently reversed the ALJ and found the defendants liable for various fraud charges under Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.

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10 The petitions were reviewed jointly.

In vacating the Order, the First Circuit held that the Commission's findings did not meet the burden of demonstrating "substantial evidence" of culpability. The ruling emphasized that the Commission had not pointed to any actual investors who could testify to the materiality of a presentation that was at issue, had "failed to identify a single witness that supports a finding of materiality" as to statements in letters providing investment advice to clients, and had not affirmatively shown that any one statement in the client letters was inaccurate.

In finding an absence of substantial evidence, the court emphasized that neither Flannery nor Hopkins bore responsibility for alleged misstatements in certain of the documents. For statements that were made by the individuals, the court explained that the materiality and scienter analyses are interrelated, and concluded that the Commission's "thin materiality showing cannot support a finding of scienter." The court added that even if it were to accept that a slide prepared by Hopkins was misleading, it did not necessarily follow that the misstatement was material to investors, or that it met the evidentiary burden of demonstrating "highly unreasonable" actions necessary for a finding of recklessness under Section 17(a)(1), Section 10(b) and Rule 10b-5.

The same day that the *Flannery* decision came down in the First Circuit, the Second Circuit overturned the 2014 conviction of Jesse Litvak, a former fixed-income trader with Jefferies & Company, a global securities broker-dealer and investment banking firm. Among other charges, Litvak had been charged with making misleading statements to purchasing counterparties (including the US Treasury) about residential mortgage-backed securities prices in order to maximize Jefferies' profit margin on the transactions.

As in the First Circuit opinion, the *Litvak* decision centered around the government's materiality arguments. The Second Circuit reversed Litvak's conviction for fraud against the United States on the grounds that the evidence presented at trial, which did not show that Litvak's statements influenced any actual government decision, was an insufficient basis for a rational jury to find that they were material to the government under the applicable statutes. Proceeding to Litvak's conviction for securities fraud, the court found that there was sufficient evidence to support a jury's finding that Litvak's misrepresentations were material and that the scienter element was satisfied. Nevertheless, the court vacated Litvak's conviction for securities fraud, and remanded for a new trial on those charges, on the grounds that the district court exceeded its discretion by excluding portions of testimony from the defense's expert witness that went to the issue of materiality.

In reaching these conclusions, the Second Circuit highlighted the district court's exclusion of expert testimony that investment managers typically conduct their own research to determine fundamental values of a security and tend to disregard statements of traders as relevant only to the "price" and not the "true value" of a bond. The court observed that "[t]he full context and circumstances in which RMBS are traded were undoubtedly relevant to the jury's determination of materiality," and held that without this relevant evidence, the jury could not properly weigh the question of importance to investors.

The court also held that the district court exceeded its discretion in excluding testimony that Litvak's supervisors at Jefferies regularly approved of conduct that was identical to Litvak's. The Second Circuit viewed this evidence as relevant in determining whether Litvak "held an honest belief" that his actions were proper and lawful, disagreeing with the lower court's characterization of the evidence as merely "suggesting that everybody did it and therefore it isn't illegal."

Takeaway

These significant rulings emphasize the government's heavy burden in proving market-based securities fraud offenses in both civil and criminal contexts. Regulators face particularly challenging obstacles in enforcement actions concerning specialized over-the-counter markets, which operate in a manner distinct from the more transparent equities market. As these rulings demonstrate, federal courts will continue to closely analyze the government's evidentiary showings of materiality and scienter, even, as in *Flannery*, where the Commission itself has found that the necessary burdens were met.

The rulings further demonstrate that individual prosecutions—something both the DOJ and SEC have stressed as essential components of their enforcement agendas—will continue to be a double-edged sword for the government, as individuals are more likely than companies or regulated entities to litigate and challenge aggressive enforcement theories.

IRAN SANCTIONS RELIEF

On January 16, 2016, the International Atomic Energy Agency announced that Iran had completed the necessary preparatory steps to mark "Implementation Day" under the Joint Comprehensive Plan of Action ("JCPOA"). As a consequence, US Secretary of State John Kerry confirmed that US sanctions relief under the JCPOA was now in effect.

The United States took a number of different actions to implement its commitments under the JCPOA, and the US Treasury Department's Office of Foreign Assets Control ("OFAC") has issued detailed guidance as well as a set of frequently asked questions and answers about these changes. The changes highlighted here are those that relate most closely to banking and regulatory matters.

The changes to US sanctions apply principally to the Iran-related "secondary sanctions," which, as discussed below, affect transactions by non-US companies that occur outside the United States. Primary US sanctions that generally prohibit persons in the United States and US companies and individuals anywhere in the world from dealing with Iran largely remain in effect. In particular, transactions with Iran that involve the US banking system (including "U-turn" transactions) remain strictly prohibited.

Nuclear-Related Secondary Sanctions Suspended

The United States has suspended "secondary sanctions" imposed due to concerns about Iran's nuclear program, although secondary sanctions against companies dealing with Iranian entities on the Specially Designated Nationals ("SDN") list and certain other secondary sanctions remain in force.

"Secondary sanctions" were rules adopted by the United States to apply sanctions primarily against non-US companies and individuals that engage in significant dealings with Iran (including with respect to its energy, petrochemical, banking and other sectors). Under the US secondary sanctions regime, non-US persons and entities engaging in any of the sanctioned activities with Iran may be subject to a number of restrictions imposed by the US government, up to and including being restricted from accessing the US financial and banking system and being prohibited from engaging in business with the United States. Faced with this threat, many non-US companies that otherwise are not required to comply with US sanctions have decided to abstain from Iran-related transactions.

As of January 16, 2016, the United States has largely suspended the secondary sanctions imposed on Iran due to its nuclear program. This is a very important change, as it will allow Iran, among other things, to resume crude oil exports to many countries and once again to have access to the global banking system, as long as no US financial institutions are involved. Among the secondary sanctions that have been suspended are those that relate to transactions by non-US persons with Iran's financial, banking and insurance sectors (including sanctions on transacting with Iranian banks).

Non-US Entities Owned or Controlled by US Persons Allowed to Transact Business with Iran

The United States has authorized non-US subsidiaries of US companies to engage in most dealings with Iran, although restrictions on participation by the US parent companies remain.

In 2012, US primary sanctions were extended to non-US entities owned or controlled by a US person, such as foreign subsidiaries of US companies. In the JCPOA, the United States committed to permitting non-US entities owned or controlled by a US person to engage in activities with Iran consistent with the JCPOA. Implementing this commitment, OFAC has issued Iran General License H, which authorizes US-owned or US-controlled foreign entities to engage in most transactions that would otherwise have been prohibited.

Certain restrictions remain. The non-US subsidiaries may not export, sell, or supply any US-origin goods, services, or technology to Iran, nor may they engage in Iran-related transactions that involve the use of US depository institutions or US-registered broker-dealers to transfer funds.

Significantly, General License H permits US persons to engage in certain limited categories of activities with regard to non-US subsidiaries that otherwise likely would be prohibited as “facilitation” under the US sanctions laws. These activities include allowing US persons to establish or alter policies to allow their foreign subsidiaries to do business with Iran, and permitting foreign subsidiaries and affiliates to use a US parent’s “automated and globally integrated” support systems such as email or document management systems in support of transactions with Iran. This license allows, in effect, US parent companies to take the necessary steps to re-enable their non-US subsidiaries to do business with Iran.

Apart from these limited authorizations, however, the United States has not lifted the prohibition on facilitation or approval by US persons of transactions that they could not engage in directly. Therefore, non-US subsidiaries and affiliates of US companies, while allowed to conduct the specified transactions with Iran, must act independently of their US parent companies in any Iran-related activities they choose to undertake. US persons employed by or on the boards of directors of non-US companies must continue to take care not to approve or facilitate transactions involving Iran.

Continued Application of Disclosure Requirements for Securities Issuers
Section 13(r) of the Securities Exchange Act continues to require issuers with securities trading on US exchanges to disclose certain transactions involving Iran in their annual and quarterly reports filed with the Securities and Exchange Commission (“SEC”), even if the transactions are not material. The disclosure requirement applies to knowing transactions by the issuer or its affiliates with the Government of Iran (defined to include entities owned or controlled by the Government of Iran), unless licensed, or with Iranian SDNs listed for nonproliferation or antiterrorism reasons. It also applies to transactions that fall within the scope of Section 5(a) of the Iran

Sanctions Act ("ISA") as amended, which includes many types of transactions related to Iran's energy sector, as well as transactions falling under certain other provisions regarding facilitation of proliferation of weapons of mass destruction and human rights abuses.

Transactions related to the Iranian energy sector that fall within the scope of Section 5(a) of the ISA must continue to be reported by both US and non-US issuers listed on US exchanges. Based on past guidance from SEC staff, transactions by foreign subsidiaries of US companies with the Government of Iran, if authorized by General License H (and as long as they are not transactions related to Iran's energy sector within the scope of Section 5(a) of the ISA), will not need to be disclosed under Section 13(r) because they have been licensed by OFAC. At this time, it appears that disclosure requirements with respect to issuers or affiliates of issuers not owned or controlled by US persons would not be similarly exempted from reporting, because their transactions with the Government of Iran are not within the scope of General License H. The reduction in the number of entities on the SDN list for nonproliferation reasons means that transactions with the delisted entities will no longer need to be reported under Section 13(r), if they are not energy-sector-related transactions within ISA Section 5(a) and are not sanctionable as involving facilitation of weapons proliferation or human rights abuses.

Nuclear-Related Designees Removed from US Sanctions Lists, But Some Assets Remain Blocked

The United States removed over 400 individuals and entities specified in the JCPOA from the SDN, Foreign Sanctions Evaders and the Iran Sanctions Act Lists. Those delisted include, among many others:

- The Central Bank of Iran and certain government departments, including the Ministry of Energy and the Ministry of Petroleum;
- Most Iranian financial institutions;
- Many shipping and trading companies;
- Numerous aircraft and vessels; and
- Many major Iranian energy companies and their foreign affiliates, including the Islamic Republic of Iran Shipping Lines, National Iranian Oil Company, Naftiran Intertrade Company and National Iranian Tanker Company.

The de-listing of these 400 individuals and entities has different implications for US and non-US persons. Non-US persons may deal with any of these individuals and entities without triggering secondary sanctions implications. US persons, however, may still be restricted from dealings with many of the delisted parties because they are owned or controlled by the Government of Iran ("GOI") or are Iranian financial institutions. US persons continue to be restricted from engaging in transactions with such entities and must continue to block any property of such entities. To help US persons meet their continuing compliance obligations, OFAC will maintain a new list of entities (the Executive Order 13599 List) that the US government has identified as falling within the definition of the GOI or an Iranian financial institution.

Consequences for Business

The principal sanctions relief contemplated by the JCPOA is now in effect. For most non-US companies, Iran is now open for business. However, important restrictions remain and are worth highlighting, including that:

- US-owned or -controlled entities must ensure sufficient independence in their Iran-related activities to ensure that their

US parent companies and affiliates do not engage in prohibited approval or facilitation of Iran-related transactions;

- The primary US embargo on Iran continues in full force and prevents US persons, including US financial institutions, from directly or indirectly engaging in or supporting any business involving Iran. This means that all Iran-related business must continue to be screened from the US financial system;
- Other concerns may arise from the US secondary sanctions that remain in force, such as dealing with an Iranian person that remains, or is later placed, on the SDN list. Understanding Iranian partners will remain an important diligence step as companies consider the newly opened markets;
- Companies in countries other than the United States and EU member countries that have maintained sanctions on Iran will need to confirm that their countries' sanctions have been lifted before proceeding to do business with Iran; and
- Mechanisms exist in the JCPOA for the "snap-back" of sanctions in the case of certain future events. Companies may need to be mindful of this risk.

POST-NEWMAN INSIDER TRADING LIABILITY

On October 5, 2015, the Supreme Court of the United States denied certiorari in *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), cert. denied, 136 S. Ct. 242 (Oct. 5, 2015), leaving the Second Circuit's insider trading decision undisturbed. In *Newman*, the Second Circuit held that to establish insider trading tippee liability, the government must prove that the tippee knew: 1) that the tipper breached a fiduciary duty by disclosing material, non-public information *and* 2) that the tipper received a personal benefit by disclosing the information.

In reversing the convictions of hedge fund managers Todd Newman and Anthony Chiasson, the Second Circuit found that the government's evidence was insufficient to prove that the corporate insiders had obtained any personal benefit in exchange for their tips, stating that proof of a personal benefit cannot be inferred from "the mere fact of a friendship, particularly of a casual or social nature" between the tipper and tippee. Rather, the government must present some proof "of a meaningful[] close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." The court added that in this case, even if there was sufficient proof of a personal benefit, there was no evidence that the defendants knew of that benefit.

The sweeping nature of *Newman* led many to opine that the decision represents a seismic shift in insider trading liability, as it would be a challenge for the government to demonstrate knowledge of personal benefit by tippees. A review of *Newman*'s progeny, however, suggests that, although significant, the prediction that *Newman* will severely limit insider trading investigations and prosecutions going forward might be overstated.

Recent Second Circuit Case Law Applying Newman

Following *Newman*, several defendants facing insider trading allegations moved to withdraw guilty pleas or vacate convictions of insider trading based on the new standard, to varying results.

In *United States v. Conradt*, No. 12-887, 2015 WL 480419 (S.D.N.Y. Jan. 22, 2015), four of five defendants had pled guilty to trading on inside information concerning IBM Corp.'s $1.2 billion purchase of SPSS, Inc. The government alleged that one of the defendants had received a tip from a friend who was an associate at a prominent law firm and had been working on the IBM deal. After receiving the tip, the analyst allegedly passed it along to his roommate, a trader, who traded on the information and tipped the information to three other traders, all of whom traded on the information in their personal accounts. The government's indictment contained no obvious allegations that the law firm associate who provided the inside information received a benefit for that disclosure.

After additional briefing from the parties regarding the applicability of *Newman*, the district court vacated the guilty pleas, finding them to be insufficient in light of *Newman*'s two tippee knowledge requirements. Importantly, the court echoed the Second Circuit's pronouncement in *Newman* that "the elements of tipping liability are the same, regardless of whether the tipper's duty arises under" the classical theory—whereby a corporate insider trades on the basis of material, non-public information—or the misappropriation theory—whereby a corporate outsider trades on such information—of insider trading liability. Following the district court's ruling, the government sought to dismiss the charges against all five defendants, admitting that it lacked the evidence to establish personal benefit or knowledge thereof.

In *United States v. Riley*, 90 F. Supp. 3d 176 (S.D.N.Y. 2015), a jury convicted Riley for tipping material non-public information after the court instructed that it could convict if the insider provided the information for the purpose of "maintaining or furthering a friendship." Riley unsuccessfully argued that, in light of *Newman*, this jury instruction was plain error.

The district court acknowledged that under *Newman*, "the mere fact of a friendship, particularly of a casual or social nature," between the tipper and tippee is not sufficient to establish a personal benefit. The court nonetheless denied the motion for a new trial: while the instruction may have been erroneous, it was not plain error, as the instruction did not permit the jury to convict Riley *solely* because the tippee and Riley were friends. Instead, the instruction "required that the tip be given to maintain or further a friendship." The court concluded that if a tip maintains or furthers a friendship, it is circumstantial evidence that the friendship is a *quid pro quo* relationship. Furthermore, the district court also found that Riley received three other concrete benefits that satisfied *Newman*: aid to his business, investment advice resulting in profitable trades and assistance in trying to secure a new job.

In *United States v. Gupta*, 111 F. Supp. 3d 557 (S.D.N.Y. 2015), the district court rebuffed Gupta's attempts to "take advantage" of *Newman* in moving to vacate his sentence under 28 U.S.C. § 2255—a provision entitling sentenced prisoners to petition for relief on the ground that their sentence is in violation of the Constitution or laws of the United States. Gupta, a former member of the Goldman Sachs Board of Directors, had been charged with providing inside information to Raj Rajaratnam, with knowledge that the tip would in turn be used to buy and sell securities. He was convicted on four separate counts, including fraud and conspiracy to commit securities fraud. Describing the motion as "too late and too little," the court found that because Gupta failed to raise the argument that the jury instruction was erroneous on direct review, he could not now raise that argument on a § 2255 motion.

The district court proceeded to reject Gupta's argument that *Newman* requires that a tipper such as Gupta receive from his tippee a "quid pro quo" in the form of "a potential gain of a pecuniary or similarly valuable nature." The district court observed that *Newman* was fundamentally concerned with what evidence of a personal benefit could reasonably support an inference of knowledge on the part of a remote tippee—and did not suggest that in all circumstances a potential pecuniary benefit must be obtained by the tipper. In this case, the court observed, Gupta was the tipper and consequently what the tippee Rajaratnam knew was irrelevant to Gupta's own liability.

The district court further found that even if the personal benefit element did apply to tippers, the burden of proof was satisfied in Gupta's case. At trial, the evidence had established that Gupta and Rajaratnam were close business associates with a "considerable history" of exchanging financial favors. The district court found that the tips, which conveyed non-public information about a $5 billion investment in Goldman Sachs as well as an unprecedented quarterly loss, were "objective, consequential and represent[ed] at least a potential gain of a pecuniary or similarly valuable nature." Further, because Gupta was an investor in the fund managed by Rajaratnam, any tips on which Rajaratnam traded had the potential to increase the value of Gupta's shares.

Interestingly, Rajaratnam, who was convicted of fourteen counts of securities fraud and conspiracy to commit securities fraud and is currently serving an eleven-year prison term, has also moved to vacate five of those securities fraud counts under *Newman*. His motion is still pending, as are similar motions challenging other insider trading convictions, suggesting that courts will continue to grapple with how to apply *Newman* retroactively.

The government has also effected a strategic retreat in cases with seemingly unfavorable facts. After the Supreme Court denied certiorari in *Newman*, US Attorney Preet Bharara indicated that charges would be dropped against Michael Steinberg, the former SAC Capital Advisors LP portfolio manager convicted of insider trading, as well as six cooperating witnesses who pled guilty in connection with the government's cases against Steinberg, Newman and Chiasson.

Courts are also grappling with the impact of *Newman* in civil proceedings. In the companion SEC enforcement action to *United States v. Conradt*, *SEC v. Payton*, 97 F. Supp. 3d 558 (2015), the district court denied a motion to dismiss by two of the alleged remote tippees accused of trading on inside information. Defendants argued that under *Newman*, the SEC failed to adequately allege either that the original tipper received a personal benefit in exchange for disclosing the inside information, or that defendants knew of any such benefit.

The district court noted that post-*Newman* it was unclear when a benefit can be inferred from a personal relationship. Nevertheless, it held that even under the "more onerous standard of benefit" set forth in *Newman*, the SEC had adequately alleged personal benefit by presenting evidence that the direct tippee and tipper "shared a close mutually-dependent financial relationship, and had a history of personal favors" and that their expenses were intertwined. Moreover, the court found that even though the alleged remote tippees arguably had no specific knowledge of a personal benefit, the SEC had plausibly pled that they knew, *inter alia*, that (1) the tipper was the source of the inside information, (2) the tipper and tippee were friends and roommates and (3) the tipper had legal troubles. The district court found that this circumstantial knowledge was sufficient, at least under the burden of proof in a civil action, "to raise the reasonable inference that the defendants know that [tipper's] relationship with [tippee] involved reciprocal benefits."

Payton raises the suggestion that, in spite of *Newman*, district courts may be reluctant to dismiss cases where the SEC has articulated a colorable claim of personal benefit.

Legislative Focus on Insider Trading Following Newman

One of the more interesting developments to follow *Newman* was the introduction of several pieces of proposed legislation intended to define prohibited insider trading. Each of these bills, as currently proposed, would reverse the precedent set by *Newman* and potentially call into question certain other aspects of decades of Supreme Court and lower court decisions, while also raising a new set of interpretive challenges necessitating extensive guidance through jurisprudential developments.

SEC SANCTIONS FOR FAILURE TO ADOPT CYBERSECURITY PROTECTIONS

In September 2015, the Securities and Exchange Commission ("SEC") found a registered investment adviser, R.T. Jones Capital Equities Management, Inc. (the "Adviser"), liable for failing to adopt written policies and procedures designed to protect customer records and information. The SEC Order makes good on the promise, embodied in the SEC Division of Investment Management's April 2015 IM Guidance and the SEC Office of Compliance Inspections and Examinations ("OCIE") Cybersecurity Examination Guidelines issued in September 2015, that the SEC will continue to focus on firms' development of robust cybersecurity protections.

Background

The Adviser offered investment advice to participants in a retirement plan through a managed account program. To confirm prospective clients' eligibility to enroll in the program, the Adviser would request their names, dates of birth and social security numbers, subsequently checking that information against a database it maintained containing the same personally identifiable information of over 100,000 eligible participants. This database was stored, unencrypted, on a third-party-hosted web server, and the Adviser did not have written cybersecurity policies or an incident response plan in place.

In July 2013, the Adviser discovered a potential breach of that server. The Adviser promptly retained cybersecurity consultants, who were able to confirm that an intruder had gained full access and rights to copy the information in the database. Even though the consultants couldn't determine whether the client data had actually been accessed, exfiltrated or otherwise compromised during the breach, the Adviser provided notice and free identity theft monitoring to all clients whose data may have been compromised.

The SEC's Findings

Even though the Adviser promptly retained expert consultants and disclosed the potential breach, the SEC found that these facts represented a willful violation of Rule 30(a) of Regulation S-P, 17 C.F.R. § 248.30(a), which requires broker-dealers and investment advisers to maintain written policies and procedures to safeguard customer records and information.

The SEC censured the Adviser, ordered it to cease and desist from any continuing or future violations of the Regulation, and fined it $75,000. The Order notes that the Adviser cooperated with the government and promptly took remedial steps, including appointment of an information security manager, retention of a cybersecurity firm to provide reports and advice, implementation of a written information security policy and elimination of the data security flaws that contributed to the breach.

This case serves as a useful reminder that registered investment advisers should carefully consider how to adopt those cybersecurity measures recommended by the SEC's Division of Investment Management in guidance issued in April 2015. That guidance instructed funds and advisers to establish strategies—memorialized in written policies and procedures—for preventing, detecting and responding to cybersecurity threats.

Takeaway

The Order highlights the risks of disregarding the SEC's expectation that firms develop and continually refresh written policies and procedures for dealing with cybersecurity incidents. Firms should consider taking the following steps to protect themselves:

- Develop, test and regularly update a formal, written incident response plan. Ideally, this plan should be distinct from any business continuity plans;
- Adopt and follow written cybersecurity policies and procedures;
- Engage outside counsel and consultants experienced with cybersecurity issues to assist in complying with the SEC's guidance;
- Develop and implement document and data retention policies, and prune data in accordance with those policies;
- Be mindful of third-party vendors. Consider contractual provisions that mandate a certain level of cybersecurity controls, appropriate indemnifications and obligations to disclose in the event of a breach; and
- Consistent with business needs, consider where encryption can be deployed to protect sensitive data.

This enforcement action continues the regulatory trend of converting technology "best practices" (e.g., encrypting sensitive data) into legally mandated requirements for managing cyber risk. It also underscores that regulators tend to borrow from each other in crafting mandates and guidance about cybersecurity, with the SEC joining Massachusetts and the Federal Financial Institutions Examination Council in calling on companies to develop written information security policies. All companies—regardless of whether they are SEC filers—would do well to consider the SEC's enforcement action in crafting their own data security programs. As the SEC and other government agencies increasingly focus on cybersecurity issues, companies must as well; the failure to do so may carry with it the consequences of an enforcement action.

FINRA RULE 13200, ARBITRATION AND WAIVER

In *Credit Suisse Securities LLC v. Tracy*, 812 F.3d 249 (2d Cir. 2016), the Second Circuit held that Financial Industry Regulatory Authority ("FINRA") Rule 13200's requirement that disputes be arbitrated in a FINRA forum was waivable, and that a private employment agreement between Credit Suisse and its employees providing for arbitration in a non-FINRA forum was enforceable.

Respondents-Appellants ("Employees") are a team of financial advisors who were employed at Credit Suisse. When they joined Credit Suisse, Employees entered into employment agreements that required them to resolve all employment-related disputes through Credit Suisse's Employment Dispute Resolution Program ("EDRP"), which provided for arbitration in a non-FINRA forum. An employment-related dispute arose and rather than adhering to the EDRP, Employees initiated arbitration against Credit Suisse with FINRA. Credit Suisse responded by initiating an action in the Southern District of New York seeking an order to stay or dismiss the FINRA arbitration and to compel arbitration in a non-FINRA forum in accordance with the EDRP. The district court granted Credit Suisse's petition, ordered Employees to dismiss their claims in the FINRA arbitration, and compelled arbitration in the non-FINRA forum. Employees appealed.

Employees contended that Rule 13200, which mandates that certain disputes between FINRA members and associated persons be arbitrated under the FINRA code, requires that arbitrations within its scope take place before FINRA and that parties cannot waive that requirement and agree to arbitration in a non-FINRA forum.

The Second Circuit agreed that Rule 13200 requires arbitration according to the FINRA code and that such a requirement includes arbitration in a FINRA forum. However, it held that parties could waive that requirement and agree to arbitration in a different forum in a pre-dispute agreement, noting that in several cases it had held that FINRA's arbitration provisions "are default rules which may be overridden by more specific contractual terms." The court further noted that nothing in the FINRA rules precluded waiver of the FINRA forum requirement.

The court distinguished its holding from the holding in *Thomas James Associates v. Jameson*, 102 F.3d 60 (2d Cir. 1996), where it found a complete waiver of arbitration unenforceable in light of the public policy favoring arbitration disputes. The court held that *Jameson* was not implicated because in the instant case the parties did not waive FINRA's arbitration requirement in its entirety, but only provided for arbitration in a different forum. Such a provision did not raise the same policy concern implicated by a complete waiver of arbitration.

Takeaway

Employers and employees often enter into pre-dispute agreements providing for arbitration of disputes. Even where the employer and employee are members of a self-regulatory organization ("SRO"), such as FINRA, they are generally free to modify the SRO's general arbitration provisions with a more specific arbitration agreement, provided the SRO has not made its rules non-waivable and the specific arbitration agreement does not implicate the public policy favoring arbitration.

DISCLOSURE-ONLY SETTLEMENTS AND THE DELAWARE CHANCERY COURT

In *In re Trulia, Inc.*, No. 10020-CB, 2016 WL 325008 (Del. Ch. Jan. 22, 2016), the Delaware Court of Chancery considered whether a proposed class settlement was fair and reasonable. In holding that it was not, the court opined on "the dynamics that have led to the proliferation of disclosure settlements" and considered "some of the particular challenges the Court faces in evaluating disclosure settlements through a non-adversarial process."

In February 2015, Zillow, Inc. announced a proposed acquisition of Trulia, Inc. Shortly thereafter, four Trulia stockholders filed complaints alleging that Trulia directors had breached their fiduciary duties in approving the proposed merger. Within four months, the parties agreed to settle plaintiffs' claims in what is known as a disclosure-only settlement. The terms of the settlement required Trulia to provide stockholders with additional information before they voted on the proposed transaction. In return, plaintiffs agreed to dismiss their action to enjoin the transaction and provided a release of all claims on behalf of the proposed class of Trulia stockholders. Under the terms of the settlement, Trulia was not required to make any payments other than fee payments to plaintiffs' counsel.

The court rejected the settlement, finding that its terms were neither "fair nor reasonable." The court determined that none of the supplemental disclosures required by the settlement were "material or even helpful to Trulia's stockholders" and that the broad release of claims was not supported by "any meaningful consideration."

The court acknowledged that in the past it had been willing to approve disclosure-only settlements, and suggested that its willingness encouraged an explosion of deal litigation in the United States. Going forward, the court announced, it would be more vigilant before approving such settlements. The court explained that the settlements "rarely yield genuine benefits for stockholders," even as plaintiffs' attorneys benefit from six-figure legal fees and the defendant corporation benefits by obtaining "deal insurance" in the form of a broad release. Moreover, throughout the process the court is deprived of any meaningful opportunity to evaluate the potentially frivolous claims advanced by the plaintiffs. And, because the process is largely non-adversarial, there is often little motion practice or discovery, which hampers the court's ability to evaluate the fairness of the settlement before approving it.

The court expressed its view that disclosure claims should be advanced in an adversarial setting and in a manner that does not incentivize defendants to settle so as to obtain a broad release. In such a setting, the defendant would be properly incentivized to contest the merits of a plaintiff's disclosure claims.

Takeaway

In light of Delaware's announced hostility to disclosure-only settlements, plaintiffs will need to show that the defendant's supplemental disclosures meaningfully alter the mix of information available to stockholders, and defendants seeking a release of claims as part of the settlement will need to narrowly tailor the release so that it is limited to those claims actually investigated. The volume of deal litigation may decrease, as plaintiffs' lawyers may be discouraged from bringing suits in light of the increased difficulty of recovering fees. However, it is also possible that the litigation will simply shift to other, potentially more favorable, jurisdictions. Currently, Delaware target companies often include in their bylaws a provision requiring that shareholder suits be brought in Delaware. These companies should consider the wisdom of including such provisions. As part of that analysis, they need to weigh the loss of the ability to obtain "deal insurance" against the other benefits of litigating in Delaware.

Section D: Hong Kong and India Banking Litigation and White Collar Update

BANK NOT NEGLIGENT FOR FAILING TO DISCOVER MADOFF FRAUD

(*But contractual exclusion clauses unenforceable*)

Introduction

An investor failed in his claim that a Bank had been negligent for failing to discover that the fund it had recommended was connected to the Madoff Ponzi scheme. Given that the Madoff fraud was undetected for years by the fund's auditors, administrators and regulators, this result was perhaps unsurprising – particularly as the alternative result would potentially impose an impossibly onerous duty on banks to verify the veracity of its investment recommendations. However, the case is an interesting illustration of the limitation of the effectiveness of so-called "basis" clauses.

In the past few years, banks have been highly successful in defending claims by customers who allege that the bank provided negligent investment advice causing loss. A key defensive weapon for financial institutions has been contractual "basis" clauses which typically provide that no advice is given and the customer is not entitled to rely on any representations made by the bank. The controversial effect of such clauses is that, when applicable, customers are estopped from bring claims even if negligent advice has been given.

The question for the Courts in such circumstances is whether the basis clause reflects the reality of the agreed bargain or relationship. The courts are generally slow to strike down the terms of a freely negotiated commercial contract. However, as is illustrated in *Li Kwok Heem John v Standard Chartered International (USA) Ltd* [2016] HKEC 7 basis clause will not be upheld in circumstances where they "*part company with the reality*" of the agreed bargain for the purposes of circumventing statutory controls on the exclusion of liability.

Facts

The Plaintiff was a former PWC audit partner and an independent non-executive director of several listed companies. The defendant was a Registered Institution carrying out various regulated activities including dealing in and advising on securities (Types 1 and 4).

In 2005, the Plaintiff met with his Relationship Manager and an Investment Adviser ("**IA**") from the Bank. The IA introduced to the Plaintiff the Fairfield Sentry Fund ("**FS Fund**"). In recommending the FS Fund, the Bank also provided various marketing materials from the FS Fund, including a Fact Sheet. The Plaintiff invested about US$1 million in the FS Fund. During various periodic reviews of the Plaintiff's account, the Plaintiff was told that the performance of the FS Fund was good and better than other funds. The Bank recommended to the Plaintiff to maintain his investment in the FS Fund. It transpired that the FS Fund was one of the Ponzi schemes operated by Bernie Madoff and in December 2008 the Plaintiff was informed that he had lost the entirety of his investment.

The claim

The Plaintiff claimed damages from the Bank arising from an array of causes of action including:

- The Bank had made a number of misrepresentations about the characteristics of the FS Fund, including an implied representation that the FS Fund was authentic and had the characteristics mentioned in the Fact Sheet. These false misrepresentations had been made negligently because the Bank had failed to make reasonable enquiries as to the truth or accuracy of those representations. In other words, the Bank had failed to conduct adequate due diligence into the authenticity of the FS Fund.

- In advising the Plaintiff to invest in the FS Fund and for failing to advise him to withdraw from the FS Fund, the Bank had breached a duty of care (arising in common law or implied by Supply of Services (Implied Terms) Ordinance).
- The Plaintiff also relied on section 108(1) of the SFO and section 3 of the Misrepresentation Ordinance to advance statutory misrepresentation claims.

The Bank defended the claims on the basis that:

- The Bank had not given any advice.
- The Plaintiff had made his own decision to invest and had not relied on any advice or recommendations.
- Any representation in respect of the Fact Sheet was made by the FS Fund and not by the Bank.
- The Bank further relied on certain contractual documentation including the General Business Conditions and the Risk Disclosure Statement ("**RD Statement**") to argue that the Plaintiff was not entitled to and should not have relied on any advice or recommendation given by it (the "**Contractual Estoppel Defence**")
- The Bank also denied that it had failed to conduct a reasonable inquiry into the truth or accuracy of the representations that the FS Fund had in fact made and that its due diligence had in fact been adequate. The bank also disagreed that any additional enquiry by the bank could have uncovered the Madoff Ponzi scheme.

The decision

The Court found in favour of the Plaintiff on all but one of the issues, including:

- **The representations had been given** - The bank had a team of staff with the title "Investment Adviser" whose duties were to understand the Bank's investment products and to recommend products according to customers' risk profiles and investment objectives. The IA in question admitted that she had authority to give advice.

  Further, the Bank had endorsed the representations in the Fact Sheet and wanted the Plaintiff to rely on them. Accordingly, the Bank had assumed responsibility for those representations.

- The Bank's account opening documentation indicated that the Plaintiff preferred to make investment decisions with the Bank's advice. It was clear on the facts that the Plaintiff had relied and followed the bank's advice.
- **The representations were in fact false** - The FS Fund had been part of a Ponzi scheme and it was uncontested that the representations about the characteristics and performance of the FS Fund had been false.
- **The Contractual Estoppel Defence failed**. The Bank sought to rely on the RD Statement, which referred to the substantial risks associated with trading in foreign exchange, options, metals and other over-the-counter derivatives. The RD Statement also stated that the Bank was not an adviser and that the transactions were entered into at arm's length. The RD Statement further stated that the Bank's employees had no authority to give advice. The Court found that the Bank was unable to rely on the RD Statement for the following reasons:

- The RS Document applied to certain high risk investments and did not apply to the FS Fund which purported to be low risk;
- The statement that employees had no authority to give investment advice was inconsistent with the Business Conditions and contradictory to the reality.

In the circumstances, it was artificial for the Bank to rely on the terms of the RD Statement.

- **The RD Statement was an unreasonable exemption clause** – the Bank failed in its argument that the RD Statement was a basis clause (which was not subject to the Exemption Clauses Ordinance and the Misrepresentation Ordinance) and not an exemption clause. The Judge held that the Bank employed a team of investment advisers and that, contrary to the reality, the RD Statement was simply a set of clauses seeking to exclude liability. Accordingly, the document was subject to the statutory reasonableness test.

  With regards to the question of whether the terms were in fact unreasonable, the Court noted that although the Plaintiff was a sophisticated business man who had experience investing in equities, he was not a sophisticated investor in funds. The Bank had a team of investment advisers to provide advice and the RS Statement was seeking to exclude the bank's liability from the very service it was purporting to provide. Further, in reality such terms (which are common in the private banking industry) were non-negotiable. In these circumstances, the Court held that the terms were unreasonable.

Finally, the RD statement did not exclude the Bank's liability under section 108 of the SFO. This was because liability to compensate investors for losses suffered by relying on misrepresentation had nothing to do with assumption of liability by the Bank.

- **The Bank owed a duty of care**. Given the findings outlined above, the Court reached the inevitable conclusion that the Bank had assumed duty of care.
- **Bank not negligent in making misrepresentation**. Having found that an actionable misrepresentation had been made, the final question for the judge was whether the Bank had been negligent in making the representation. The crux of the matter was whether the Bank should have discovered the Ponzi scheme as a result of its due diligence. The Bank adduced extensive evidence on the initial and on-going due diligence it had conducted into the FS Fund. The judge found that the Bank could not have reasonably detected the fraud notwithstanding a number of "red flags". In reaching this decision, the judge noted that the FS Fund had been audited by PWC for 12 years, was provided with custodian services by a reputable fund administrator and Madoff's businesses had been investigated by the SEC on several occasions. All of these third parties (which had far greater access to the FS Fund than the Bank), had failed to detect the fraud.

Takeaways

- The key takeaway is that purported basis clauses which in reality are exclusion clauses will be subject to statutory reasonable tests.
- From a practical perspective, it is important that appropriate contractual documentation and risk warnings are provided to customers. In this case the RD Statement was inappropriate

because (a) it concerned high risk investments (whereas the FS Fund was a low risk investment); (b) it was inconsistent with the advisory relationship between the customer and the bank.

- Financial institutions should also be wary of the fact that they can be held liable for marketing documentation published by third parties to funds used to make investment recommendations to customers. Accordingly, it is important for banks to take reasonable steps to ensure that the information in such market material is truthful.

OFFICERS AND EMPLOYEES OF PRIVATE SECTOR BANKS DEEMED "PUBLIC SERVANTS" UNDER INDIA'S ANTI-CORRUPTION LAW

Corruption is prolific in India's banking sector, yet India's anti-corruption regime contains no express offences in relation to private sector corruption and bribery.

However, in *Central Bureau of Investigation v. Gelli, India Supreme Court* (February 23 2016), India's Supreme Court ruled that officers and employees of banks are "public servants" for the purposes of prosecution under the Prevention of Corruption Act 1988 (the "PCA"). In order to reach this decision, the Court adopted a highly purposive approach to legislative interpretation in order to remedy "unintended omissions" in relation to the application of the PCA to officers and employees of a bank. The decision is another important example of judicial activism to tackle India's corruption issues.

Background

The case involved corruption charges against a number of senior executives from Global Trust Bank ("GTB"), which was licensed under the Banking Regulation Act 1949 by the Reserve Bank of India. In essence, the individuals concerned entered into a conspiracy to cheat GTB, resulting in a wrongful gain of over US$2 million.

India's Central Bureau of Investigation (the "CBI") brought charges against the individual for offences under the PCA (among other things). However, the claims were quashed by the High Court of Judicature at Bombay on the basis that executives of a private sector bank were not "public servants". The CBI appealed to the Supreme Court.

The decision by the Supreme Court

In order to decide the question of whether the officers and employees of a private bank were "public servants" for the purposes of offences punishable under the PCA, the Supreme Court analysed the legislative history of the Banking Regulation Act 1949 and the purpose of the PCA.

Section 46A of the Banking Regulation Act 1949 stated that bankers were "public servants" for the purposes of the offences under chapter XI of the Indian Penal Code (the "IPC"). Chapter XI of the IPC was subsequently repealed and the relevant offences were consolidated into the PCA. However, the provisions of the IPC relating to officials / employees of a Banking Company were not incorporated into the PCA. Accordingly, private sector bankers were not expressly identified as "public servants" under the PCA.

The common law rule relating to the interpretation of statute is that "*what has not been provided for in the statute cannot be supplied by the Courts*". However, the Supreme Court referred to an exception to this strict rule of interpretation as expressed by the renowned English judge, Lord Denning "*We sit here to find out the intention of Parliament and carry it out and we do this better by filling in the gaps and making sense of the enactment than by opening it up to destructive analysis*". Notwithstanding the fact that this liberal approach to legislative interpretation was immediately disapproved by England's highest court, India's Supreme Court found that it had been adopted as good law by India's courts. Accordingly, the Supreme Court set about "*filling in the gaps*" in the PCA.

The Supreme Court observed that the legislature had specifically intended the PCA to widen the scope of the definition of "public servant". It followed that the omission of S. 46A of the Banking Regulation Act 1949 from the PCA was a "*wholly unintended legislative omission*". The Court then reasoned that, were it to express "*judicial helplessness to rectify the omission*" (thereby upholding the quashed charges), it would have the opposite effect of the intention of the PCA. The Supreme Court therefore decided that the intent of the PCA could not be allowed to be defeated and hence the omission was capable of being "filled up". This reasoning led to the finding that private sector bankers were public servants for the purposes of the PCA by virtue of the provisions of section 46A of the Banking Regulation Act 1949 and accordingly the prosecutions by the CBI under the PCA were allowed to proceed.

Takeaway

India's drive against corruption is perceived to be hampered by the general weakness of the country's anti-corruption institutions. However, India's Supreme Court is regarded as one of the key institutions which has been effective in fighting corruption. This decision is consistent with this view, notwithstanding any misgivings about the judicial activism required to reach the decision.

The case could further be seen in the context of an international trend of courts demonstrating a willingness to stretch public sector anti-bribery legislation in order to tackle corruption in the private sector. Another notable recent example was the 2014 conviction of a former Deutsche Bank employee in Japan in relation to the payment of bribes to a client, who was a pension fund manager. In that case, the court found that the pension fund manager was a public servant because the money his pension oversaw included public funds. Accordingly, both the banker and the fund manager were subject to Japan's public sector anti-corruption legislation.

Practical points

Financial institutions licensed under India's Banking Regulation Act 1949 should be aware that its officers and employees are subject to the anti-corruption offences under the PCA.

Banks may need to adapt their anti-corruption and bribery policies to ensure compliance with this decision.

Banks may also need to consider any further training requirements for officers and staff.

"NO CONSENT" REGIME IN RELATION TO SUSPICIOUS TRANSACTION REPORTS NOT UNCONSTITUTIONAL OR *WEDNESBURY* UNREASONABLE

Section 25A of the Organized and Serious Crimes Ordinance, Cap 455 ("**OSCO**") requires a person (an "informant") to disclose their knowledge or suspicion that any property represents the proceeds of crime to the Joint Financial Intelligence Unit (the "**JFIU**").

Suspicious transaction reports are frequently made by financial institutions to the JFIU and, in circumstances where the JFIU believes that the property may in fact represent the proceeds of crime, it may decline to give consent to the financial institution to deal in the property by way of a "no consent" letter. The purpose of the "no consent" regime is to prevent the dissipation of the suspected proceeds of crime whilst law enforcement agencies investigate the matter or decide whether to take further action such as applying to confiscate the assets.

The case of *Interush Ltd v Commissioner of Police* [2015] HKEC 1589 is an interesting insight into the practical operation of the "no consent" regime.

Background

Interush had a bank account with Bank of East Asia ("BEA") and Hang Seng Bank ("HSB"). Interush was alleged to have operated an illegal pyramid scheme. Prompted by media coverage of the pyramid scheme, BEA suspended the account (and subsequently made a report to the Police) and HSB filed an STR to JFIU, pursuant to s.25A. In the meantime, JFIU issued a "no consent" letter to HSB and refused to allow Interrush to deal in the account.

The claim

Interush challenged the constitutionality of Section 25A of OSCO and the "no consent" letter on the ground that they infringed articles 6 and 105 of the Basic Law because they interfered with the use or disposal of the property, i.c. the "no consent" letter had no expiry date and the Government did not compensate Interush for its loss as a consequence of its property being frozen under the "no consent" letter.

In the alternative, Interush claimed that the withholding of consent in all circumstances was unreasonable and irrational.

The decision

The challenge failed.

<u>The regime was not unconstitutional</u>

The regime was not constitutional. The Court held that Section 25A(2)(a) of OSCO does not operate to withhold the accounts or property of a suspect. It only creates a defence for further dealings with the property after disclosure. This ensures that the further dealing would not prejudice the investigation. It remains for the financial institutions to decide whether to honour the instructions of their customers despite their suspicion and the disclosure. Accordingly, Articles 6 and 105 of the Basic Law were not engaged.

<u>The "no consent" letter was not irrational or unreasonable</u>

Theoretically, the police can extend the 'no consent' letter for an indefinite period. Accordingly the Court determined that Interush was entitled to challenge the decision of the police concerning the "no consent regime" by way of Judicial Review to ensure that a person affected by the "no consent regime" is adequately protected.

The Court noted that the Police had internal Guidelines which set out the procedure for issuing and reviewing a letter of "no consent". According to the judgment, the Guidelines required the following steps to be taken:

- When the JFIU receives a STR, it will refer the STR to an investigation unit for action. The Superintendent of the investigation unit will then decide whether a 'no consent' letter is warranted.
- In considering whether the "no consent" letter is warranted, the Superintendent should consider the following relevant factors: nature of the offence; prospect of a conviction; value of proceeds and realizable property; reasonable likelihood of obtaining a restraint order; reasonable likelihood of obtaining an injunction

by the victim and the preservation of proceeds of crime for confiscation.

- Once a 'no consent' letter is issued through the JFIU, its extension should be reviewed by the Superintendent of the investigation unit on a monthly basis. If the aggregate extension exceeds three months, the Formation Commander will be responsible to review the situation on a monthly basis.
- Under normal circumstances, a "no consent" letter should not exceed 6 months. In exceptional cases, the Formation Commander will review the situation critically and consult the Department of Justice for legal advice.

According to the Interush judgment, the police's Internal Guidelines acted as a safeguard to ensure that the "no consent" regime operates fairly but that it was impossible for the court to decide the appropriate time limit. This was because what was reasonable depended on "many factors and the individual case". The judge also held that a "court in judicial review proceedings should be slow to interfere with the ongoing criminal investigation".

Accordingly, in order to determine the question of whether the Police had acted unreasonably in this instance, the Court considered the steps taken by the police and how those steps corresponded with the Guidelines. The Court noted the following relevant factors:

- The money laundering by Interush involved a high value and international Ponzi scheme, which affected a large number of victims. These circumstances justified the issue of the "no consent" letter.
- The "no consent" letter was review by a Superintendent in the first 3 months and, after that by Chief Superintendent Wong on a monthly basis.

- There was constant liaison between JFIU and CCB. The police adduced memos from the CBB to the JFIU evidencing this.
- There was constant liaison with Department of Justice for legal advice with a view to prosecute and apply for a restraint order.
- The scale of the investigation was large due to the volume of transactions and that applicants spread over several provinces in China.
- The cross border investigation took longer time.
- The account holder failed to cooperate in the investigation.

In light of the above, the judge ruled that the Police had properly taken into account the relevant factors and both the initial 'no consent' letter and its subsequent extension are justified and they were not *Wednesbury* unreasonable.

INSIDE INFORMATION DISCLOSURE REGIME: NO EXCEPTION FOR NEDS AND INEDS

Introduction

On 11 March 2016, the Securities and Futures Commission (SFC) commenced proceedings in the Market Misconduct Tribunal (MMT) against Mayer Holdings Limited (Mayer), and ten of its current and former senior executives (Senior Executives), in connection with Mayer's failure to disclose inside information[11] under Part XIVA of the Securities and Futures Ordinance (SFO). This is the second set of MMT proceedings brought by the SFC under Part XIVA of the SFO since it became effective on 1 January 2013.

[11] Pursuant to section 307A of the SFO, inside information is information that is specific, not generally known to the segment of the market which deals or would likely deal in the listed company's securities, and if so known, would be likely to have a material effect on the price of the listed securities.

Overview of the Inside Information Disclosure Regime

Subject to limited exceptions[12], section 307B of the SFO requires a listed company to disclose inside information as soon as reasonably practicable. Section 307G of the SFO further imposes personal obligations on officers of a listed company to take all reasonable measures to ensure that proper safeguards exist to ensure the company's compliance.

Background

Mayer is a company incorporated in the Cayman Islands listed on the Main Board of The Stock Exchange of Hong Kong Limited, principally engaging in the business of processing and manufacturing steel sheets and steel pipes.

It is alleged by the SFC that between April and August 2012, the then auditors of Mayer had repeated communications with Mayer's management regarding issues identified in the course of auditing Mayer's financial statements for the year ended 31st December 2011 (Outstanding Audit Issues), including that:

- The nature of the disposal of a wholly-owned subsidiary for a consideration of HK$15,500,000 was questionable;
- Mayer's projects in Vietnam were not under its control, and the prospects of those projects were far less promising than initially valued and contemplated; and
- Two subsidiaries of Mayer's jointly controlled entity entered into two supply agreements, whereby substantial prepayments in the

[12] Pursuant to section 307D of the SFO, no statutory disclosure is required if (i) the disclosure would breach an order by a Hong Kong court or any provisions of a Hong Kong statute; (ii) the information relates to an incomplete proposal or negotiation; (iii) the information concerns a trade secret. For the categories (ii) and (iii), the confidentiality of the information must have been preserved.

sum of US$10,000,000 and US$4,000,000 were respectively made to the suppliers without security (Prepayments), which caused the auditors to raise concerns as to their recoverability.

Mayer failed to give satisfactory answers to any of the Outstanding Audit Issues.

On 23 August 2012, Mayer's then auditors sent a list of "potential qualifications to the audit report" to Mayer indicating that they would have to qualify their audit opinion if the Outstanding Audit Issues were not resolved (Potential Qualified Audit Report).

On 27 December 2012, Mayer received a resignation letter from its then auditors (Auditors' Resignation) which was addressed to "The Audit Committee and the Board of Directors" of Mayer.

On 23 January 2013, Mayer disclosed the Auditors' Resignation and the Outstanding Audit Issues in an announcement.

SFC's Allegation

The SFC alleges that each of the Outstanding Audit Issues, the Potential Qualified Audit Report, the Prepayments and the Auditors' Resignation was specific price sensitive information generally not known to the public, and thus constituted "inside information" within the meaning of Part XIVA of the SFO (see footnote 1).

The SFC alleges that the Outstanding Audit Issues and the Potential Qualified Audit Report came to the knowledge of Mayer on 23 August 2013, and the Auditors' Resignation (which was addressed to the board and audit committee of Mayer) came to the knowledge of Mayer on 27 December 2012. Specifically, The SFC considers that each of the above issues did, or alternatively, ought to reasonably have, come to the knowledge of the Senior Executives in the course of performing their functions as officers of Mayer.

For the above reasons, the SFC commenced MMT proceedings against Mayer for its purported failure to disclose inside information under section 307B of the SFO, and against the Senior Executives of Mayer for their reckless or negligent conduct (which allegedly led to Mayer's failure to disclose inside information), under section 307G of the SFO.

Takeaway

These MMT proceedings not only highlight the SFC's determination to enforce the statutory disclosure regime in connection with inside information, but also exemplify the SFC's effort to hold senior management personally liable for serious violation of the SFO.

It shall be noted that unlike the MMT proceedings concerning AcrossAsia[13], where the SFC's allegations were only directed at the chairman and chief executive officer, the Senior Executives of Mayer who are subject to the MMT proceedings include Mayer's chairman and executive director; company secretary and financial controller; executive directors; independent non-executive directors (INED) and non-executive director (NED) in office at the material time.

It is not uncommon for INEDs and NEDs to sit on a listed company's audit committee. The commencement of these MMT proceedings sends a clear message to listed companies and their senior officers that even NEDs and INEDs, who presumably have no

[13] On 27 July 2015, the SFC commenced proceedings in the MMT against AcrossAsia Limited, its Chairman and Chief Executive Officer for failing to disclose inside information as soon as reasonably practicable pursuant to sections 307B and 307G of Part XIVA of the SFO. This is the first set of MMT proceedings brought by the SFC under Part XIVA of the SFO.

day-to-day control over the management of a listed company's affairs, can still be held personally accountable for a listed company's failure to disclose inside information in accordance with Part XIVA.

Being Kept Sweet: Court of Appeal Rules on Rafael Hui Appeal

On 16 February 2016, the Court of Appeal handed down its ruling dismissing the appeals of former Chief Secretary Rafael Hui, Thomas Kwok and others.[14] The bulk of the judgment by Vice President Lunn (and the entirety of a shorter opinion by Vice President Yeung) dealt with the question of whether a prosecution for conspiracy to commit the common law offense of misconduct in public office could be made out merely based on an agreement by Rafael Hui "to be or remain favourably disposed to" Sun Hung Kai Properties ("SHKP"). In other words, the court found that a "general sweetener" could be the basis of a misconduct in public office offence, even in the absence of a specific act of misconduct or *quid pro quo*.

Immediately prior to Hui's becoming Chief Secretary, Thomas Kwok paid him $8.5 million through "a circuitous and devious route."[15] The payment was made through a company controlled by Thomas Chan (an executive director of SHKP) via Francis Kwan, a close friend of Hui.[16] This transaction formed the basis of the fifth count against all the defendants at trial, that the defendants conspired that Hui would "willfully misconduct himself in the course of or in relation to his public office by being or remaining favourably disposed to SHKP."[17]

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14 HKSAR v. Hui Rafael Junion and others, CACC 444 of 2014 (16 February 2016).

15 Id. at ¶ 3 (Opinion of Hon. Yeung VP).

16 Id. at ¶¶ 60, 74 (Opinion of Hon. Lunn VP).

17 Id. at ¶ 55.

This was the only charge on which Thomas Kwok was convicted at trial. Hui, Kwan and Chan were additionally convicted for conspiracy to offer an advantage to a public servant (contrary to sections 4(1)(a) and 12 of the POBO) for a different payment, but under the same theory, that the "act in his capacity as a public servant" was the act of "being or remaining favourably disposed to SHKP.[18]

The appellants' case relied on different forms of the argument that "remaining favourably disposed" to someone was a state of mind, rather than an act of misconduct. As a result, they argued, a case of misconduct in public office (or conspiracy to commit the same) could not be made out in the absence of proof of a specific act of misconduct (or agreement to commit such an act). The court of appeal rejected these arguments, holding that the concept of corruption by a payment as a "general sweetener" was sufficient, without more, to prove misconduct in public office. After the payment, "[Hui] had been sweetened; his goodwill had been bought. That is the abuse of office."[19] Or, in the words of Vice President Yeung, "having received $8.5 million from SHKP, Rafael had completely destroyed the duty of loyalty he owed HKSAR Government and the people of Hong Kong…"[20]

The facts of the *Hui* case are quite stark and the judgment does not provide clear guidance as to when an advantage short of $8.5 million should be considered a "general sweetener" sufficient to prove misconduct in public office or bribery. However, Vice President Lunn's judgment drew on a number of bribery cases, and serves as a reminder that it is possible to make a case for bribery without

[18] Id. at ¶ 57.

[19] Id. at ¶ 226.

[20] Id. at ¶ 35.

evidence of a specific *quid pro quo*. As long ago as 1978, Leonard, J in the court of appeal stated that "I would regard being or remaining favourably disposed to the person solicited as sufficient to amount to an 'act' within the meaning of [Section 4 of POBO]."[21] The same is true for commercial bribery under Section 9. The prosecution in the *Hui* case and Vice President Lunn[22] referred to the Section 9 case *Li Defan & Another v. HKSAR*,[23] in which the prosecution offered no evidence as to why the money was paid, but the appeal was dismissed as it was permissible to infer an improper act because "people do not usually pay large sums of money to business acquaintances without expecting something in return."

SFO SECTION 300 USED BY THE HONG KONG SFC TO COMBAT INSIDER DEALING IN RESPECT OF SECURITIES LISTED OVERSEAS

The Court of First Instance (the "Court") made an important decision on 15 January 2016 in relation to the judicial interpretation of section 300 of the Securities and Futures Ordinance (the "SFO"), which prohibits the use of fraudulent or deceptive schemes in transactions involving securities.

Background

This case concerned, among other things, confidential and materially price sensitive information regarding Standard Chartered Bank's ("SCB") tender offer for all of the shares of Hsinchu International Bank Co Ltd ("Hsinchu Bank"), a corporation listed on the Taiwan Stock Exchange, in 2006.

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21 *Attorney General v. Chung Fat-Ming* [1978] HKLR 480, 497.

22 *HKSAR v. Hui* at ¶ 225.

23 (2002) 5 HKCFAR 320, 335 (Lord Hoffman, NPJ).

A solicitor named Young Bik Fung ("Young"), who was employed in private practice and seconded to SCB at the material time to work on the tender offer, was given access to confidential and price sensitive information in relation to the tender offer, including SCB's decision to make a firm offer and the exact price of the offer.

Prior to the announcement of the tender offer, Young allegedly bought, and tipped off her boyfriend and his two sisters to buy, Hsinchu Bank shares, which resulted in a total profit of HK$2.685 million.

The Court held that such behavior amounted to fraud or deception within the meaning of section 300 of the SFO because Young owed duties to her employer and their client, SCB, including the duty to refrain from using inside information for personal gain.

Takeaway

The insider dealing provisions in the SFO, i.e., sections 270 and 291, are subject to a jurisdictional limitation, i.e., their applications are limited to securities listed on the Hong Kong Stock Exchange. This decision sends a clear message to all market participants that the Securities and Futures Commission ("SFC") may now investigate and prosecute insider dealings in respect of shares listed overseas.

Section E: Brexit: Issues for Financial Institutions

If the UK votes to leave the European Union ("EU") in the referendum on 23 June 2016, the future application of EU-based legislation to the banking and financial services industry will ultimately depend on how the UK re-negotiates its relationship with the EU.

Post-Brexit relationship with the EU

In general terms, one of three different post-Brexit relationships is the most likely outcome:

- membership of the European Economic Area ("EEA"), like Norway;
- negotiating a bilateral agreement, whether that goes as far as Switzerland's membership of the European Free Trade Agreement ("EFTA"), joining the EU Customs Union alongside Turkey, or agreeing tariff-free access for certain goods and sectors in the way Canada has done; or
- reliance on the World Trade Organisation ("WTO") rules for trading access.[24]

EEA and/or EFTA membership would result in the closest possible post-Brexit relationship with the EU, subject to the UK's on-going compliance with EU legislation governing access to the single market – including the freedoms of movement. It is unlikely that under such an agreement the relevant EU-based rules and obligations on companies and institutions active in the UK and EU would substantially change, or that the UK would repeal significant legislation. As an EEA member the UK would not, however, have full access to the single market for financial services as that is limited

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[24] "*Alternatives to membership: possible models for the United Kingdom outside the European Union*", 2 March 2016, Policy Paper of The Cabinet Office

in some parts of the sector. The outcome of EFTA membership would depend on what was negotiated. Switzerland, for example, does not have an agreement in respect of financial services and Swiss banks are required to operate in the EU through subsidiaries located in the EU.

At the other end of the spectrum, a relationship only on the basis of the UK's WTO membership would result in the current benefits of the UK's participation in the EU single market falling away and it would instead only benefit from and be subject to the same principle of non-discrimination as other WTO members. The UK would be free to retain, repeal or modify EU-based legislation, and would no longer be required to interpret national law consistently with EU law.

Timing and process
Following a vote to leave, the UK would need to serve notice on its EU membership.[25] The relevant Treaty provision sets out the timeline for exit, which states that the UK would cease to be an EU Member once the withdrawal agreement comes into force or automatically two years after notification, but this period can be unanimously extended by the UK or the European Council.

In practice, agreeing withdrawal terms may well take longer than two years and agreeing the UK's new legal relationship with the EU significantly longer again. Any new agreement[26] regulating a post-Brexit relationship between the UK and the EU would also require the agreement of each of the remaining 27 Member States, which may in turn require domestic ratification. The only country

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[25] Article 50 of the Treaty on the Functioning of the European Union

[26] Theoretically, it would be possible for the UK to retain its EEA membership, which would not require any additional consents, but as above, would require the UK to adhere to most EU legislation.

previously to leave the EU is Greenland in 1985 after a process that took six years to complete.

Whilst the eventual outcome may therefore be very uncertain, one can still identify certain implications that Brexit would have for the UK financial services sector.

The UK and the Single Market

The most immediate effects of Brexit will likely be felt around issues of access to the single market.

Currently UK-based financial service providers are not required to obtain parallel authorisations in any other Member State that they offer their services in. The so-called "passport" scheme allows financial service firms incorporated in one EEA Member State to establish a branch or provide services remotely in another Member State on the basis of their authorisation and supervision by their state of incorporation.

The 'passporting' principle is not limited to cross-border establishment, and the principle of mutual recognition also applies to other areas. For example, it is sufficient for a company to seek approval of a prospectus in only one Member State, in order to offer shares or bonds to investors across the EU, or to list them on an EEA 'regulated market'. At the same time, companies with dual listings do not have to comply with separate disclosure and transparency obligations in different Member States. Similarly, clearing houses that handle Euro denominated currencies do not have to be within the Eurozone, but can offer their services EEA-wide.[27]

[27] The European Central Bank tried to require clearing houses handling Euro-denominated operations to be located within the Eurozone, but lost the UK's challenge before the General Court of the European Court of Justice.

Following a Brexit, it is unlikely that the passporting rules, and similar abilities of UK institutions would change if the UK was to enter into a Norway-type combined EEA and EFTA relationship with the EU. In such case, the majority of rules regulating access to the single market, including the freedom to provide services, would remain unchanged. The UK would, however, need to implement future EU legislative developments without having the same influence in determining any rule change.

Under any emerging relationship that is less closely aligned with the EU single market, UK-based financial institutions may - subject to any special bilateral agreements to the contrary – lose the above advantages they enjoyed as part of the EU single market. At the same time, should a UK-based institution wish to continue offering services in the EU, it would have to continue to comply with the prevailing EU legislation. That will have greater impact on some areas than on others, as not all financial services – in particular those at the retail level – necessarily or directly benefit from single market access.

Financial regulation

The UK's model of financial regulation is, as is the financial regulatory environment in all other Member States, derived from EU legislation. Convergence has further increased since the 2008 financial crisis as a result of large scale reform of the EU financial sector regulatory framework. A defining feature of the post-2008 reforms, however, is that they have been shaped by the EU's obligations to implement G20-driven international standards on matters such as bank capital, liquidity, leverage and prudential regulation.

In principle, Brexit could mean lighter regulation in the UK as regulators would no longer be obliged to enforce certain regulations, and the UK would be able either to repeal or simply no longer be subject to certain financial regulations that it was required to abide by or transpose into national law. Examples include the cap on bank remuneration, the power of the European Securities and Markets Authority to ban short selling in case of emergency, and the proposed Financial Transaction Tax.

A recent review of the post-crisis EU financial regulatory framework concluded, however, that, absent a number of exceptions such as the above, it is likely that the UK would have implemented the vast bulk of the financial sector regulatory framework had it acted unilaterally, not least because it was closely engaged in the development of the international standards from which much EU legislation derives.[28]

For that reason, the future legislative impact of Brexit on the financial services sector may be less than in other areas.

[28] "The post-crisis EU financial regulatory framework: do the pieces fit?", 2 February 2015, House of Lords European Union Committee.

Section F: Hong Kong Competition Law

HONG KONG INTRODUCES NEW COMPETITION LAW REGIME

The Competition Ordinance came into full force on 14 December 2015. The objective of the Ordinance is to prohibit conduct that prevents, restricts or distorts competition, and to prohibit mergers that substantially lessen competition in Hong Kong. The scope of the application of the merger rule is limited to carrier licences issued under the Telecommunications Ordinance.

In this article we give a brief overview of:

- The key law enforcement agencies and bodies
- The prohibitions on anti-competitive conduct
- The exclusions and exemptions
- Enforcement priorities and leniency policy
- The penalties

The key law enforcement agencies and bodies

Competition Commission

The Competition Commission (the "Commission") is tasked with the following functions:

- To investigate conduct that may contravene the competition rules of the Ordinance and enforce the provisions of the Ordinance;
- To promote public understanding of the value of competition and how the Ordinance promotes competition;
- To promote the adoption by undertakings carrying on business in Hong Kong of appropriate internal controls and risk management systems and to ensure their compliance with the Ordinance;

- To advise the Government on competition matters in Hong Kong and outside Hong Kong;
- To conduct market studies into matters affecting competition in markets in Hong Kong; and
- To promote research into and the development of skills in relation to the legal, economic and policy aspects of competition law in Hong Kong.

The Communications Authority

The Communications Authority shares concurrent jurisdiction with the Commission in respect of anti-competitive conduct of certain undertakings operating in the telecommunications and broadcasting sectors. In this connection, the Commission has entered into a Memorandum of Understanding with the Communications Authority to coordinate the performance of their functions under the Ordinance.

The Competition Tribunal

The Competition Tribunal (the "Tribunal") is a superior court of record set up by the CO to deal with legal proceedings concerning competition matters. The Tribunal is headed by a President and a Deputy President. They are judges of the Court of First Instance ("CFI"). All other CFI judges are members of the Tribunal.

The Tribunal has jurisdiction to hear and determine:

- applications made by the Commission or Communications Authority with regard to alleged contraventions of the competition rules;
- applications for the review of reviewable determinations;
- private actions in respect of contraventions of the conduct rules; and

- allegations of contraventions, or involvements in contraventions, of the conduct rules raised as a defence.

Prohibitions on anti-competitive conduct

With the exception of the "merger rule", the law is conceptually similar to the EU competition law regime. In particular, the CO prohibits restrictions on competition in Hong Kong through three competition rules:

- The First Conduct Rule prohibits anti-competitive agreements;
- The Second Conduct Rule prohibits abuse of market power;
- The Merger Rule prohibits anti-competitive mergers and acquisitions.

The First Conduct Rule and the Second Conduct Rule apply to all sectors of the Hong Kong economy. At present, the Merger Rule only applies to mergers involving carrier licence holders within the meaning of the Telecommunications Ordinance.

The First Conduct Rule

The First Conduct Rule prohibits businesses from making or giving effect to an agreement, engaging in a concerted practice, or making or giving effect to a decision of an association, if the object or effect is to harm competition in Hong Kong.

In order to assist businesses, the Commission has published extensive Guidance on the First Conduct Rule. The Guideline on the First Conduct Rule provides:

- An overview of key concepts used by the Commission in relation to the First Conduct Rule.

- The Commission's approach to various types of business conduct, including, price fixing, market sharing, bid rigging and output restrictions;
- Resale price maintenance; and
- Joint ventures, joint tendering, franchising and distribution agreements.

The Guidance also includes a wide range of hypothetical examples to assist understanding of how the Commission applies the First Conduct Rule to common forms of business conduct.

The Second Conduct Rule
The Second Conduct Rule prohibits businesses with a substantial degree of market power from abusing that power by engaging in conduct that has the object or effect of harming competition in Hong Kong.

The Guideline on the Second Conduct Rule provides:

- The Competition Commission's approach to defining the relevant market (which also applies to the First Conduct Rule and the Merger Rule).
- Guidance on how to assess whether a business has a substantial degree of market power.
- The Competition Commission's approach to certain types of business conduct, including

    - Below-cost pricing;
    - Tying and bundling;
    - Margin squeeze;
    - Refusals to deal; and
    - Exclusive dealing.

The Guidance also includes hypothetical examples to assist businesses understand how the Second Conduct Rule will be applied to common forms of business conduct.

The Merger Rule

The Merger Rule prohibits mergers between businesses which substantially lessen competition in Hong Kong. At present, the Merger Rule only applies to mergers involving carrier licence holders within the meaning of the Telecommunications Ordinance (Cap106).

The Guideline on the Merger Rule provides:

- An overview of key concepts used by the Commission in relation to the Merger Rule.
- The Commission's approach and analytical tools for assessing mergers.
- Merger control and relevant enforcement procedures.

The exclusions and exemptions

The CO provides for various exclusions and exemptions. Again, these exemptions are conceptually similar to the exclusions and exemptions under EU competition law. For example, an agreement or conduct may be exempted from the Conduct Rules where it:

- enhances economic efficiency (subject to satisfaction of prescribed criteria);
- is performed by an undertaking entrusted with the operation of services of general economic interest;
- is made in compliance with a legal requirement.

Further there are various *de minimis* thresholds in relation to both the First and Second Conduct Rules.

First Conduct Rule does not apply to:

- an agreement between undertakings in any calendar year if the combined turnover of the undertakings for the turnover period does not exceed HK$200 million;
- a concerted practice engaged in by undertakings in any calendar year if the combined turnover of the undertakings for the turnover period does not exceed HK$200 million; or
- a decision of an association of undertakings in any calendar year if the turnover of the association for the turnover period does not exceed HK$200 million.

With regards to the Second Conduct Rule, the commercial conduct of smaller undertakings might also fall within the exclusion for conduct of lesser significance in section 6(1) of Schedule 1 to the CO. This exclusion provides that the Second Conduct Rule does not apply to conduct engaged in by an undertaking with an annual turnover of not more than HK$40 million. Section 6(1) of Schedule 1 should not, however, be interpreted to mean that undertakings with an annual turnover above the threshold would automatically be considered to have a substantial degree of market power or be more likely to contravene the Second Conduct Rule.

Enforcement Priorities and Leniency Policy

According to the Commission's Enforcement Policy, the Commission intends to direct its resources to the investigation and enforcement of matters that provide the greatest overall benefit to competition and consumers in Hong Kong.

- Where it identifies a possible contravention, the Commission will seek to take action that is proportionate to the conduct and the resulting harm. To this end, when considering whether to investigate and how to seek to resolve individual cases, the

Commission will consider three key issues in addition to the specific facts of the case:

- Compliance Focus;
- Severity Factors; and
- Effective and Appropriate Remedies.

When considering whether to investigate a particular case, the Commission will accord priority to those cases which involve any one or more of the following types of conduct:

- cartel conduct;
- other agreements contravening the First Conduct Rule causing significant harm to competition in Hong Kong; and
- abuses of substantial market power involving exclusionary behavior by incumbents.

Section 80 of the CO provides that the Commission may make a leniency agreement with a person that it will not bring or continue proceedings in the Tribunal for a pecuniary penalty in exchange for the person's cooperation in an investigation or in proceedings under the Ordinance.

The penalties

The Tribunal has the power to fine a company which has infringed the CO up to 10% of its Hong Kong turnover for up to three years of the period during which the company committed such behavior.

In addition, the Tribunal has wide powers to disqualify directors and impose penalties on individuals, award damages to aggrieved parties, make injunction orders, and terminate or vary an agreement.

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