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EFFECT OF THE MIFID II RESEARCH REGIME ON US INVESTMENT MANAGERS

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The MiFID II regime will have significant ramifications for US investment managers and their use of client commissions to obtain research—especially as cross-border impacts have yet to be addressed by global regulators.

With the January 3, 2018 effective date of the Markets in Financial Instruments (MiFID) II regime looming over European Union (EU) investment firms, many investment managers are struggling to deal with the changes affecting inducements and research. Some of the most challenging issues include determining the purchase price of research, assigning value to research internally, reconciling the cost of research to multiple clients, determining mechanisms for payment, and the clashing of EU and US regulatory regimes. Absent regulatory relief from either US or EU regulators, conflicts between regulatory regimes could force US broker-dealers to curtail providing research or execution services to covered investment managers.[1] The issues and incompatibilities between the EU and US regimes are extensive and will affect US investment managers in many key ways.

As we described previously,[2] effective January 3, 2018, EU investment managers will effectively no longer be able to use client dealing commissions (commonly referred to as "soft dollars") to pay for research from broker-dealers. Rather, EU investment managers must either pay for research out of their own pockets (*i.e.*, out of profit and loss (P&L)) or reach agreement with clients to have research costs paid by clients through so-called research payment accounts (RPAs) funded either by a specific research charge to the client or out of dealing commissions, provided that the research element of the commission is priced separately from the execution element (*i.e.*, "unbundled").

For US investment managers subject to the MiFID II regime (which is itself a matter subject to considerable uncertainty), this potentially means either (*i*) treating EU clients

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differently, or (*ii*) coalescing around the MiFID II standards and relinquishing important safe harbors from liability under Section 28(e) of the Securities Exchange Act of 1934 (Section 28(e)). All of this is subject to forthcoming guidance from the European Securities and Markets Authority (ESMA) and regulatory authorities in EU member states (and possible "gold plating"[3] of the new rules by them), not to mention the likelihood of further complications with Brexit and third-country regulation in the EU.

Below, we identify and briefly discuss the key issues we are discussing with clients:

Uncertainties in the Reach of MiFID II to US Investment Managers in Cross-Border Dealings

MiFID II applies to EU investment firms, including investment managers, which means investment firms domiciled in the EU. (Typically, a US investment manager with an office or affiliate in an EU member state from which it provides portfolio management will be required to become licensed in accordance with the local regulation.) While it is clear that MiFID II will apply to US investment firms' affiliates domiciled in the EU, it is less clear whether and when MiFID II restrictions effectively will apply to a non-EU-domiciled investment manager on a "pass through" basis managing client accounts under various types of sub-advisory arrangements (*e.g.*, delegation, sub-advisory, and dual hatting or "participating affiliate" arrangements under guidance provided by the Securities and Exchange Commission (SEC) staff). Potentially, covered arrangements might include any arrangement under which an EU investment manager has delegated investment discretion and trading authority to a US investment manager, which some EU regulators informally have suggested would require that MiFID II requirements be imposed contractually on the US investment manager.

When considered with the potentially broad extraterritorial scope of MiFID II, which can apply to an EU investment manager generally without regard to where its clients are located, determining the reach of MiFID II is particularly tricky in a cross-border context. The numerous scenarios for cross-border dealings among affiliates and the analysis under MiFID II go beyond the scope of this commentary but deserve serious attention by US investment managers offering investment management services on a global basis. In particular, US asset managers should carefully consider any amendments to sub-advisory or other delegation arrangements with EU firms or EU-

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domiciled funds to understand fully the potential impact on their US regulatory obligations and organizational structure.

Effect of MiFID II Adherence on US Investment Managers Relying on Section 28(E)

A US investment manager that seeks to adhere to MiFID II should be able to continue to use client dealing commissions to pay for research outside the zone of MiFID II in reliance on Section 28(e). Section 28(e) insulates a fiduciary from claims that it has paid excessive commissions and, with disclosure, that the higher commissions for some clients are paid to finance research even though such research may be used in the management of accounts of other clients (so-called "cross-subsidization"). However, if a US investment manager seeks to pay for research in connection with its US business on an unbundled basis—*i.e.*, using client commissions to follow an RPA-like approach of paying for research alongside commissions (*e.g.*, by having each account charged a research fee alongside a trading commission, or "hybrid RPA")—it is not clear that the research payment would be treated as a "commission" for purposes of Section 28(e).[4]

For US investment managers, including MiFID II covered accounts in aggregated trades for other accounts might complicate compliance with fiduciary obligations and regulatory requirements.

Correspondingly, issues might arise regarding the availability of the Section 28(e) safe harbor, including for accounts subject to the Investment Company Act of 1940 or the Employee Retirement Income Security Act of 1974 for which disclosure alone does not suffice to address conflicts, and transactions outside of the Section 28(e) safe harbor may be prohibited. In addition, taking this sort of hybrid RPA approach in the US could raise issues regarding the investment manager's authority to impose research costs on clients outside bundled commissions and the treatment of such research expenses for various reporting purposes, including expense reporting for pooled investment vehicles such as investment companies and performance reporting on a "net" basis.[5]

Effect on US Investment Manager Trading of US and EU Client Accounts

For US investment managers, including MiFID II covered accounts in aggregated trades for other accounts might complicate compliance with fiduciary obligations and regulatory requirements. Investment manager and broker-dealer mechanisms for the imposition of research costs through RPAs are still in development and could require that order flow for MiFID II covered accounts and other accounts be segregated. This could raise issues under traditional trade aggregation and trade order procedures, especially for orders that are potentially market moving or which might be only partially filled. Even where a US investment manager can aggregate orders for MiFID II covered accounts with orders for other accounts, current SEC staff guidance[6] can be read to require that commission costs be allocated to all accounts participating in an aggregated order on a pro rata basis without regard to whether the accounts are similarly situated because of their research funding arrangements. This could mean that EU accounts included in an aggregated order would have to be charged an average commission with other participating accounts, even where the average commission includes the implicit cost of research.

Accordingly, if the other accounts pay full service commissions to finance research on a soft dollar basis consistent with US law and practice, it could raise inducements concerns under MiFID II. (We would expect that the SEC staff will address this and confirm that the obligation to allocate commission costs pro rata only applies to similarly situated accounts.)

Potential Custody Issues for RPAS and the Authority to Fund Them

Depending on emerging EU guidance on the status of RPAs and investment managers' authority to fund such accounts, US investment managers might be confronted with possible custody issues under Rule 206(4)-2 and, for investment company clients, Section 17(f) of the Investment Company Act of 1940. EU guidance thus far has indicated that, although clients need to agree to their managed accounts funding RPA accounts and that any unspent balances would revert to the client, RPA accounts need not be treated as client money (*e.g.*, for purposes of United Kingdom (UK) client money rules). The research charges should belong to the investment manager once deducted from the client account (and until any unspent balances revert to the client) and should be used to purchase research to benefit that client.

As long as these positions remain in place, it is possible that US investment managers will not have to treat RPA account balances as customer funds under Rule 206(4)-2 or Section 17(f) of the Investment Company Act of 1940, and that client authorization to use client monies to fund RPA accounts should be treated as akin to an investment manager's authority to deduct fees from client accounts (*i.e.*, such authority would not trigger the surprise examination requirements under the rule). However, SEC staff confirmation of these points will be important as we approach the compliance date in January 2018.

Practical questions abound in this context with global investment managers that coordinate investment decision making and share research—and the related questions may well outnumber the answers.

Similarly, the requirement that unspent monies in RPA accounts be returned to the client is an aspect of the MiFID II requirements that will have to be evaluated for US law implications, including custody, required Form ADV Part 2A disclosure of fee arrangements, refundability of prepaid fees, and insolvency risk.

Complication with Research-Sharing Arrangements

Research-sharing arrangements between and among affiliates has been an open issue without clear regulatory guidance in the US on the proper analysis under Section 28(e), although various legal theories and policies can support the practice. This issue becomes more complicated in the context of MiFID II, which requires that research funded by a client's RPA assessments be used in the management of that client's account and, conversely, not be used in the management of other client accounts not contributing to the RPA arrangement (*i.e.*, no cross-subsidization). The UK Financial Conduct Authority (FCA) stated the following in September 2016:

> Firms must ensure the specific charge to a client and the corresponding budget that charge is contributing towards does actually pay for research which can assist its investment decisions for the client. Firms should document and be able to justify how they have grouped client portfolios for this purpose. . . . A group of portfolios for which a shared budget is set should not be so broad that portfolios with substantively different research needs are subject to the same budget.[7]

Practical questions abound in this context with global investment managers that coordinate investment decision making and share research—and the related questions may well outnumber the answers. Further guidance from ESMA or regulators in EU member states on whether research may be shared, for example, where sharing is reciprocal (*i.e.*, where the affiliated investment managers reciprocally and mutually share research for the benefit of all client accounts) or incidental (*i.e.*, where the obtaining

investment manager properly obtains and uses the research, and sharing it with an affiliate does not deplete the RPA balances available for the obtaining investment manager's clients) will be critical for global investment managers.

Consequence of Conflicting Research Valuations

The need to ascribe a specific price or value to research under MiFID II could result in difficult-to-resolve pricing issues across multiple firms and strategies if pricing decisions differ. For example, since different research votes can value research differently, issues might arise if a global investment manager has established different prices for the same items of research for different strategies or categories of accounts (*e.g.*, EU versus US accounts, or different values determined by different portfolio management or research teams). Moreover, if a global investment manager determines that an item of research has a lower value for MiFID II covered accounts and a higher value (and implicit cost) for US accounts for which the item can be obtained through soft dollars, will this raise questions under the reasonableness determination requirement under Section 28(e) or inducements concerns under MiFID II?

Clients that Say "No" to RPA Funding of Soft Dollars

In the past, global investment managers have had to navigate complexities of trading for a relative minority of clients that say "no" to soft dollars. Possible options have included having those clients' accounts traded separately at an execution rate or aggregating those clients' trades at the same commission rate as other clients' trades but with the investment manager forgoing soft dollar credits on the accounts that said "no" to soft dollars. Of course, it has always been difficult to reconcile the potential cross-subsidization or "free-rider" issues that arise when certain clients prohibit the use of commissions to acquire research. The complexity of this issue may grow, however, if the universe of objecting clients increases in response to the imposition of explicit research charges, or if any of the current approaches is seen to exacerbate inconsistencies between the treatment of US and EU clients or raise other fiduciary concerns. At a minimum, investment managers may wish to consider the scalability of current approaches and revisit disclosures in this area.

Exposure of RPA Account Balances to the Claims of Creditors

While guidance from ESMA suggests that RPAs are not client assets and must be within the control of the investment manager, ESMA has not specified whether RPA accounts must be maintained in a manner sufficient to protect them from the claims of an investment manager's general creditors. ESMA has made clear, however, that when administration of the RPA is outsourced, RPA account money should be "ring-fenced" and clearly separated from other funds of the RPA administrator "such that [the money] remain[s] legally owed to the investment firm" and the "third party provider should have no right of set-off over the money or be entitled to use it as collateral or otherwise for their own benefit."[8] The safekeeping of RPA accounts thus differs from maintenance of soft dollar balances by broker-dealers in the US, where at least one bankruptcy court has ruled that soft dollar balances maintained with a broker-dealer are not customer property under the Securities Investor Protection Act of 1970 but rather are general unsecured claims.[9]

Strategies to "Ring Fence" MiFID II's Research Requirements

Given the substantial change from current practice (*i.e.*, using soft dollars), it seems obvious that both managers and broker-dealers will have incentives to "ring fence" the strict application of MiFID II's requirements. However, the broad scope of the MiFID II restrictions may make this difficult and, currently, there are more questions here than answers:

- Will the MiFID II regime lead to a restructuring of inter-affiliate investment management agreements and arrangements to limit the scope and applicability of the regime?
- Will investment managers seek to restructure their operations to permit trades to be conducted under the US regime both to obtain research under Section 28(e) on a bundled basis and to avoid a possible cut-off from research by US broker-dealers, absent SEC relief making it clear that they may receive cash payments for research without causing them to be investment advisers under the Investment Advisers Act of 1940?
- Will global money managers with EU-domiciled affiliates seek to move investment management out of EU member states, thereby limiting the role of EU-domiciled investment teams to providing trading and/or research?
- Will global investment managers seek to bypass MiFID II or limit its scope by changing their trading strategies—such as by purchasing non-US securities in ADR form or synthetic exposure through derivatives in the US where available?
- Will the new MiFID II regime prompt research arbitrage—firms seeking to rationalize their usage of research to make the greatest use of available items (*i.e.*, obtaining market data, corporate access, and conferences under Section 28(e) and using client RPAs to finance research on futures, foreign exchange, and principal trades in fixed income)?

Care with Disclosures

For US investment managers who are potentially subject to MiFID II's research regime, the next round of Form ADV Part 2A disclosures will be particularly important to describe each firm's approach to obtaining research—whether through the firm's own money, soft dollars, or client-funded RPAs. This topic scarcely is covered in existing firm Form ADV Part 2As and will be an important area of focus—given that in-artful drafting can lead to sharp regulatory judgments with the benefit of hindsight.

. . .And Many More

Other open questions under MiFID II include the following:

- Can EU investment managers use Section 28(e) vis-´-vis US clients?
- Does compliance with SEC staff guidelines requiring the use of gross performance require that gross performance be shown net of research costs? (Presumably, yes.)
- Who will be responsible for paying RPA administrators for their services (*i.e.*, will investment managers have to pay the costs, or can they be passed on to clients through a debit from the RPA funds)?
- Since MiFID II requires client agreement to the use of RPAs to finance research, may a covered investment manager seek client agreement to use RPA funds to obtain items or materials that may otherwise be precluded under current law (*e.g.*, in the UK, corporate access)?

ENDNOTES:

[1]With no press coverage, the Securities and Exchange Commission's Equity Market Structure Committee in April published recommendations of its buy-side members that steps should be taken to address MiFID II impacts in two ways: (i) "Ensure that the safe harbor established under Section 28(e) of the Securities Exchange Act of 1934 allows for firms to pay for research out of separate Research Payment Accounts as defined by MiFID II that are funded out of client's custodian accounts"; and (*ii*) "Exemptive Relief/rule-making from Investment Advisers Act Section 202(a)(11)(C) to allow broker-dealers to

receive "hard dollars" without invoking the "special compensation" clause that would require them to become investment advisers." According to the statement, "[b]uy-side participants are concerned that failure to provide such relief would limit U.S. broker dealer counterparties and prevent U.S. broker dealers from trading with them on a principal basis." *See* Memorandum from Equity Market Structure Advisory Committee Customer Issues Subcommittee to Equity Market Structure Advisory Committee (EMSAC), *available here*: https://www.sec.gov/spotlight/emsac/emsac-customer-issues-subcommittee-status-report-040317.pdf (April 3, 2017).

[2]*See* "EU's New Regime on Payments for Research, Use of Dealing Commissions"; *LawFlash*, posted April 3, 2017; *available here*: https://www.morganlewis.com/pubs/eus-new-regime-on-payments-for-research-use-of-dealing-commissions.

[3]The practice whereby national competent authorities in transposing an EU Directive into local law include additional requirements that go beyond what is required by the Directive.

[4]The term "commissions" is not defined in the Exchange Act. The SEC itself has adapted the concept of "commissions" to embrace changes in US securities markets, including to overcome narrower SEC staff interpretations that construed the term to encompass only commissions on agency transactions. In 2001, the SEC stated that "we now interpret the term 'commission' in Section 28(e) of the Exchange Act to include a markup, markdown, commission equivalent or other fee paid by a managed account to a dealer for executing a transaction where the fee and transaction price are fully and separately disclosed on the confirmation and the transaction is reported under conditions that provide independent and objective verification of the transaction price subject to self-regulatory organization oversight." SEC Interpretation: Commission Guidance on the Scope of Section 28(e) of the Exchange Act, Exchange Act Release No. 45194 (Dec. 27, 2001).

[5]For example, see Form N-1A, Item 3, which sets forth requirements for disclosure of fund annual expenses in a prospectus. In general, a specific applied expense will be reflected in a fund's expense ratio. In contrast, implicit soft dollar research costs generally will not be treated as an expense but will nonetheless affect total return.

[6]*SMC Capital, Inc.*, SEC Staff No-Action Letter (Sept. 5, 1995); *available here*: https://www.sec.gov/divisions/investment/noaction/1995/smccapital090595.pdf.

[7]*See* FCA, CP16/20, Markets in Financial Instruments Directive II Implementation—Consultation Paper III, Section 3.22 (Sept. 2016).

[8]ESMA, Questions and Answers on MiFID II and MiFIR investor protection topics (Apr. 4, 2017), Inducements, Answer 2 at 42.

[9]*In re Lehman Brothers, Inc., Debtor*, 474 B.R. 139 (S.D.N.Y. July 10, 2012).

SEC ENFORCEMENT, ALJs AND THE APPOINTMENTS CLAUSE

By Thomas O. Gorman

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The future of the Securities and Exchange Commission's (SEC's) administrative enforcement process and, in particular its Administrative Law Judges (ALJs), will be the focus of the D.C. Circuit later this month as the Court, sitting *en banc*, hears oral argument in *SEC v Raymond J. Lucia Companies, Inc., v. SEC*.[1]

The question for decision is whether the SEC's ALJs must be appointed to their positions in accord with the Constitution's Appointments Clause, Art. II, sec. 2, cl. 2. The SEC admits that its ALJs are not appointed in accord with the dictates of the Clause—they are hired through a typical employee hiring process. If the ALJ's must, as Petitioners' contend, be appointed in accord with the Clause, it is a structural error which voids the proceeding. Its impact on other proceedings may be equally significant, although the question has been little attention discussed in other cases presenting the issue.[2]

Petitioners' Brief

SEC registered investment adviser Raymond J.

Lucia Companies, Inc., charged with, and found liable for, violating certain provisions of the Advisers Act, contends that the administrative proceedings in which the adverse ruling was made are a nullity. Specifically, the adviser asserts that the ALJ who presided over the hearing was not appointed in accord with the Constitution's Appointment Clause, voiding the proceeding.

The Appointments Clause provides in pertinent part that that the:

> President shall nominate, and by and with the Advice and Consent of the Senate, shall appoint Ambassadors, other public Ministers and Consuls, Judges of the supreme Court, and all other Officers of the United States, and all other Officers of the United States, whose Appointments are not herein otherwise provided for, and which shall be established by Law; but the Congress may by Law vest the Appointment of such inferior Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments.

With this Clause the Framers sought to ensure that all officers of the United States would be the choice of the people, thereby preventing the type of abuses which took place at the time.[3] The Appointments Clause provides the exclusive means for appointing any officer of the United States whose position is established by law and who exercises significant authority pursuant to the laws of the United States, as exemplified by *Buckley v. Valeo*.[4] The Clause recognizes two types of Officers: *i*) Principal Officers and *ii*) Inferior Officers. The former includes ambassadors, ministers, heads of departments, judges and others who report directly to the President. They can only be appointed by the President with the consent of the Senate. The latter has been held to include a variety of positions. The appointment to those positions can only be made by the President, a Department Head or the Courts.

The limitations of the Clause serve to preserve the "Constitution's structural integrity by preventing the diffusion of the appointment power, as seen in *Freytag v. Commissioner*.[5] Indeed, the safeguard is so fundamental that an impropriety in the Officer's appointment "goes to the validity of the [underlying] proceeding."[6] Stated differently, proceedings conducted by those appointed in violation of the Clause are a nullity.

The question here is whether SEC ALJs are "inferior" officials who must be appointed by the President, a Department Head or otherwise in accord with the Clause. The test, as established by *Buckley* and other decisions of the Supreme Court, is twofold: *i*) Whether the position was "established by Law" and *ii*) if the person exercises significant authority under the laws of the United States. The first prong of the test has been construed to be very broad. This is reflected in the long list of those held to be Officers within the meaning of the Clause, according to Petitioners, which include: district-court clerks, a clerk to an assistant treasurer, an assistant-surgeon and cadet-engineer, numerous clerks in the Departments of the Treasury, Interior and others, election monitors, federal marshals, commissioners of the circuit courts who took bail for the appearance of those charged with a crime, extradition commissioners and U.S. attorneys.

With this Clause the Framers sought to ensure that all officers of the United States would be the choice of the people, thereby preventing the type of abuses which took place at the time.

Under the Clause, those who preside over adjudicative proceedings in the role of a trial judge have been held to be Officers within the meaning of the Clause. The leading case is *Freytag*, where the Supreme Court concluded that the appointment of "special trial judges" of the U.S. Tax Court who preside over trials and make preliminary dispositions is subject to the

Clause. This is because their position was established by law and, while the ultimate case decision is subject to the ruling of a Tax Court judge, the special trial judges exercise a great deal of authority.

Under *Buckley* and *Freytag* it is clear that SEC ALJ's must be appointed under the Clause. First, the position is established by law, according to Petitioners. The position of the ALJ's is specified in U.S. Code Sections 556-557 of Title 5 and their duties are defined in the securities laws and by Commission regulations.

Second, there can be no doubt that SEC ALJs exercise significant authority under federal law. They are empowered, for example, to amend the charging documents, enter default judgments, consolidate proceedings, administer oaths, issue subpoenas, order the production of evidence, issue protective orders, reject filings for procedural noncompliance, grant extensions of time and stays, hold pre-hearing conferences, regulate the course of the hearing, receive relevant evidence and rule on its admissibility, rule on offers of proof, examine witnesses, regulate the scope of cross-examination, regulate the conduct of the parties and their counsel and impose sanctions. In sum, SEC ALJ's have most of the powers of federal judges and magistrates, Petitioners argue.

Indeed, all three branches of government have recognized them as Officers: The Congress refers to them in statues as Officers; they are Officers under the definitions of that term detailed by the Department of Justice Office of Legal Counsel; and the Supreme Court has noted that the role of an administrative law judge is comparable to that of a judge.

Finally, the decision of a panel of this Court in *Landry v. FDIC*,[7] which suggests a contrary result here should be overruled, according to Petitioners. The *Landry* interpretation of the two-prong test for determining whether the position falls within the clause over emphasizes the question of final authority, contrary to Freytag. The question under *Buckley* and *Freytag* is not one of final authority as Landry found, but of having the ability to exercise significant authority. Thus, the US Court of Appeals for the Tenth Circuit recognized this point in choosing not to follow *Landry* in its recent decision in *Bandimere v. SEC*.[8]

Here it is clear that SEC ALJs do in fact exercise significant authority and in many instances make the final decisions. The rulings by SEC ALJs, for example, become the final decision in the proceeding in about 90% of the cases. And, as the Commission has conceded, Congress "indisputably permitted the SEC to treat ALJ initial decisions as final," according to Petitioners (emphasis original). Accordingly, SEC ALJs are in fact Officers of the United States within the meaning of the Appointments Clause.

Respondent's Brief

SEC Administrative Law Judges are civil service employees of the agency, not Officers of the United States. The federal securities laws vest the adjudicative powers of the SEC exclusively in the Commission whose five members are appointed by the President. The Commission has broad authority in exercising its functions and may employ its employees as deemed appropriate. Regardless of the task delegated to an employee, however, sole and exclusive authority remains with the Commission.

The Commission has chosen to employ ALJs to "assist in the adjudication of matters. . . That practice is discretionary." In making this choice the agency has the authority to decide what role, if any, ALJs or others may undertake in assisting with the implementation of Commission adjudicative powers. Final decisions in adjudicative matters remain at all times with the agency, not those who assist it such as ALJs: "In no circumstance can an ALJ issue a decision that in any respect commits the Commission to a particular view of the law or facts, or in any other way inhibits the Commission's discretion to decide the case. . ." as it deems appropriate.

The Commission's authority is reflected in the man-

ner in which adjudications are typically conducted. The Commission's review of an ALJ initial decision is *de novo*—the agency is free to resolve the case in any manner deemed appropriate. Yet even if the Commission choses not to conduct a plenary review, the determination of the ALJ is not final and effective until the Commission issues a finality order.

This view of Commission ALJ's is consistent with its historical use of ALJs and that adopted by Congress in the Administrative Procedure Act (APA) in 1946. First, employees comparable to current ALJs, but originally called "examiners" or "hearing examiners," have long assisted federal agencies by developing administrative records and crafting the initial determination.

The Commission's authority is reflected in the manner in which adjudications are typically conducted.

Second, when enacting the APA, Congress considered various proposals regarding the adjudicative function of agencies. One, for example, was to create an administrative court. After considering this and other alternatives Congress, in the APA, provided for examiners that would be appointed by each agency in accord with "'the civil-service and other laws.' " The Supreme Court in *Ramspeck v.Federal Trial Exam'rs Conference*,[9] a case in which examiners challenged aspects of the Civil Service Commission's regulations applicable to them, rejected the claim and upheld the regulations as reflecting the intent of Congress. This reading of the APA is also consistent with the structure of the Act which makes it clear that "as employees, ALJs function to assist—but not to bind—politically accountable agency heads in the exercise of their adjudicative powers," according to the Commission. While the name "hearing examiner" was changed to administrative law judge in 1978 by Congress, their subordinate role remained the same.

Petitioners' efforts to analogize SEC ALJs to Article I judges, as well as their reliance on the Supreme Court's decision in *Freytag*, is misplaced. *Freytag* centered on the role of special trial judges. Originally the Tax Court was established as the Board of Tax Appeals. It was an independent agency that adjudicated disputes regarding tax assessments. Subsequently, Congress re-established the Board as the Article I Tax Court in the Tax Reform Act of 1969. The commissioners were renamed "special trial judges." Their authority was enhanced, empowering them to issue final and enforceable judgments of the Tax Court in specified classes of cases. They were thus Officers within the meaning of the Appointments Clause.

Commission ALJs are not Article I judges as in *Freytag*. Article I judges, for example, have the ability to enforce discovery orders through the power of contempt, a point *Freytag* found significant. In contrast, SEC ALJs have no such authority.

Finally, Petitioners' claim that each branch of the federal government has recognized that ALJs are in fact the equivalent of an Article I judge is incorrect. Congress did not make such an acknowledgement. This claim is contrary to the fact that Congress classified ALJs as Civil Service employees in the APA. Equally clear is the fact that the DOJ Office of Legal Counsel has not made such an acknowledgement. Rather, in an opinion not cited by Respondents, that office concluded that the Department of Education's ALJs are employees of that department. Finally, the Supreme Court has not acknowledged that ALJs are in fact Officers within the meaning of the Clause, a point reflected by the Court's decision in *Ramspeck.*

To the contrary, this Court's decision in *Landry* faithfully followed *Freytag* as did the earlier panel decision in this case concluding that SEC ALJs are not Officers within the meaning of the Appointments

Clause. Rather they are Civil Service employees as Congress concluded when enacting the APA.

ENDNOTES:

[1]*SEC v Raymond J. Lucia Companies, Inc., v. Securities and Exchange Commission*, No. 15-1345 (D.C. Cir. Argument May 24, 2017).

[2]*See* "Were the SEC Administrative Law Judges Appointed in Violation of the Constitution?" (Thomas O. Gorman); *Wall Street Lawyer*, vol. 21, no. 3; (March 2017); Thomson Reuters West LegalEdCenter.

[3]*The Federalist*, No. 39 at 271 (James Madison).

[4]*See, e.g., Buckley v. Valeo*, 424 U.S. 1 (1976).

[5]*Freytag v. Commissioner*, 501 U.S. 868, 878 (1991).

[6]*Id*. at 879.

[7]*Landry v. FDIC*, 204 F. 3d 9 (D.C. Cir. 2015).

[8]*Bandimere v. SEC*, 844 F. 3d 1168 (10 Cir. 2016).

[9]*Ramspeck v. Federal Trial Exam'rs Conference*, 345 U.S. 128 (1953).

REGULATORY SEA-CHANGE UNDER TRUMP COULD BE LARGEST SHIFT IN HISTORY

An Interview with Scott Mason

Scott Mason is a senior policy advisor with the Public Policy & Regulation Group in Holland & Knight's Washington, D.C., office. He focuses on the intersection between Capitol Hill and the White House on major policy initiatives. Mason was also a member of Pres. Donald Trump's transition team. Contact: scott.mason@hklaw.com.

The changes in regulatory and enforcement priorities usually brought with each new incoming presidential administration can signal a time of confusion and delays as new federal authorities—from cabinet members down to front-line regulators—step in, assess the landscape and start about their work.

Given the focus on deregulation and rule-easement already voiced by the new administration of Pres. Donald Trump, the regulatory shift this time around may be greater than any time in recent history. But what does that mean to certain industries and the legal counsel and law firms that advise those industries?

Scott Mason is a senior policy advisor with the Public Policy & Regulation Group in Holland & Knight's Washington, D.C., office, focusing primarily on the intersection between Capitol Hill and the White House on major policy initiatives and other key priorities. (Mason was also a member of Trump's transition team.)

Mason discussed with Thomson Reuters' Practical Law how the shifting landscape for regulations and federal rules may impact law firms and how best they can benefit in the current environment.

Given the focus on deregulation and rule-easement already voiced by the new administration of Pres. Donald Trump, the regulatory shift this time around may be greater than any time in recent history.

Wall Street Lawyer: *Is there usually a reset or a new approach to regulation with every new presidential administration?*

Scott Mason: Yes, but I think the transition from the Obama administration, which ruled by regulation and ignored the entire Congressional process, to a Trump administration, which is going to be much more business-friendly and less government intervention, is probably more significant. This transition from the 44th President to the 45th, may have a greater impact than potentially ever before.

The Obama administration, once Congress became a roadblock to their agenda, just ignored the legislative branch of government and went about a regulatory regime that really stifled business.

Wall Street Lawyer: *And you think that's going to be different now under President Trump's administration.*

Scott Mason: Absolutely. I think you've seen it already. You've seen that, under Trump's order, that for every new regulation imposed, you've to go take out two. Then also, he assigned to each of the Cabinet secretaries, a 90-day window for them to, quite frankly, summarize the lists of regulations in their agencies that they are working on or would like to eventually do away with, and report back to the President on. That's a significant change.

Also, look at the executive order on climate change that he signed recently and how he undid the stream protection rule before that. Those are pretty significant, and I think that it sets a tone and sends a message that he's serious about changing the regulatory message coming out of Washington. I don't think they're going to repeal every regulation in government, but regulators are certainly going to take a more common sense, business approach to them. That's encouraging.

"I mean, there's been a lot of references to Washington as the swamp. But, in my opinion, the swamp is an important part of the ecosystem."

Wall Street Lawyer: *What do you think the impact of this could be?*

Scott Mason: Ideally, if you remove government from the equation between business and customers, then the idea is that government intervention is not necessary in that relationship. Government does not need to be the big brother for the customer. The customer ultimately is going to make the decision whether or not to support company X.

Are there some industries that some broad-scope, general government regulations are necessary? Sure, there are, but over the last eight years the government had really inserted itself in places of the economy where, I think, it became prohibitive and costly to businesses. So, rather than spending dollars in expansion perhaps, those businesses ended up having to spend their dollars in compliance. I think that was the general frustration of business under the Obama administration.

Wall Street Lawyer: *Looking overall, what does this mean to law firms and the legal industry? Is this new regulatory regime going to be a boom or a deterrent to business?*

Scott Mason: I think it's a boom, really, but I can only speak to it from a public policy perspective.

Those firms like Holland and Knight, quite frankly, that have significantly built-up policy shops are in an extraordinary position to represent their clients across the board before the administration and identify a lot of those rules and regulations, quite frankly, that have handcuffed business for the last eight years.

These public policy shops allow firms to broaden their ability to service their customers, all of whom are going to be impacted by government in some way, shape or form. It gets back to the old adage, if you're not at the table, then you're on the menu. Quite frankly, our public policy shop works hand in hand with lawyers across the firm in all our offices, looking for opportunities to better serve clients that we may or may not already be doing some advocacy work for.

I mean, there's been a lot of references to Washington as the swamp. But, in my opinion, the swamp is an important part of the ecosystem.

Our elected officials, and quite frankly the unelecteds in Washington, are not all subject matter experts on everything that they deal with. I think it's important that there are people in Washington that play the role

that we play in the public policy and the advocacy side to bring their attention to issues that are impacting our clients and the economy, and making them aware of opportunities to improve.

We look at it this way—laws only come from one place, the state or federal government. If you can engage with them before the idea becomes a law, then there's a much greater likelihood that it's going to look like something that you actually can support. Your public policy shops, your advocacy shops, and your lobbyists, quite frankly, allow you to influence that process before it becomes after the fact.

Wall Street Lawyer: *Just looking at the policy actions and the regulatory actions that are happening, from your perspective in a law firm although not a lawyer, do you see what's going on as beneficial to certain practice areas more than others?*

Scott Mason: Certainly. Look at the healthcare bill, for example, and look at the ACA which is still the law. There are 1,400 instances in the law where is says ". . .the secretary shall" or ". . .the secretary may." But now you have a different Secretary of Health & Human Services. I would assume all 1,400 of those instances are now subject to review by Tom Price. That impacts everybody in the healthcare industry.

Or look at tax reform. Corporations are withering on the vine out there at 35% or 36% tax rates. Would they like to see 20%? Yeah, they would. Law firms' tax practices are probably set to thrive and expand. I know that at Holland and Knight, our public policy teams work hand-in-hand with our tax groups, with our healthcare groups, and with our transportation groups as we look ahead to infrastructure bills. Given those opportunities, firms must ask themselves how do we position our clients for success?

Wall Street Lawyer: *Is it a matter of what industries may be under the most regulatory change from one administration to the other that necessitates where legal advice and counsel will be most needed?*

Scott Mason: Definitely. Some industries or some segments of the economy are certainly more regulated than others—your top-end are your financial services, your energy sectors, things like that. The lesser, lower-end are traditionally the retail industry. It's not as heavily regulated, per se. There's not a Secretary of Retail.

But, so many industries across the board, including retail, are also impacted by healthcare, tax reform, trade and transportation.

Wall Street Lawyer: *So, where does this go? Does this find its equilibrium as the Trump administration moves forward?*

Scott Mason: Yes, it will. I think the only thing that slows the reversal of the regulatory environment from the Obama administration to the Trump administration, is, quite frankly, this administration's slower pace to staffing up the agencies.

There are a number of Cabinet secretaries that are frustrated by the administration's slow-paced approach to staffing, because it's oftentimes, with all due respect to Cabinet-level members, the assistant secretaries that actually make the wheels turn. The Trump administration has been a little bit slow in submitting a lot of those assistant secretary-level people for confirmation. It'll take a little time, so that's really the only thing that will slow the pace of the regulatory reversal. Once those people get into their office and start to settle, then I think you'll see a wave of reversals at the agency level that don't require a Presidential executive order to enforce or administrate.

The wheels of Washington turn slowly sometimes, but they do still turn.

REVIVING THE U.S. IPO MARKET: OPENING REMARKS AT SEC-NYU DIALOGUE

A Speech by SEC Commissioner Piwowar

Securities and Exchange Commission (SEC) Commissioner Michael S. Piwowar spoke recently at the joint SEC-New York University (NYU) dialogue on Securities Market Regulation on May 10 in New York City. The event was organized by the SEC's Division of Economic and Risk Analysis and the Salomon Center for the Study of Financial Institutions at NYU. This article is a partial transcript of his remarks; the full speech can be found here: https://www.sec.gov/news/speech/opening-remarks-sec-nyu-dialogue-securities-market-regulation-reviving-us-ipo-market.

I am happy to join you in this discussion and exchange of ideas on the current state of, and outlook for, the U.S. initial public offering (IPO) market. This event is particularly timely, because it coincides with the arrival of Jay Clayton, the SEC's new Chairman as of last week. He has made it clear that, under his leadership, making public capital markets more attractive to business while providing appropriate safeguards for investors will be a priority for the Commission.

An IPO has historically been one of the most meaningful steps in the lifecycle of a company. Going public gives a growing company access to an important source of funding—the public equity market—allowing it to raise capital from a diverse group of investors, often at a lower cost compared to other funding sources. This capital can be used to hire employees, develop new products and technologies, and expand operations. The beneficial uses to which that capital may be put are even more pronounced for small companies because they tend to be more innovative than large companies and they account for a substantial percentage of the jobs created every year.

Furthermore, IPOs give successful entrepreneurs an exit strategy for some or all of their investment, and provide an opportunity for them to allocate their capital and talent to other productive ventures. The same is true for institutional and other early-stage investors. IPOs also have important implications for employees for whom a portion of compensation before the IPO is a promise of future payment from options and stock grants. Through an IPO, such employees can access secondary market trading of the firm's securities and therefore translate anticipated compensation to real dollars.

A vibrant IPO market also allows retail investors to add economic exposure from growing firms and industries to their investment portfolios, either directly or through vehicles such as mutual funds. As such, investors can share in the wealth created by these companies and enhance their overall risk diversification.

Going public gives a growing company access to an important source of funding—the public equity market—allowing it to raise capital from a diverse group of investors, often at a lower cost compared to other funding sources.

Notably, IPOs can enhance capital formation in both public and private markets. For example, if private sources of capital are aware that companies have a viable financing alternative through public markets, an entrepreneur may be in a better position to realize more favorable financing terms from more sources. The number of value-enhancing projects and innovations thus may increase.

In addition, an active IPO market can enhance efficient decision-making among suppliers of capital. The robust disclosures generated by newly public

firms provide investors information to better evaluate investment options because they serve as benchmarks versus other companies both public and private. When complemented with the information provided to the market by third parties such as securities analysts, disclosures by IPO firms provide an important layer of investor protection that typically is not available in private markets.

Given all of the benefits I just articulated, the importance of IPOs to the U.S. economy cannot be overstated. In a nutshell, a robust IPO market encourages entrepreneurship, facilitates growth, creates jobs, and fosters innovation, while providing attractive opportunities for investors to increase their wealth and mitigate risk.

The substantial drop in the number of IPOs in the United States is primarily driven by the disappearance of small IPOs.

For decades, the United States enjoyed a strong IPO market that produced a steady supply of newly public firms and allowed millions of investors to participate in the value creation generated by those firms. Many foreign companies chose to go public in the United States, which gave U.S. investors global investment options to diversify portfolios. For those foreign companies, an IPO in the United States enabled them to expand their funding sources and take advantage of a lower cost of capital compared to their domestic markets. In fact, between 30% and 50% of worldwide IPOs occurred in the United States during the 1990s.[1]

In the last 15 years, however, the reduction in IPO activity has been dramatic. For example, since 2000, the average annual number of IPOs is 135—less than one-third the average annual number of IPOs—457—in the 1990s.[2] This decline has occurred despite the fact that there has been no downward trend in the creation of new companies over the same period. Traditional economic factors, such as fluctuations in companies' demand for capital and changes in investor sentiment, also cannot explain the large decrease. Strikingly, the fraction of worldwide IPOs occurring on U.S. markets fell below 10% between 2007 and 2011.[3]

The substantial drop in the number of IPOs in the United States is primarily driven by the disappearance of small IPOs. In the 1980s and 1990s, IPOs with proceeds of less than $30 million constituted approximately 60% and 30%, respectively, of all IPOs.[4] In fact, some of the most iconic and innovative U.S. companies, such as Apple, Cisco, and Genentech, entered the public market as small IPOs. This trend reversed in the 2000s.[5] IPOs with proceeds less than $30 million accounted for only 10% of all IPOs in the period 2000-2015. By comparison, large IPOs have increased from 13% in the 1990s to approximately 45% of all IPOs since then.[6]

What caused this precipitous decline in IPOs, particularly those of small firms, after 2000? Today's event is intended to identify and discuss the potential causes and consequences. I suspect panelists will highlight a variety of factors that have contributed to making it more difficult, or less attractive, for small companies to go public. For instance, the availability of alternative sources of capital, such as from private equity, hedge funds, and even mutual funds, means that private firms may be able to finance growth without having to go public. The emergence of trading venues that provide liquidity for privately-held shares has had the same effect.

In the interest of time, let me quickly list several other possibilities. New offering methods—namely Crowdfunding and Regulation A—have provided alternatives to the IPO. Consolidation in investment banking and brokerage services has left fewer underwriters for small IPOs. Changes in the economic environment due to globalization, along with the

"winner-takes-all" trend in some industries, means that firms have to get bigger faster to improve profitability, and therefore may prefer being acquired by a large company instead of growing organically. Macroeconomic factors, such as cheaper debt financing and increased mergers and acquisitions activity, may also play a role.

Moreover, regulatory changes may have contributed to the downward trend in IPOs. The Sarbanes-Oxley Act of 2002 imposed higher regulatory burdens on smaller public companies. Decimalization and Regulation NMS changed the economics of market making for small company stocks and left fewer market makers willing to organize a market for small stocks post-IPO. Modifications to the Section 12(g) shareholder threshold introduced by the Jumpstart Our Business Startups (JOBS) Act in 2012 also make it more likely that companies will stay private for a longer period of time.

Changes in the economic environment due to globalization, along with the "winner-takes-all" trend in some industries, means that firms have to get bigger faster to improve profitability, and therefore may prefer being acquired by a large company instead of growing organically.

What, then, can be done to revitalize the IPO market, particularly for smaller companies? As a start, during my tenure as Acting Chairman the Commission adopted amendments to conform our rules and forms to Title I of the JOBS Act.[7] Specifically, Title I of the JOBS Act provided an IPO on-ramp for emerging growth companies, allowing them to use scaled disclosure for a certain period of time. It also improved the information available for IPO firms by allowing analyst reports to be published during the quiet period.

I hope that today's Dialogue will generate even more interesting insights and ideas. I look forward to hearing your discussions, analyses, and recommendations. Both SEC Chairman Clayton and I are especially interested in any suggestions for regulatory and other reforms that could be implemented to reverse the more than decade long decline in U.S. IPOs.

ENDNOTES:

[1]*See* Craig Doidge, G. Andrew Karolyi, and Rene M. Stulz, "The U.S. left behind? Financial globalization and the rise of IPOs outside the U.S.," *Journal of Financial Economics* (Dec. 2013).

[2]*See* Michelle Lowry, Roni Michaely, and Ekaterina Volkova, "Initial Public Offerings: A Synthesis of the Literature and Directions for Future Research" (Mar. 20, 2017), *available at* https://ssrn.com/abstract=2912354.

[3]*See* Doidge, et al., *supra* note 2.

[4]*See* Lowry, et al., *supra* note 3.

[5]*Id.*

[6]Large IPOs are IPOs with proceeds of more than $120 million. Dollar values are inflation-adjusted.

[7]Securities Act Rel. No. 10332 (Mar. 31, 2017), *available at* https://www.sec.gov/rules/final/2017/33-10332.pdf.

SEC/SRO UPDATE: SEC ADOPTS T+2 SETTLEMENT CYCLE FOR SECURITIES TRANSACTIONS; SEC ADOPTS HYPERLINK REQUIREMENT FOR EXHIBITS IN COMPANY FILINGS; SIGNIFICANT SEC APPOINTMENTS BEGIN IN EARLY MAY; SEC CHARGES FORMER STAFFER WITH SECURITIES FRAUD VIOLATIONS

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SEC Adopts T+2 Settlement Cycle for Securities Transactions

On March 22, the Securities and Exchange Commission (SEC) announced that the agency had adopted an amendment to Rule 15c6-1(a) to shorten by one business day the standard settlement cycle for most broker-dealer securities transactions from three business days after the trade date (T+3), to two business days (T+2).[1] The amendment applies only to the securities transactions currently covered by the T+3 cycle and does not affect other portions of the rule, such as the provisions allowing issuers and their underwriters to agree on a different settlement cycle for securities being sold for cash in firm commitment underwritten public offerings.[2]

The amendment reflects the SEC's continuing focus on reducing risks resulting from failed settlements by shortening the settlement cycle, which was previously reduced from T+5 to T+3 in 1993.[3] "As technology improves, new products emerge, and trading volumes grow, it is increasingly obvious that the outdated T+3 settlement cycle is no longer serving the best interests of the American people," said then-Acting SEC Chairman Michael Piwowar, adding that "[t]he SEC remains committed to ensuring that U.S. securities regulation is reflective of modern times, and in shortening the settlement cycle by one day we aim to increase efficiency and reduce risk for market participants."[4]

Broker-dealers will be required to comply with the amended rule beginning September 5, 2017. In the final rule, the SEC indicated that its staff will undertake to provide a report within three years of the effective date about the possibility of reducing the settlement cycle beyond T+2.[5]

SEC Adopts Hyperlink Requirement for Exhibits in Company Filings

On March 1, the SEC announced that the agency had adopted amendments requiring exhibits listed in the exhibit index of specified SEC filings to be hyperlinked.[6]

The amendments will require certain issuers to include a hyperlink to each exhibit in an SEC filing's exhibit index. Currently, an investor seeking to access an exhibit that has been incorporated by reference in an issuer's filing must review the filing's exhibit index to determine the filing in which the relevant exhibit is included, and then must search through the issuer's filings to locate the relevant filing. Hyperlinking will allow investors to directly access such exhibits by clicking on the hyperlinked document in the exhibit index. "As the SEC looks for new ways to modernize financial disclosures, one of the easiest things we can do is add hyperlinks that automatically direct users to additional information on our EDGAR system," said then-Acting SEC Chairman Piwowar. "We are so accustomed to clicking hyperlinks on basically every

website we visit, this commonsense solution will make life simpler for a lot of people."[7]

The amendments apply to SEC forms that are subject to Item 601 of Regulation S-K, which include Forms S-1, S-3, S-4, S-8, S-11, SF-1, SF-3, F-1, F-3 and F-4 under the Securities Act of 1933 (Securities Act) and Forms 10, 10-K, 10-Q, 8-K and 10-D under the Exchange Act, and Forms F-10 and 20-F.[8] Registrants will be required to file such registration statements and reports in HTML format, because the text-based American Standard Code for Information Interchange (ASCII) format cannot support functional hyperlinks. While the affected registration statements and reports will be required to be filed in HTML, registrants may continue to file in ASCII any schedules or forms that are not subject to the exhibit filing requirements under Item 601, such as proxy statements, or other documents included with a filing, such as an exhibit.[9]

The amendments will become effective on September 1, 2017, and most companies will be required to comply with the requirements for SEC filings submitted on or after that date. In the adopting release for the final rule, the SEC expressly encouraged early compliance with the new hyperlink requirements.[10]

The amendments provide a transition period for non-accelerated filers and smaller reporting companies that currently submit SEC filings in the ASCII format. These issuers will have until September 1, 2018 to comply.[11]

Significant SEC Appointments Begin in Early May

Starting with Jay Clayton's swearing in as Chairman of the SEC on May 4,[12] the SEC has begun to address many of the vacancies created by the departure of staff members over the past few months, filling the positions of Director of the Division of Corporation Finance, chief of staff, deputy chief of staff, Chief Counsel to the Chairman, and General Counsel.

Jay Clayton—Mr. Clayton was nominated as Chairman of the SEC on January 20, by President Donald Trump and confirmed by the U.S. Senate on May 2. According to the press release, prior to joining the SEC, Mr. Clayton was a partner at Sullivan & Cromwell, where for more than 20 years he advised public and private companies on a wide range of matters, including securities offerings, mergers and acquisitions, corporate governance, and regulatory and enforcement proceedings.

William Hinman—William Hinman was named the Director of Division of Corporation Finance on May 9.[13] According to the press release, Mr. Hinman recently retired as a partner in the Silicon Valley office of Simpson Thacher & Bartlett, where he was a recognized leader in advising public and private companies in corporate finance matters. Prior to joining Simpson Thacher as a partner in 2000, Mr. Hinman was the managing partner of Shearman & Sterling's San Francisco and Menlo Park offices.

Lucas Moskowitz—On May 11, the SEC announced that Lucas Moskowitz was named the SEC's chief of staff.[14] According to the press release, Mr. Moskowitz served as Chief Investigative Counsel of the U.S. Senate Committee on Banking, Housing, and Urban Affairs, where he led the Committee's investigative and oversight activities in connection with a wide variety of banking, securities, housing, and insurance matters. Before joining the Senate Banking Committee staff, Mr. Moskowitz served as a counsel on the Financial Services Committee of the U.S. House of Representatives, where he worked on legislative and oversight matters to strengthen U.S. capital markets and promote capital formation.

Sean Memon—Sean Memon was named the SEC's deputy chief of staff on May 15.[15] Immediately prior to joining the SEC, Mr. Memon practiced law at Sullivan & Cromwell in Washington, D.C. and previously, Mr. Memon was a member of the Finance and Acquisitions department at Time Warner Inc.

Jaime Klima—On the same day, the SEC announced that Jaime Klima was named Chief Counsel to SEC Chairman Jay Clayton.[16] According to the press release, as Chief Counsel, Ms. Klima will be senior legal and policy adviser, and will coordinate the rulemaking agenda of the Commission. She will also serve as the Chairman's representative on the Deputies Committee of the Financial Stability Oversight Council. Ms. Klima recently served as SEC co-chief of staff under then-Acting SEC Chairman Piwowar, advising on all issues of agency management and policy. Before that, she was counsel to Commissioner Piwowar and Commissioner Troy A. Paredes.

Robert B. Stebbins—The final appointment on May 15 was the naming of Robert B. Stebbins as General Counsel of the SEC.[17] According to the press release, the General Counsel is the chief legal officer of the agency, providing a variety of legal services to the SEC and staff. Mr. Stebbins practiced law at Willkie Farr & Gallagher since 1993, first as an associate and beginning in 2001 as a partner. At Willkie, Mr. Stebbins focused on mergers and acquisitions, private equity and venture capital, investment funds, and capital markets transactions. He also advised clients on SEC compliance issues and corporate governance matters.

SEC Charges Former Staffer with Securities Fraud Violations

On May 9, the SEC charged a former employee with securities fraud in connection with his trading of options and other securities.[18] The SEC's complaint alleged that the employee, who worked at the SEC from 1998 to 2014, concealed his personal trading from the SEC's ethics office and later misrepresented his trading activities to the SEC's Office of Inspector General when questioned during an investigation.

According to the press release, "SEC employees are subject to rigorous rules regarding securities transactions to guard against even the appearance of using public office for private gain." In addition, the SEC's ethics rules specifically prohibit trading in options or derivatives and require staff to disclose their securities holdings and transactions to the agency's ethics office in annual filings.

According to the SEC's complaint, the employee violated the rules by engaging in transactions involving derivatives, failing to obtain pre-clearance before trading non-prohibited securities, and failing to hold securities for the required period. The complaint charged the employee with violating Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act. The employee agreed to settle the charges and pay $51,917 in disgorgement of profits made in the improper trades plus $4,774 in interest and a $51,917 penalty. He also agreed to be permanently suspended from appearing and practicing before the SEC as an accountant, which includes not participating in the financial reporting or audits of public companies. The settlement is subject to court approval.

In a parallel action, the US Department of Justice announced that the employee pled guilty to criminal charges stemming from the false federal filings.

ENDNOTES:

[1]*See* SEC Press Rel. No. 2017-68 (March 22, 2017), *available at* https://www.sec.gov/news/press-release/2017-68-0 (T+2 Press Release).

[2]Rule 15c6-1 of the Securities Exchange Act of 1934 (Exchange Act) prohibits broker-dealers from effecting or entering into a contract for the purchase or sale of a security (other than an exempted security, government security, municipal security, commercial paper, bankers' acceptances, or commercial bills) that provides for payment of funds and delivery of securities later than the third business day (second business day, after September 5, 2017, in accordance with the amendment) after the date of the contract unless otherwise expressly agreed to by the parties at the time of the transaction. 17 CFR 40.15c6-1.

[3]SEC, Amendment to Securities Transaction Settlement Cycle, Release No. 34-80295 (Mar. 22,

2017), *available at* https://www.sec.gov/rules/final/2017/34-80295.pdf (T+2 Final Rule).

[4]T+2 Press Release.

[5]*See* T+2 Final Rule.

[6]SEC Press Rel. No. 2017-55 (March 1, 2017), *available at* https://www.sec.gov/news/pressrelease/2017-55.html. (Hyperlink Press Release).

[7]Hyperlink Press Release.

[8]SEC, Exhibit Hyperlinks and HTML Format, Release No. 33-10322 (Mar. 1, 2017), *available at* https://www.sec.gov/rules/final/2017/33-10322.pdf (Hyperlink Final Rule).

[9]Hyperlink Press Release.

[10]Hyperlink Final Rule.

[11]Hyperlink Press Release.

[12]SEC Press Rel. No. 2017-94 (May 4, 2017), *available at* https://www.sec.gov/news/press-release/2017-94.

[13]SEC Press Rel. No. 2017-97 (May 9, 2017), *available at* https://www.sec.gov/news/press-release/2017-97.

[14]SEC Press Rel. No. 2017-101 (May 11, 2017), *available at* https://www.sec.gov/news/press-release/2017-101.

[15]SEC Press Rel. No. 2017-103 (May 15, 2017), *available at* https://www.sec.gov/news/press-release/2017-103.

[16]SEC Press Rel. No. 2017-104 (May 15, 2017), *available at* https://www.sec.gov/news/press-release/2017-104.

[17]SEC Press Rel. No. 2017-105 (May 15, 2017), *available at* https://www.sec.gov/news/press-release/2017-105.

[18]SEC Press Rel. No. 2017-96 (May 9, 2017), *available at* https://www.sec.gov/news/press-release/2017-96. *See also SEC v. Humphrey*, May 9, 2017, Civil Action No. 17:CV:850 (D.C. Dist. Ct.), *available at* https://www.sec.gov/litigation/complaints/2017/comp-pr2017-96.pdf.

FROM THE EDITOR

By the Numbers: What Does the Am Law 100 Data Really Say about the Legal Industry?

While it's rare that *Wall Street Lawyer* looks at the overall legal industry, the always-anticipated Am Law 100 numbers for 2016, released last month, show a legal industry that may be growing oblivious to the myriad pressures that others are saying will eventually take its toll—and that is worth noting.

Indeed, the release of these relatively strong marks—revenue growth up 4.3% (an increase of a full 150 basis points compared to last year) and profits per equity partner up by 3%—demonstrate, as *The American Lawyer* wrote, "results [that] were rather impressive for an industry facing a number of headwinds, not least of which was flat demand for their lawyers' time."

Of course, critics made a bit of hay about the dip in what the Am Law 100 has always considered its most reliable single indicator of a law firm's financial health, revenue per lawyer (RPL). But even here the news was not dire: RPL still *gained*, though not as much as last year, 1.5% for 2016 compared to 2.6% the previous year. The numbers also showed that the percentage gain in lawyer headcount almost *tripled* in 2016, compared to each of the last two years.

For those—and they are legion—who have warned that large law is ignoring the pressures of tech innovation, heightened client desire for efficiency and lower cost, new legal service provider entrants and a changing legal workforce at their own peril, the new numbers were something of a surprise.

"These results in the context of the way the world is going are frankly shocking," says Ralph Baxter, former chair of Orrick and chair of the Thomson Reuters' *Legal Executive Institute* Advisory Board. "These are very favorable numbers and shows that many firms are doing well."

While that's good news, obviously, Baxter explains, as results such as these continue to be the norm rather than the exception, law firms are growing complacent about the need for change even as the legal industry continues to evolve around them. "Why haven't profits eroded? I don't know," Baxter says. "Firms are not making major changes in their business models or in their process management models. They are defying the pressures of the market."

Bruce MacEwen, of *Adam Smith, Esq*. and author of the new book *Tomorrowland: Scenarios for Law Firms Beyond the Horizon*, agrees that the totals are impressive and continues to show the stratification of those large firms that are building on years of continued success to pull further away from the pack. Indeed, *The American Lawyer* wrote that the second leg of their roster, firms ranked #51 to #100, were facing "a crossroads" and urged them to concentrate on differentiating themselves to remain relevant.

"There are out-performing firms and then there's everyone else," he says, adding that he also agrees with Baxter that results such as these diminish the case that large law firms need to act now to ensure their survival. "The innovation being done at many of these firms is next to nothing," MacEwen notes. "But how can we expect anything different when there is no urgency?"

Baxter adds that may be the ultimate take-away from the Am Law 100 numbers for 2016: Despite the robust profit numbers that may reflect a healthy industry at its prime, the legal world is changing, and no entity can prevail if it does not accept and adjust to that fact. "Work is leaking away, and that pressure will continue," he says. "The next five years will see it increase much faster than it did in the last five."

—Gregg Wirth, Managing Editor

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