Financial Industry Regulatory Authority

Annual Conference

Washington, DC May 27-29, 2015

Ethics and Professional Responsibility for Compliance and Legal Professionals
Thursday, May 28
4:15 p.m. – 5:15 p.m.

Topics:

- Understand when internal investigations are privileged.
- Identify the ethical issue in contacting former employees.
- Recognize what provisions to remove from confidentiality agreements.

Speakers:

Alan Lawhead *(moderator)*
Vice President and Appellate Group Director
FINRA Office of General Counsel

Norman Ashkenas
Senior Vice President and Chief Compliance Officer
Fidelity Brokerage Services, LLC

Anirudh Bansal
Partner
Cahill Gordon & Reindel LLP

Elizabeth Mitchell
Partner
WilmerHale

Ethics and Professional Responsibility for Compliance and Legal Professionals

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FINRA
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Panelists

Moderator:

- Alan Lawhead, Vice President, FINRA Office of General Counsel

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- Elizabeth Mitchell, Partner, WilmerHale

Chief Compliance Officer

- The Firm is a mid-sized, full service broker-dealer.
- The chief compliance officer (CCO) is a lawyer.
- The CCO is a member of the firm's committee that reviews reportable matters under FINRA Rule 4530 (Reporting Requirements).
- The agenda for the 4530 committee includes two items.

Form U4 and U5 Issues

- **Item one involves Form U4 and U5 filing mistakes.**
  - **Approximately 50 U4s and U5s were filed between 31 and 365 days after the reportable event.**
  - **A few Form U4s and U5s did not disclose arbitration claims against the Firm's registered persons when the registered person was identified as selling an unsuitable product, or a similar violation, but was not a named respondent.**
  - **These problems lasted for years.**

Form U4 and U5 Issues

- The compliance specialist who investigated this problem concludes that the late filings were a result of employee departures and an inattentive manager.
- The failure to report arbitration claims resulted from procedures that were out-of-date. The procedures had been written, years earlier, by a law firm that the Firm hired.
- The compliance specialist who summarized this item is not a lawyer.

Outside Business Issues

- **Item two describes Lucky Larry, a registered representative, who sold a term life insurance policy without disclosing it to the Firm.**
  - **Larry had just completed the Firm's training on outside business activities and private securities transactions, but sold the insurance policy anyway.**
  - **The Firm's Director of Sales has docked Larry's pay by $2,000.**
- **The compliance specialist who summarized this item is a lawyer.**

Internal Investigations

- **Issue: When are internal investigations privileged?**
- **Analysis: Understand what attorney-client privilege is:**
  - **The asserted holder of the privilege is or sought to become a client.**
  - **The person to whom the communication was made**
    - is a member of the bar of a court or her subordinate and
    - is acting as a lawyer in connection with this communication.

Internal Investigations

- **The communication relates to a fact of which the attorney was informed**
  - **by her client**
  - **without the presence of strangers**
  - **for the purpose of securing primarily either**
    - an opinion on law or
    - legal services or
    - assistance in some legal proceeding and
    - is not for the purpose of committing a crime or tort.
- **The privilege has been asserted and not waived by the client.**

Internal Investigations – Who conducts them?

- **Issue: Do you have to use an attorney to maintain privilege?**

  Not necessarily, as depending on facts and circumstances privilege may be successfully asserted when a non-attorney is used, or unsuccessful when an attorney is used.

- **Analysis: Under Upjohn, the attorney-client privilege may still apply even if the internal investigation interviews were conducted by non-lawyers if the non-lawyers were acting under the direction of attorneys.**

Internal Investigations – Who conducts them?

- ***But* – even using attorneys to gather information is not determinative, as information gathering by an attorney will not be privileged when the underlying facts are not privileged.**
  - For example, certain documents are not privileged:
    - Documents collected at in-house counsel's direction; and
    - Drafts prepared to respond to investor questions.
    - *SR Int'l Bus. Ins. Co. v. World Trade Ctr. Props.* LLC, 2002 U.S. Dist. LEXIS 11949, at *11-12 (S.D.N.Y. Jul. 3, 2002).

Internal Investigations – Who conducts them? (cont.)

- **Note:** "Magic words" such as "the purpose of the interview was to assist the company in obtaining legal advice" are not required where employees are aware that the legal department is conducting a sensitive internal investigation and that the information they disclosed would be protected.
- **Do you need to use outside counsel**? Again, under Upjohn involvement of outside counsel in an internal investigation is not a necessary predicate for the attorney-client privilege to apply.
  - **But –** In-house counsel may be subject to more scrutiny than outside counsel because of concerns about independence and because of a more likely mix of business and legal functions.
    - *Bank Brussels Lambert v. Credit Lyonnais SA*, 220 F. Supp. 2d 283 (S.D.N.Y. 2002).

Internal Investigation – What warnings are given?

- **Provide *Upjohn* warnings:**
  - Counsel represents the firm, not the employee
  - Interview is being conducted in order to provide legal advice to the firm
  - Conversation is privileged
  - Privilege belongs to the firm, not the employee
  - The firm may decide to waive the privilege and share the information with third parties, including regulators
  - In order to maintain privilege, keep conversation confidential
- **Repeat *Upjohn* warning at each interview.**
- **Document recitation of warning.**

Internal Investigation

- **Issue: Who should be on the 4530 Committee to keep the review privileged?**
- **Analysis: Who is on the committee is less important than the purpose of the investigation, as held in *Kellogg Brown & Root* which provided significant support, and guidance, for protection of the privilege in internal investigations:**
  - Communications that relate to both business and legal purposes can be privileged, as "long as obtaining or providing legal advice was one of the significant purposes of the internal investigation, the attorney-client privilege applies, even if there were also other purposes for the investigation and even if the investigation was mandated by regulation rather than simply an exercise of company discretion."(emphasis added).
  - Kellogg Brown & Root, Inc., 756 F.3d 754, 758 (D.C. Cir. 2014).

Internal Investigation

- **Issue:** Who should be on the 4530 Committee to keep the review privileged?
- **Analysis:** Consistent with state law, *U.S. v. Halifax Hospital* held that the attorney-client privilege will not protect communications with lawyers which are deemed to constitute business advice. Thus, to the extent attorney investigators were acting as investigators to aid a business decision, rather than lawyers providing legal advice, the attorney-client privilege would likely not apply. It follows that routine advice from Compliance officers will be presumptively viewed as non-privileged.
- **Note:** The Compliance advisory role, which is often played by members of the 4530 Committee, is not afforded the protections of privilege and work product. Given the role played by Compliance in regulated entities, regulators expect ready access to communications between Compliance officers and those within the organization to whom they provide advice, as well as the work product generated in the course of fulfilling their monitoring and control functions.

Maintaining Privilege in Internal Investigations

- Create a written document – from a legal officer – authorizing / outlining the planned review.
- Issue *Upjohn* warnings at the beginning of interviews.
- Limit communications about the investigation within the entity to those with a "Need to Know."
- Carefully consider any communications outside the privileged group which could constitute a waiver.
- Utilize attorneys for key tasks such as interviews; where non-attorneys are engaged on tasks, document that tasks are undertaken at the direction of counsel and provide appropriate oversight / supervision.

2. Cooperation With Regulators and Waiver of the Privilege

Cooperation With Regulators

- **Facts:** The Firm reported the late Form U4 and U5 filings to FINRA under Rule 4530. But the Firm also wants to cooperate fully.
- **Issue:** How can the Firm cooperate with FINRA while not waiving any privileges?
- **Analysis:** The Firm can:
  - provide non-privileged key documents
  - summarize findings for the regulator, and
  - have counsel answer questions.

Cooperation With Regulators

- **Facts:** The Firm discusses its findings with FINRA, and FINRA requests additional email searches, using search terms it provides.
- **Issue:** Would using FINRA's search terms waive work product protection?
- **Note:** FINRA does not require waiver of privilege for a firm to be under consideration for cooperation credit.
  - ***Regulatory Notice 08-70*, n.9 (Nov. 2008).**

Subject Matter Waiver

- **Facts:** The Firm voluntarily decides to give FINRA some witness interview memos.
- **Issue:** Does sharing interview memos waive work product or attorney-client privilege?
- **Analysis:** Uncertainty.
  - For no waiver: *see, e.g., U.S. v. Treacy*, 2009 U.S. Dist. LEXIS 66016 (S.D.N.Y. Mar. 23, 2009). Even when a company turns over witness interview memos to a regulator, interview memos of other witnesses remain privileged.
  - Caution: Facts and circumstances driven. Other decisions find subject matter waiver.

Selective Waiver

- **Issue:** If the Firm decides to share privileged material with FINRA, can it retain the privilege with respect to those materials for other purposes?
- **Analysis:** Selective waiver of the attorney-client privilege has been widely rejected.
  - The First, Third, Fourth, Sixth, Tenth, and DC Circuits have rejected selective waiver.
    - *In re Qwest Commc'ns Int'l, Inc.*, 450 F.3d 1179 (10th Cir. 2006).
  - The Eighth Circuit has approved the selective waiver doctrine. *Diversified Indus., Inc. v. Meredith*, 572 F.2d 596 (8th Cir. 1977).
  - The Second Circuit has adopted a case-by-case approach to application of selective waiver.

Selective Waiver

- For a claim of attorney work product protection, the Second Circuit has declined to outright reject the selective waiver doctrine. In *Steinhardt Partners, L.P*., 9 F.3d 230, 236 (2d Cir. 1993), the court wrote that it:
  - "decline[d] to adopt a *per se* rule that all voluntary disclosures to the government waive work product protection."
- Some courts have left the door open for the application of selective waiver where the party asserting it produced privileged materials to regulators pursuant to a protective order or confidentiality agreement.
  - *Teachers Ins.& Annuity A'ssn. of America v. Shamrock Broadcasting Co.,* 521 F. Supp. 638 (S.D.N.Y. 1981).

3. External Reporting: The Whistleblowing Attorney

External Reporting – The Whistleblowing Attorney

- **Facts:** The Firm concludes its investigation of Larry's outside business activity, and decides not to report it to FINRA because the disciplinary action taken does not meet the requirements of Rule 4530(a)(2), which requires member firms to report discipline involving suspension, termination or the withholding of compensation *in excess of $2,500*.
  - However, the Firm's responsible Compliance Investigator – an attorney – insists, in a memo to the General Counsel, that she has not completed her investigation. She intends to resign.
- **Issue:** Can the Compliance Investigator "report out" the Rule 3720 violation to the SEC?

External Reporting – SEC Position

- **Section 205.3 of the SEC's Standards of Professional Conduct for Attorneys (17 C.F.R. § 205.3(d)(2)) permits attorneys "appearing and practicing before the Commission in the representation of an issuer" to reveal confidential company information to the extent the attorney "reasonably believes necessary" to:**
  - Prevent a "material violation" likely to cause substantial injury to the issuer or investors;
  - Prevent perjury or false statements before the Commission; or
  - Rectify injury from a material violation "in the furtherance of which the attorney's services were used."

External Reporting – SEC Position

- "Appearing and practicing" includes communicating "in any form" with the SEC, "representing" a company in connection with any SEC proceeding or request, or "providing advice" impacting any SEC filing, but does not include such activities outside the attorney-client relationship. (17 C.F.R. § 205.2(a)).
- A "material violation" is a "material violation of … federal or state securities law, [or] a material breach of fiduciary duty arising under … federal or state law." (17 C.F.R. § 205.2(i)).
- **Question:** Does a violation of FINRA Rule 3270 (Outside Business Activities of Registered Persons) qualify as a "material violation"?

External Reporting – State Ethics Rules

- ABA Model Rule 1.6: An attorney may reveal confidential client information only if reasonably necessary to prevent the client from committing a crime or fraud that is "reasonably certain" to result in substantial financial harm, or to mitigate or rectify such harm, *where the lawyer's services have been used in furtherance of the crime or fraud*.
- **Question:** Were the Compliance Investigator's services used in furtherance of a crime or fraud?

External Reporting – State Ethics Rules

- Many state ethics rules, including those in the four states with the highest number of recent SEC whistleblower complaints – New York, Texas, Florida and California – are more restrictive than the SEC or ABA positions:
  - New York and Florida: NYRPC 1.6(b)(2) and FRPC 4-1.6(b) only permit disclosure as reasonably necessary to prevent the client from committing a crime, and do not include reporting civil fraud, material civil violations, or disclosures meant to rectify harm from either a civil or a criminal violation.
  - Texas: TRPC 1.05(c)(7) authorizes disclosure to prevent "a criminal or fraudulent act."
  - California: CRPC 3-100(b) permits disclosure only to prevent a criminal act "likely to result in death … or substantial bodily harm."

External Reporting – What Law Governs?

- **SEC Position:** "Where the standards of a state or other United States jurisdiction where an attorney is admitted or practices conflict with this part, this part shall govern." (17 C.F.R. § 205.1).
  - More explicitly: "An attorney who complies in good faith with the provisions of this part shall not be subject to discipline or otherwise liable under inconsistent standards imposed by any state or other United States jurisdiction where the attorney is admitted or practices." (17 C.F.R. § 205.6(c)).
- Bar associations in New York, California and Washington have disputed the SEC's authority to pre-empt state ethics rules.
  - Business Law Section of the California State Bar: "An attorney relying on the SEC's safe harbor in disclosing client confidences would be doing so at his or her own peril." 32 Pepp. L.Rev. 89, at *149 (2004).

External Reporting – What Law Governs?

- In a recent decision involving the False Claims Act, the Second Circuit held that the FCA's *qui tam* whistleblower provisions did not "preempt state statutes and rules that regulate an attorney's disclosure of client confidences," because Congress had not expressed a "clear legislative intent" to do so. (*U.S. ex rel. Fair Lab. Practices Assocs. v. Quest Diagnostics, Inc.*, 734 F.3d 154, 163 (2d Cir. 2013).
  - Quest's general counsel was found to have violated New York state disciplinary rules by disclosing client confidences while participating in a *qui tam* action against the company.
- There does not appear to be any "clear *legislative* intent" to pre-empt state ethics rules with the rules in 17 C.F.R. Part 205.
  - Section 307 of the Sarbanes-Oxley Act, under which Part 205 was promulgated, merely requires the SEC to issue rules setting forth "minimum standards of professional conduct" for attorneys.

External Reporting – Key Takeaways

- While Section 205.3 does permit external reporting of confidential information, it does so only in limited circumstances, focused on preventing or mitigating harm to the issuer or investors.
- Even where Section 205.3 does permit external reporting, state ethics rules could prohibit such disclosure, and a number of states have taken the position that the SEC's rules do not preempt state ethics rules.
- A whistleblowing attorney may act "at his or her own peril" with respect to his or her law license.

4. Issues Involving Former Employees

Contacting Former Employees

- **Facts:** In response to Stickler's complaint, the Firm, through counsel, seeks to investigate further. The main source identified by Stickler is a former employee.
- **Issue:** Can the Firm contact the former employee? What if Stickler's memo states that the former employee told her he was considering engaging counsel?
- **Analysis:**
  - **Lawyers may not contact a person known to be represented.**
    - Rule 4.2 of the Model Rules for Professional Conduct: In representing a client, a lawyer shall not communicate about the subject of the representation with a person the lawyer knows to be represented by another lawyer in the matter, unless the lawyer has the consent of the other lawyer or is authorized to do so by law or a court order.
  - **Here, former employee is not known to be represented by counsel, so outreach by a lawyer for the Firm is appropriate.**

Paying Former Employee as Fact Witness

- **Issue:** If the former employee requests to be paid for his time, can the Firm accommodate that request?
- **Analysis:**
  - **Check severance agreement, if applicable, which may require cooperation.**
  - **Witness may not be paid as inducement to give false information; payment may not otherwise be contingent on substance or efficacy of information provided.**
    - Rule 3.4(b) of the Model Rules for Professional Conduct: A lawyer shall not "falsify evidence, counsel or assist a witness to testify falsely, or offer an inducement to a witness that is prohibited by law."

Paying Former Employee as Fact Witness

- **Analysis (continued):**
  - **Majority view: Witness may be paid a reasonable amount for lost time and expenses.**
    - Rule 3.4(b) cmt. c: "it is not improper to pay a witness's expenses . . . ."
    - ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 96-402 (Aug. 2, 1996):
      - "[T]he witness is entitled to be reimbursed for his or her travel expenses, including lodging when an overnight stay is required."
      - Payment is allowed "[a]s long as it is made clear to the witness that the payment is not being made for the substance or efficacy of the witness's testimony, and is being made solely for the purpose of compensating the witness for the time the witness has lost . . . ."
  - **Note: Consult applicable rules by jurisdiction as some do not allow compensation of fact witnesses and others significantly restrict what compensation is allowed.**

Severance Agreement – Limiting Disclosure or Disparagement

- **Facts:** While the Firm's investigation is ongoing, Stickler hires an attorney and seeks to negotiate a severance agreement. Prior severance agreements used by the Firm impose the following obligations on the departing employee:
  - **a promise not to disclose confidential information of the Firm and not to use it to the Firm's detriment;**
  - **a requirement of future cooperation with internal investigations, regulatory matters, and litigation; and**
  - **a general non-disparagement clause.**
- **The Firm seeks your advice on whether to enter a comparable agreement here.**

Severance Agreement – Limiting Disclosure or Disparagement

- **Issue:** Should the Firm enter a severance agreement with Stickler? On what terms?
- **Analysis:**
  - **Firm may not "impede an individual from communicating directly with the Commission staff about a possible securities law violation." Securities Exchange Act Rule 21F-17.**
  - **Prohibition includes "enforcing, or threatening to enforce, a confidentiality agreement . . . with respect to such communications." *Id.***
    - In re *KBR, Inc.,* Exchange Act Rel. No. 74619 (Apr. 1, 2015)(KBR violated Rule 21F-17 based on blanket prohibition, set forth in confidentiality agreements signed by employees in internal investigations, against discussing the fact or substance of their interviews without prior authorization, and accompanying threat of disciplinary action).

Severance Agreement – Limiting Disclosure or Disparagement

- **Analysis (continued):**
  - **Note: Rule 21F-17, by its terms, does not bar enforcing or threatening to enforce "agreements dealing with information covered by § 240.21F-4(b)(4)(i) and § 240.21F-4(b)(4)(ii) of this chapter related to the legal representation of a client."**
  - **These sections relate to information obtained:**
    I. through a communication that was subject to the attorney-client privilege or
    II. in connection with the legal representation of a client and you seek to use the information to make a whistleblower submission for your own benefit

    unless disclosure would otherwise be permitted pursuant to 205.3(d)(2), applicable state attorney conduct rules, or otherwise.

Severance Agreement – Limiting Disclosure or Disparagement

Analysis (continued):

- **Could entry of a separation agreement with Stickler with attendant payments and standard non-disclosure/non-disparagement clauses be construed as a measure designed to prevent Stickler from going to the SEC, assuming she otherwise could do so?**
  - In *KBR*, the SEC Director of Enforcement warned that SEC rules "prohibit employers from taking measures through confidentiality, employment, severance or other types of agreements that may silence potential whistleblowers before they can reach out to the SEC."
  - Could the SEC view the threat of non-payment in the event of whistleblower disclosure as akin to a threat of disciplinary action in *KBR*?
  - Could the SEC view Stickler's request as a bribe? And any severance payments as satisfying that bribe?

Severance Agreement – Limiting Disclosure or Disparagement

- **Analysis (continued):**
  - **Severance agreements typically make clear that confidentiality/non-disparagement clauses are not intended to impede communications otherwise required by law or judicial process.**
  - **Should severance agreements also make clear that confidentiality/non-disparagement clauses are not intended to impede permissible whistleblower communications?**
    - As part of resolving its SEC case, KBR amended the confidentiality agreement provided to witnesses in internal investigations to make clear that nothing in the agreement prohibits an employee from reporting possible violations of law to the appropriate authorities; nor is approval or notification to KBR required.
    - If implemented, need to ensure that language is appropriately tailored for attorneys in light of privilege implications.

Reference Material

Attorney-Client privilege rulings:

Bank Brussels Lambert v. Credit Lyonnais SA, 220 F. Supp. 2d 283 (S.D.N.Y. 2002).

"The Evolving Role of Compliance" ("2013 White Paper"). *Available at www.sifma.org/issues/item.aspx?id=8589942363*.

In re: Kellogg Brown & Root, Inc., 756 F.3d 754,758 (D.C. Cir. 2014).

SR Int'l Bus. Ins. Co. v. World Trade Ctr. Props. LLC, 2002 U.S. Dist. LEXIS 11949, at *11-12 (S.D.N.Y. Jul. 3, 2002), aff'd on other grounds, 343 F. App'x 629 (2d Cir. 2009).

Upjohn Co. v. United States, 449 U.S. 383 (1981).

See United States Postal Svc. v. Phelps Dodge Refining Corp., 852 F. Supp. 156, 159-60 (E.D.N.Y. 1994); *see also Seibu Corp. v. KPMG LLP*, 2002 WL 87461, at *3 (N.D. Tex. 2002); *Marten v. Yellow Freight Sys.*, 1998 WL 13244, at *6–*7 (D. Kan. 1998).

Reference Material

- **Attorney-Client privilege rulings (cont'd):**

  U.S. ex rel. Baklid-Kunz v. Halifax Hosp. Med. Ctr., which held that documents created to *"facilitate the provision of compliance advice," "facilitate the rendering of compliance advice," "reflecting request for compliance advice," "reflecting compliance advice," "are not privileged and are discoverable."* No. 6:09-cv-1002, 2012 U.S. Dist. LEXIS 158944 at *23 (M.D. Fla. Nov. 6, 2012).

- **Waiver of the privilege**

  United States v. Treacy, S2 08 CR 366 (JSR) 2009 U.S. Dist. LEXIS 66016, (S.D.N.Y. Mar. 23, 2009), *aff'd in part and remanded in part on other grounds*, 639 F.3d 32 (2d Cir. 2011).

- **Whistleblower**

  In re KBR, Inc., Exchange Act Rel. No. 74619, 2015 SEC LEXIS 1207, (Apr. 1, 2015).

Reference Material

Selective Waiver

United States v. Mass. Inst. of Tech., 129 F.3d 681 (1st Cir. 1997);
Westinghouse Elec. Corp. v. Republic of Philippines, 951 F.2d 1414 (3d Cir. 1991);

In re Martin Marietta Corp., 856 F.2d 619 (4th Cir.1988);

In re Columbia/HCA Healthcare Corp. Billing Practices Litigation, 293 F.3d 289 (6th Cir. 2002);

In re Qwest Commc'ns Int'l, Inc., 450 F.3d 1179 (10th Cir. 2006);

Permian Corp. v. United States, 665 F.2d 1214 (D.C. Cir. 1981).

Selective waiver and confidentiality agreement

Teachers Insurance & Annuity Ass. of Am. v. Shamrock Broadcasting Co., 521 F. Supp. 638 (S.D.N.Y. 1981);

Dellword Farms, Inc. v. Cargill, Inc., 128 F.3d 1122 (7th Cir. 1997);

United States v. Billmyer, 57 F.3d 31 (1st Cir. 1995).

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Resources

- FINRA Rule 4530 (Reporting Requirements)

  www.finra.org/industry/rule-4530

- SIFMA: The Evolving Role of Compliance (March 2013)

  www.sifma.org/issues/item.aspx?id=8589942363