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“Given that the regulations are not yet in effect, it does seem to be the type of low hanging fruit that the new administration might go after.”

DOL Wins First Fiduciary Rule Challenge, But Trump Waits in the Wings

Will **Donald Trump** upset the Department of Labor’s Fiduciary Rule applecart after he takes office on January 20?

The DOL on November 4 won the first challenge brought against the Rule in federal court. The U.S. District Court for the District of Columbia tossed out a civil action brought by the **National Association for Fixed Annuities**, which had challenged how the Fiduciary Rule, the Best Interest Contract Exemption and another rule would affect the market for fixed annuities.

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How to Give Testimony in an SEC Investigation: Preparation is Key

Yes, the time has come that you, the chief compliance officer, have dreaded. You and others have been called to provide testimony to the SEC as part of an investigation into suspected fraud at your firm. Are you ready?

Sound scary? It should. If and when this ever occurs and your firm finds its employees facing subpoenas to testify, things are “pretty serious,” said **Morgan Lewis** partner and former SEC Division of Enforcement associate director **Steve Korotash**, who spoke on the subject at the **National Society of Compliance Professionals** Conference

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Stein Calls on SEC to Step Up on Data Technology

The SEC needs to get ahead of the data technology curve – or at least keep up with it.

That, at least, appears to be the view of agency commissioner **Kara Stein**, who in a recent speech¹ called on the agency to take advantage of opportunities data provides, and to overcome challenges that may get in the way of the SEC “keeping up” with data’s growing role in the markets. She also called for a new office within the agency to coordinate the creation of data strategy.

“Ultimately, regulators are being disrupted by new technology, and it is important to focus on what we should do about it,” she said.

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DOL Wins

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The ruling can be appealed. In addition, other court challenges are underway, including one brought by the **U.S. Chamber of Commerce**, the **Securities Industry and Financial Markets Association** and several Texas business groups in the U.S. District Court for the Northern District of Texas, and is scheduled for November 17.

But with a president-elect Trump due to take office in about 10 weeks, do these court cases really matter? Does the Final Rule really matter?

“Given the election results, it’s hard to know precisely what might happen” said **Mayer Brown** partner **Brian Netter**. “The Supreme Court, the DOL appointees, the new Justice Department all might influence what is required.”

“I anticipate that we will see changes to the DOL fiduciary rule,” said **Drinker Biddle** counsel **Joan Neri**. “I just don’t know to what extent and how soon. It is entirely possible that the Trump administration will want to delay the effective date to allow time to formulate a specific action plan.”

The Fiduciary Rule, currently scheduled to go into effect in April 2017, raises the standard that financial professionals making retirement investment recommendations must meet. All financial professionals, including investment advisers and broker-dealers, will, under the Rule be considered fiduciaries, meaning they must always act in the best interest of the investor.

The BIC Exemption, which allows fiduciaries to receive certain kinds of compensation, such as commissions, 12b-1 fees and revenue sharing that, under the new Fiduciary Rule, would otherwise be seen as a conflict of interest, goes into effect in January 2018.

“Republicans have previously taken measures to block the regulations, but were overridden by the White House, and House speaker **Paul Ryan** has commented that he is in favor of the Rule being reversed,” said **Skadden Arps** ERISA counsel **Jeffrey Lieberman**. “Given that the regulations are not yet in effect, it does seem to be the

type of low hanging fruit that the new administration might go after.”

“One of the difficulties,” he said, “is that the effective date of April 10 is not that long after inauguration day, and it may take some time procedurally before any delay or other steps could be taken. That means that the fate of the regulations won’t likely be known until after most industry participants have already revised policies and otherwise geared up to comply. So even if the regulation is withdrawn or delayed, many of the effects may well be felt in any event.”

“The rabbit is now out of the hat,” said **Stark & Stark** attorney **Max Schatzow**. “Americans are now aware that their retirement accounts and plans have been subject to high commissions and hidden third-party payments. Politically, it might be a case of wasted political capital to completely fight the Best Interest Contract Exemption and Fiduciary Rule from becoming fully effective. I’d be somewhat shocked to see these rules overturned by the Department of Labor, Congress or the Supreme Court. We might see the Best Interest Contract Exemption watered down a bit or even limit the rules to only apply to qualified retirement plans and not individual retirement accounts.”

The NAFA ruling

NAFA, in its challenge, argued, among other things, that the DOL’s new definition of a “fiduciary” failed to meet two steps required by a 1984 federal court ruling, that the DOL acted beyond its authority, that the BIC Exemption improperly created a private cause of action, that the BIC Exemption limit on compensation or a “reasonable” level was vague, and that the new rules would have catastrophic consequences for the fixed indexed annuities industry.

U.S. district judge **Randolph Moss** tossed them all out and ruled for the DOL.

“In every respect, the DOL held off the challenge by NAFA to attack the rule,” said **Wagner Law Group** partner **Stephen Wilkes**. “However, the district court decision is just the first chapter of the story. NAFA has already filed an appeal so we expect the D.C. Circuit court to have the next say in the process.”

In addition, noted Netter, “It would be a mistake to presume from Judge Moss’s decision that other courts assessing different challenges in different jurisdictions will reach the same outcome.” “Keep in mind that the D.C. Circuit is particularly deferential when it comes to the views of the agencies, while other regional courts may not be. Other U.S. District Courts may not defer so much.”

How to Give Testimony

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last month. “When you reach this point, SEC investigators have gone from reviewing documents and talking to people off the record to saying, ‘We think there’s something here’ and it would be worth our time to speak with employees under oath.”

Just which employee SEC attorneys might call to testify depends on a number of factors, including the type(s) of violations suspected and the size of the firm. “It could be just one witness if the firm is small, or it could be several,” Korotash said. Nor do investigators necessarily start with the person they suspect as the main culprit. “They may start at the periphery of the firm and work their way in,” he said, interviewing lower-level employees first. For instance, if they suspect valuation fraud, investigators may start with members of the valuation team before taking testimony from the leader of the team.

As for the CCO, a subpoena is far from an unlikely possibility. “The CCO is always in the bullseye,” Korotash said.

Typically, testimony will be taken either at SEC headquarters in Washington, DC or at the regional SEC office that is closest to the advisory firm’s location, but there are times when, possibly for budget reasons, testimony may be taken at a third-party site.

Your firm, your friend?

One of the first things that anyone receiving a subpoena needs to determine is whether his or her firm is on the same side. Seek an initial consultation with officials from your firm to find out, Korotash said. Find out whether the firm’s counsel will represent you as well

as the firm. Other possibilities are that the firm will provide you with your own counsel, or that the firm will tell you to get counsel on your own.

If the firm shares its counsel with you, then most likely it sees your interests as aligned with the firm’s, and your worries on this count can be greatly relieved, he said. If it provides separate counsel, “there may not be a complete alignment of interests.” If it provides no counsel at all, he said, you can be fairly certain that your firm does not see itself on the same side as you, Korotash said. In that situation, you are on your own, and in fact, your firm may have already gone to the SEC and spoken to it about you. It would be wise to quickly find your own attorney, at least for the testimony.

Another factor to check on is your access to firm documents, which you may need to prepare your testimony and your overall case. “It’s a telltale sign of the way the firm is looking at you if it denies you access to company files,” Korotash said.

Preparation

Why does the SEC want testimony? It’s not as simple as looking for incriminating evidence to make its case, although that is certainly part of it. Other reasons for securing testimony include discovering facts, seeking response or reaction to documents, learning the defenses that opposing counsel might take, assessing a person’s credibility, or locking in an employee’s story, Korotash said.

The attorney representing the employee giving testimony will most likely want to get a sense of just what the SEC is trying to find out, said **Bell Nunnally** partner **Robert Long**. To that end, the attorney and the employee should review the document request that usually comes with the subpoena. By seeing the documents requested, it is often possible to gain some insight into the risk areas the agency is scrutinizing, he said. Long suggested that the attorney and employee can also learn a lot about the SEC’s investigation by requesting from the staff a copy of the SEC’s formal order in the matter. The formal order, which gives the staff the authority to issue the subpoena, will describe, at a high-level, who and what is being investigated, he said.

Anyone providing testimony will first receive a subpoena from the SEC. It's not like jury duty – "You can't easily get out of it," he said, adding that the subpoena is enforced by federal court. Long added, however, that sometimes the employee's attorney can talk with the SEC attorney and arrange for the employee to provide the SEC with information in a less formal interview setting, rather than in on-the-record testimony.

Do not expect providing testimony before the SEC to be like taking the witness stand in court or taking part in a deposition. Questioning will not be limited to the SEC attorneys. Examiners, accountants and others are allowed to question the person providing testimony, Korotash said, even though only the person providing the testimony and his or her attorney are allowed to take part on the defense side. Also be aware that any testimony given can be shared with others, including other government agencies or SROs, he said.

Don't fall into the trap of thinking that the absence of a judge or hearing officer means that the hearing will be an informal experience. It will not. The setting will be formal and those testifying will be sworn under oath. "Don't act like this is not a big deal," Korotash said.

While the hearing may be held in a conference room, he said, there will be a formal feel to the proceedings, and participants should dress and act accordingly. "Deliver your answers only to the questioner. Don't be colloquial in your language."

Prior to the hearing, counsel and those testifying will review any relevant documents, emails or calendar entries. Do not discuss the case or what you reviewed with counsel with co-workers. "Those discussions will not be privileged. The only discussions that are privileged are with your lawyers," Korotash said.

The "primary thing you have to be cognizant of" in preparing for testimony before the SEC, said advisory firm **Jasper Ridge Partners** chief compliance officer **Adan Araujo**, "is to be honest, take it seriously and that anything you say will be on the records and can be used against you. While you want to be careful and thoughtful about what you say, you cannot be deceitful."

Rehearsal

The defense attorney will work with those testifying to find one or two themes that can be used as the overarching concept behind the defense, and most specific answers will be shaped so they are in alignment with that theme. Examples of such themes include:

- It wasn't my responsibility.
- I acted in conformity with firm practice.
- I was overwhelmed by other matters.
- I acted properly at all times.
- I reported the problem up the chain.

"Rehearsal is critical to successful testimony," Korotash said. Among other things, it identifies weaknesses in presentation (too aggressive or passive, too talkative or terse, not answering questions asked, or being careless with documents), reinforces significant facts, and builds confidence.

Rehearsal should prepare employees to handle the worst, and if the worst does not occur, both the employees and the attorney will feel good that they were prepared. "My witnesses always walk out of testimony and say, 'My God, that was so painless compared to what you did to me in rehearsal,'" Korotash said.

What to expect

When the session opens, those providing testimony can expect to be questioned on a background questionnaire they will have already completed. This is usually quite routine, just the SEC attorney's way of introducing your testimony and confirming the information you provided, Korotash said.

Be aware that anything said in the room is on the record unless the SEC first decides that it is off the record. Unlike court trials, breaks in testimony cannot be called by defense counsel, he said. It is an SEC information-gathering session, and it is the agency that is in charge.

"You have to go in there with the mindset that the SEC knows more than you do about the topic," said Araujo, a

former SEC Division of Enforcement attorney. When he questioned witnesses for the agency, “99 percent of the time I already knew the answer to the question, having looked at all relevant records, including phone records, credit card records, and email, as well as having performed other research.”

Also be aware that the rules of evidence used in a courtroom do not apply. In practical terms, this means that defense counsel cannot stand up and say, “I object,” and that certain forms of questioning, such as asking for speculation or hearsay, will be allowed, Korotash said, with attorney-client privilege as the only refuge for not providing information. “It’s basically a free for all.”

What not to say

Anyone approaching testimony with any of the following attitudes needs to be quickly dissuaded from them:

- **They’ll like me if they get to know me.** This approach causes those testifying to talk too much, in the belief that they can demonstrate their sincerity and helpfulness, Korotash said. But it is dangerous, because too much information may be shared that might not be helpful to the employee or the firm. “Nature abhors a vacuum, and if the SEC attorney is quiet, don’t give in to the temptation to speak up with voluntary information. Answer what is asked in a matter-of-fact tone, nothing less, nothing more.”
- **Screw them: Name, rank and serial number, period.** This antagonistic approach is simply not helpful and can do much to prolong the testimony and engender ill will, he said.
- **I’m an expert; they’re hacks.** Arrogance is not a good approach when protecting yourself under oath, Korotash said. Don’t insult the intelligence of the SEC attorney or other questioners. Answer their questions without an attitude.
- **I’ll just say I don’t recall; that’ll show them.** This approach can lead to criminal prosecution for perjury, and, at the very least, can prevent a witness from giving favorable evidence at a subsequent proceeding, he said.

Some tips

Here are a few best practices to handle situations during testimony:

- **The SEC attorney asks you whether you discussed a particular subject with your counsel prior to the hearing.** “Don’t be intimidated by this,” Korotash said. “Of course you discussed topics with your attorney earlier. Just say, ‘Yes, I did.’”
- **When the question is not clear.** Make sure you understand the questions before answering them. Some may be ambiguous. Don’t answer without first gaining that clarity. “Just say, ‘I’m not sure what you’re getting at’ or ‘I don’t understand the question,’” Korotash said.
- **The SEC attorney hands you an exhibit or an email to review.** Sometimes a testifying employee may be asked to review a document out of sequence, or the last email in a chain of emails. Take the time to review them all before answering, Korotash said. “Say, ‘I have to review them all,’ and don’t look up at the attorney until you are finished.” Make sure, Long said, that you review who sent the emails, who was copied on them, who the emails were sent to, and the dates they were sent, among other things. “The SEC staff could show you any document, and you may not even have been one of the recipients,” he said.
- **Don’t speculate.** If asked what some other person, such as your firm’s chief executive officer, thought about something, don’t guess, said Araujo. “Say, ‘I don’t know. You will have to ask him.’” ☞

Stein Calls on SEC

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Many investment advisers might be forgiven for thinking that the SEC is already there. After all, the agency has not infrequently pointed to its use of data mining and analysis in a number of enforcement actions, particularly those undertaken by its Division of Enforcement’s Asset Management Unit. Recent settlements involving cherry-picking (*ACA Insight*, 8/8/16[Ⓔ]) and Rule 105 (*ACA Insight*, 11/2/15[Ⓔ]) are cases in point.

But “enforcement is not the most important potential use of data for the SEC,” said Stein at the Big Data in Finance Conference. “By the time we start building a case, the harm has been done. I am much more interested in establishing rules of the road that can help prevent crashes than in waiting to deal with the aftermath. Better investor protection is avoiding fraud and misconduct in the first place.”

The key, she suggested, is to design policies and monitoring systems that provide support for a healthy functioning market and that “aid in compliance on the front end. Improved data tools have the potential to be uniquely powerful in this way.”

Different SEC divisions and offices may have different needs and uses for the data they collect, said **Willkie Farr** partner **James Burns**, but “it makes sense to have an overarching approach to bringing data into the agency, particularly when it comes to setting priorities for what is collected and insuring the security and integrity of sensitive information that comes into the SEC’s possession.”

The new office

In calling for the creation of an Office of Data Strategy, Stein said that it would be responsible “for coordinating the create of a data strategy addressing how we collect, manage, use and provide data. This is a critical next step in turning our ad hoc growth as data users into a deliberate plan.”

The new Office of Data Strategy “could lend its expertise to, and would coordinate with, our policy, exam and employment offices. Having a data strategy, and a team dedicated to it, is especially important in light of our limited resources,” she said.

Existing SEC divisions and offices have helped the agency make progress in developing and using data, she said. Among those she named in this regard were the Division of Economic Research and Analysis, the Division of Investment Management’s Risk and Examinations Office, the Office of Compliance Investigations and Examination’s risk analysis examination team, and the Division of Enforcement’s Center for Risk and Quantitative Analytics.

“I am pleased to see Commissioner Stein’s continued support for the use of data and economic analysis in informing the SEC’s work,” said **Kirkland and Ellis** partner and former SEC Division of Investment Management director **Norm Champ**, who noted that the Division “recognized some time ago that the Division and the agency are becoming increasingly data-driven.”

The Division’s Risk and Examination Office “was established for the express purpose of monitoring trends in the asset management industry and analyzing data that the Division receives,” he said. “One practical example of the result of this step is the fact that Division remains the only group in the U.S. government to publish any analytics of Form PF data.”

Risk and opportunity

While data and technology offer opportunities and benefits, “they have also opened the door to new and exceedingly complicated risks,” Stein said. Not only is data distributed in a variety of ways, making it difficult to monitor and examine market participants, but “the variety of data has increased dramatically.”

As examples, she noted the use of “highly structured derivative transactions that are reported in competing taxonomies, such as FIX and FpML,” as well as information that is simply unstructured, such as posts on social media. In addition, Stein called attention to ways in which the electronic trading environment has changed the capital markets, such as through algorithmic “matching engines” that pair electronic limit orders with electronic market orders. “High-speed trading dominates, representing over 55 percent of U.S. equity markets. Further, the provision of liquidity “has largely shifted from traditional market-makers to computerized systems that trade in fractions of a second across different trading venues and securities.”

How do these risks play out in the real world? Stein noted that when the “flash crash” occurred in 2010, equities markets “suddenly plunged and then rebounded.” But “in contrast to the incredible speed of this disruption, it was months before the SEC and CFTC were able to gather the necessary information, chum through the data, and produce an analysis of trading on that one

day.” Since then, she said, the financial markets have experienced other temporary disruptions and mini-flash crashes.

“These events implicate data both in their causes and in the ability of regulators to understand and respond,” Stein said. “They also highlight the risk for regulators of driving a carriage in the age of Tesla – by the time you’re pulling out of the stable, everyone else’s autopilot will have passed you by.”

Solutions? One step that Stein credited SEC with taking was the creation of the Market Information Data Analytics System (MIDAS), which combines information to create “a more complete picture” of equity market activity.

But that, she indicated, is not enough. “We need to go further,” Stein said, and spoke favorably of a plan that the SEC will soon consider, the Consolidated Audit Trail (CAT), that would create what she called “the largest data repository of securities trading activities that has ever existed. ... This unprecedented data effort will help us, finally, move at highway speeds.”

Burns noted that “the SEC staff’s successful experiences with MIDAS helped inform the development of some market structure proposals and the determination not

to pursue other regulatory initiatives that empirical evidence simply didn’t support.”

“When the CAT is up and running,” he said, “the potential to harness the data it contains to deepen the agency’s understanding of how markets function and how they respond to different influences will be staggering. Eventually, the staff will be able to probe practices by sell side and buy side firms to evaluate where orders are being routed and why, and to ask highly informed questions about, for instance, how firms are fulfilling their best execution requirements. Similarly, access to such data has the potential to remake the surveillance landscape when it comes to looking for trading patterns that suggest market manipulation.”

Challenges

Getting the SEC to where it needs to go in terms of data technology cannot be achieved with a snap of the fingers, however. Stein listed a number of challenges she said the agency will need to overcome on its way toward meeting this goal. These included:

- **Acquiring the right data.** The SEC, she said, “need[s] data that is relevant, timely and high quality.” In order to not simply increase the volume of data but to selectively acquire the right data, “we must care-

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fully consider our possible sources, data gaps, and reporting methods. Where we mandate reporting, how can we ensure that our requirements keep pace with a quickly evolving market? Can we design reporting requirements so that our resources are spent on analysis instead of cleaning data sets?"

- **Computers that can quickly and reliably interpret data.** The use of structured data is part of the solution here, Stein said, noting that the agency in recent years has begun to employ better practices for such data. As examples, she noted the SEC's adoption of mutual fund and exchange-traded fund reporting requirements that include the use of XML, which is also required by Form PF. "Where structured data is into available or reliable, we should continue to explore techniques that allow better parsing or unstructured data."
- **Identifiers.** These, like the legal entity identifier (LEI) should be "embraced," she said, adding that LEI provides a uniform and reliable way to identify counterparties. "This free regulators to focus on the financial

risks instead of data issues." SEC investor advocate **Rick Fleming**, in a separate speech¹⁶ last month at the XBRL U.S. Investor Forum 2016, also called on the agency to adopt LEI's, as well as to require "block tagging" and "detail tagging" of narrative text disclosures. Doing so will enhance the ability to conduct data searches, he said.

- **Limited resources.** The SEC needs "more professionals with the right technical skills," Stein said. "Our systems and software also need to keep up with the speed and volume of today's markets." The agency's main reporting system, EDGAR, while "a huge leap 20 years ago, ... is ancient in tech years. With a limited budget and an ever-evolving market, we may never drive the latest model. We must, however, find a way to keep pace."
- **New data tools.** Stein reiterated a previous suggestion that a digital disclosure task force be created to "help us reimagine how the SEC acquires and provides data to investors and market participants." 

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