Debevoise & Plimpton

UK, US and Hong Kong Banking Litigation, Regulatory and Competition Law Update

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Welcome to Debevoise & Plimpton's **Banking Litigation, Regulatory and Competition Law Update**.

In this Update we pick out some recent cases involving financial institutions in the UK, US and Hong Kong Courts over the past year. We also round-up some financial regulatory and competition law developments in the UK and Hong Kong.

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

For **London** enquiries please email
klloyd@debevoise.com

For **New York** enquiries please email
cmdankwo@debevoise.com

For **Hong Kong** enquiries please email
mdjohnson@debevoise.com

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Section A: Brief overview of recent developments

1. UK banking litigation

KEY CONTACTS

Tony Dymond
tdymond@debevoise.com

Lord (Peter) Goldsmith QC
phgoldsm@debevoise.com

Sophie J Lamb
sjlamb@debevoise.com

Richard Lawton
rlawton@debevoise.com

Kevin Lloyd
klloyd@debevoise.com

Christopher Boyne
cboyne@debevoise.com

Akima Paul Lambert
apaullambert@debevoise.com

Ralph Sellar
rsellar@debevoise.com

Cormac Toomey
ctoomey@debevoise.com

KEY POINTS

In this section we summarise the key points from recent banking litigation cases in the English courts and we take a look at developments in how the Commercial Court will deal with complex financial disputes in the future.

Privilege issues in concurrent regulatory investigations and civil proceedings

In a recent hearing in civil proceedings concerning inspection of documents relating to a Bank's investigation into LIBOR manipulation, the Court has found that:

- **High level documents** created by an internal Steering Committee which oversaw a bank's investigation into LIBOR

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manipulation may not be privileged where the role of the Steering Committee extended beyond receiving legal advice.

- Documents which formed part of **genuine settlement negotiations** with a regulator should be protected from disclosure except where the content of those settlement discussions and the basis upon which a regulator has made a finding has been put in issue in a civil claim.
- Privilege material could be shared with a regulator on a confidential "**no waiver**" basis without giving rise to a broader waiver of privilege notwithstanding the fact that the regulators had extensive powers to use or publish those documents. However, on the facts of this particular case, privilege had been waived because the bank had placed reliance upon regulatory findings in its Defence. (See page 14 for more detail)

Conflicts of law issues: Italian local authority avoids liability for unpaid sums under ISDA swap

A swap governed by English law entered into under an ISDA Master Agreement was subject to certain "mandatory rules" under Italian financial services law which, on the facts of the case, overrode English law pursuant to European conflict of laws principles. The relevant Italian financial services law entitled the investor to a 7 day "cooling-off" period after entering the swap and the Bank should have informed the investor of the right of the withdrawal. The bank's failure to give this information rendered the swap null and void as a matter of Italian law. (See page 17 for more detail.)

Construction of the ISDA Master Agreements

In the past few years there has been a swathe of cases concerning the construction of various provisions of the **ISDA Master Agreement**, particularly as a result of the unusual market conditions caused by the collapse of Lehman Brothers and the global financial crisis. Most

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recently, the English Courts have made some notable decisions which relate to the construction of various termination provisions triggered by Early Termination. These include the following:

- The **late delivery of a notice** setting out the Non Defaulting Party's loss was not ineffective and the sums due were still payable. However, the late notice was a breach of contract and the Defaulting Party was entitled to claim for damages that arose from the breach. (See page 21 for more detail)
- Quotations for Replacement Transactions obtained before Early Termination were non-compliant with the "**Market Quotation**" formula. Where Market Quotation has been selected, a Non-Defaulting party must comply with the contractual provisions unless compliance produces a commercially unreasonable result. That means obtaining live quotations on or after the date of Early Termination. (See page 22 for more detail)
- A party who calculated its "**Loss**" 7 months after the collapse of Lehman Brothers in September 2008 was not in breach of the requirement to do so on the "*first reasonably practicable date*". Replacing the transaction was a complex and time consuming process, particularly in the market conditions following the collapse of Lehman Brothers. In these circumstances, it had not been practicable to obtain quotations for a replacement transaction earlier than May 2009. (See page 24 for more detail)

Contractual estoppel

Financial institutions have continued to successfully deploy **contractual estoppel** as a powerful weapon in litigation. We take a look at two notable cases in which the principle was applied by a claimant bank and a defendant bank in order to uphold the contractual terms:

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- A bank succeeding in a case where a Dutch housing association was estopped from disputing its **capacity** to enter derivative transactions due to contractual warranties that it had made about its capacity to enter into the transactions. The court upheld the contract notwithstanding the fact the transactions were outside the constitutional objects of the housing association. (See page 27 for more detail)
- A defendant Bank was found to have provided negligent advice in respect of the sale of an interest rate hedging product. However, the bank was not held liable because the contractual documentation repeatedly provided that no advice would be given and therefore no duty existed. This was a "**basis clause**" which, unlike an exclusion cause, was not subject to the UCTA reasonableness test. (See page 29 for more detail)

It is notable that in the second of these cases, the judge expressed personal sympathy with the customers of the bank and regret that the law did not allow him to make a different decision in order to find the bank liable. There has been some similar commentary in the legal market which suggests that contractual estoppel has been applied too liberally insofar as it has enabled banks to escape liability in circumstances where the contract does not reflect the realities of the transaction – for example, where a bank provides advice and intended that advice to be relied upon. Equally, however, there are powerful reasons to uphold the principle even if it creates a seemingly unfair result in particular cases. In particular, parliament has specifically legislated for the protection of a certain category of bank customers (i.e. "private persons" under section 138D of FSMA). Other types of customer and banks are therefore free to contract on terms of their choosing. Commercial parties have an expectation that the courts will uphold the agreed bargain and the doctrine of contractual estoppel is an important means of ensuring that those expectations are met.

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Investment banking cases

The English courts continue to deal with claims that implied terms exist in commercial contracts notwithstanding the fact that the law in this area is relatively well established.

We look at a recent investment banking case where the court held that there was no **implied term** in a commercial "Participation Agreement" which required a bank to sell an asset at the "*best price reasonably obtainable*". The contract had been freely negotiated and there was no need to imply any such term. (See page 32 for more detail)

Commercial court update: financial list

A new regime will be introduced in September 2015 to resolve high value or complex financial disputes.

This new regime will be known as the Financial List and it will apply to proceedings where amounts claimed are in the region of £50 million or more and/or which raise issues of general importance to domestic and international financial markets. (See page 33 for more detail)

See page 14 for a more detailed analysis of UK banking litigation cases.

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2. US banking litigation update

KEY CONTACTS

Matthew Biben
mbiben@debevoise.com

Helen Cantwell
hvcantwell@debevoise.com

Courtney Dankworth
cmdankwo@debevoise.com

Eric Dinallo
edinallo@debevoise.com

Sean Hecker
shecker@debevoise.com

Mary Beth Hogan
mbhogan@debevoise.com

Steve Michaels
ssmichaels@debevoise.com

David O'Neil
daoneil@debevoise.com

Jonathan Tuttle
jrtuttle@debevoise.com

Bruce Yannett
beyannett@debevoise.com

In this section of the Update we pick out some important recent banking litigation cases in United States courts.

KEY POINTS

Residential Mortgage Backed Securities Litigation

As RMBS matters continue to work their way through U.S. courts, the Second Circuit recently held that plaintiffs in a putative class action lacked standing to assert claims on behalf of RMBS trusts in which the named plaintiffs did not invest. Plaintiffs could not show they had the "same set of concerns" as absent class members because the alleged misconduct must be proven on a trust-by-trust basis. (See page 36 for more detail)

Other Developments in Securities Law

Courts continue to address pleading standards applicable to common law and federal securities law matters.

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- A company that represented to investors that it was managing a particular CDO for the benefit of long investors, but instead allowed a hedge fund that maintained significant short positions in the CDO to control the collateral selection process, could be sued for fraud and negligence under New York law. (See page 37 for more detail)
- Failure to make required disclosure under Item 303 of Regulation S-K in a quarterly filing can serve as a basis for a Section 10(b) fraud claim under the Securities Exchange Act of 1934 ('34 Act), if the omission meets the standard of materiality under *Basic v. Levinson*. (See page 38 for more detail)
- A bank that made statements concerning exposure to subprime assets, the success of an acquisition, and its efforts to raise capital could not be held liable in a class action for violations of Sections 10(b) and 20(a) of the '34 Act because statements were not made during the class period (and there was no duty to correct), alleged omissions were not quantitatively material, and statements were not fraudulent in light of the total mix of information available to a reasonable investor. (See page 40 for more detail)
- A plaintiff could not meet Private Securities Litigation Reform Act heightened pleading standards in asserting scienter of a bank and its executives based on their knowledge of undercapitalization or "red flags" concerning the value of mortgage-backed securities, and based on the magnitude of alleged misstatements, when valuation could yield a wide range of reasonable results. (See page 41 for more detail)

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FINRA Rule 13204 and Arbitrable Claims

The Second Circuit recently issued two opinions on the applicability of FINRA Rule 13204, which bars enforcement of class and collective claims in an arbitration.

- In a dispute over whether an arbitration clause, which incorporated Rule 13204, covered plaintiff's claims, the Second Circuit held that the grammar and construction of the arbitration provision indicated that the parties did not intend to arbitrate class or collective action claims, and thus a defendant's motion to compel arbitration was denied. (See page 43 for more detail)
- In a dispute over whether Rule 13204 barred arbitration of a putative class action when the arbitration agreement clearly covered plaintiff's claims, and when the plaintiff had waived the right to bring class and collective action claims, the Second Circuit held that Rule 13204 had no effect because it did not prohibit the enforcement of a pre-dispute waiver of class and collective action claims, and because the individual claims were clearly within the scope of the arbitration clause. (See page 46 for more detail)

Increased Use of Administrative Law Proceedings Following Dodd-Frank Act

The Dodd-Frank Wall Street Reforms of 2010 gave administrative agencies such as the SEC greater authority to adjudicate claims involving monetary penalties via internal administrative proceedings in front of an Administrative Law Judge. (See page 49 for more detail)

There has been a recent wave of litigation surrounding the constitutionality of administrative proceedings, and whether allegations against individuals and entities by the SEC should be filed in federal district courts instead.

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- The District Court of the Southern District of New York recently declined to address the constitutionality argument in *Tilton v. S.E.C.*, holding that it lacked subject matter jurisdiction to answer that question. Other federal district courts however, disagree with the SDNY's holding in *Tilton*. (See page 49 for more detail)

Conflicts of Interest in Investment Banking

In 2012, the Delaware Chancery Court criticized Goldman Sachs for its role in the merger between El Paso Corp. and Kinder Morgan, Inc. In a suit seeking to enjoin the merger, it was revealed that Goldman not only advised El Paso on the deal, but also owned nearly 19% of Kinder Morgan. While the Court found no basis on which to enjoin the merger, Goldman was ultimately denied its advisory fee when the parties reached a settlement.

Following *El Paso*, the Delaware Chancery Court heard class action claims against another investment bank for its role in aiding and abetting a breach of duty of care by a company's board in putting the company up for sale. After a trial on the merits, the Court found that the bank, which had been retained to advise the board on strategic alternatives, not only misled the board and withheld important information, but also failed to disclose its attempts to leverage its position as advisor of the company on the "sell-side" to obtain more lucrative "buy-side" financing arrangements. The court found the bank liable for more than $75 million in damages. (See page 50 for more detail)

Civil Liability for Banks Under the Anti-Terrorism Act

Recently, courts in the Second Circuit have decided cases dealing with standards of proof under the Anti-Terrorism Act ("ATA"), in which civil claims are asserted by plaintiffs against banks that

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allegedly engaged in banking activities on behalf of terrorist organizations.

- Arab Bank was held liable under the ATA for knowingly providing material support to Hamas in connection with over 20 terrorist attacks. In deciding a post-trial motion for judgment as a matter of law, the court clarified standards for intent and causation in ATA cases. (See page 53 for more detail)
- In another case, the Second Circuit reversed and remanded a district court grant of summary judgment in favor of defendants, holding that the district court applied a more stringent standard of proof on intent than was required by the ATA. (See page 55 for more detail)

See page 36 for a more detailed analysis of the cases (Section C).

3. UK regulatory update

KEY CONTACTS
Karolos Seeger
kseeger@debevoise.com

Robert Maddox
rmaddox@debevoise.com

Robin Lööf
rloof@debevoise.com

U.K. Regulators Overhaul Individual Accountability in the Banking Sector

On 6 March 2016 a raft of changes aimed at improving individual accountability in the banking sector in the U.K. will come into force. The new regulatory landscape forms part of a widespread desire to ensure that those responsible for failings in the regulated sector are held to account when things go wrong.

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However, far beyond the individuals that will be exposed to a greater risk of enforcement action, firms themselves will need to take immediate steps to ensure that their internal processes and controls are new-regime ready with little over six months to go. Final rules that will implement the changes to the U.K.'s banking regulation were published on 7 July 2015.

See page 57 for a more detailed analysis of this issue (Section D).

4. UK competition law update

KEY CONTACTS

Timothy McIver
tmciver@debevoise.com

Anne-Mette Heemsoth
amheemsoth@debevoise.com

FCA publishes guidance on its new competition law enforcement powers

From 1 April 2015, the Financial Conduct Authority ("FCA") has gained concurrent competition law enforcement powers that strengthen its existing mandate to regulate the UK financial services sector. While the FCA has rightly been stressing that adherence to competition law has always been a requirement, its new powers give the FCA an active role in investigating and enforcing against breaches of UK and EU competition law.

The FCA published practical guidance on how it will exercise those powers on 15 July 2015, with the consequent amendments to the Supervision Manual of the FCA Handbook having taken effect from 1 August 2015.

See page 62 for a more detailed analysis of this issue (Section E).

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5. Hong Kong privilege litigation update

KEY CONTACTS

Mark D. Johnson
mdjohnson@debevoise.com

Fiona Braidwood
fbraidwood@debevoise.com

Christy Leung
cleung@debevoise.com

Hong Kong's Court of Appeal rejects U.K's restrictive approach of legal advice privilege

In June 2015, Hong Kong's Court of Appeal handed down a landmark ruling relating to the treatment of legal advice privilege.

The Court of Appeal ruled that legal advice privilege would apply if the "dominant purpose" of why the document was produced or brought into existence in the first place was to obtain legal advice. This decision overturned the decision at first instance which adopted the more restrictive approach to legal advice privilege (as per the English case of *Three River (no.5)*) which protects only confidential communications between a lawyer and his client.

See Page 67 for a more detailed analysis of the case (Section F).

6. Hong Kong regulatory update

New Independent Insurance Authority to be established to regulate insurance intermediaries in Hong Kong

Legislative process is underway to establish a new independent Insurance Authority to regulate insurance intermediaries by amending the existing Insurance Companies Ordinance (Cap. 41). Pursuant to the relevant legislative bill, the IIA is expected to be given a wide range of regulatory powers, including the powers to

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license insurance intermediaries, conduct investigations, site visits, prosecute misconduct and take disciplinary actions.

See page 70 for a more detailed analysis of the case (Section G).

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Section B: UK banking litigation update

In this section we comment on some important cases involving financial institutions and developments in how the Commercial Court will deal with complex banking disputes in the future.

PRIVILEGE

Case 1: Documents relating to privileged settlement discussions with FCA admissible in civil proceedings

In *Property Alliance Group Ltd v The Royal Bank of Scotland* Plc [2015] EWHC 1557 (Ch), PAG challenged RBS's claims of privilege over certain documents relating to the Bank's LIBOR investigation and the basis on which the Bank had reached a settlement with the FSA (as it then was). The case contains a number of important practical points for any financial institution facing concurrent regulatory investigations and civil claims.

Briefly, the claimant (PAG) is a property developer with a portfolio worth about £200 million. It entered into four interest rate swaps with RBS. Each swap referenced 3 month GBP LIBOR. PAG alleges that RBS made misrepresentations about LIBOR which induced it to enter the swaps. RBS has formally admitted misconduct relating to its participation in setting Japanese Yen and Swiss Franc LIBOR (as recorded in the FSA's Final Notice) but has denied any other misconduct relating to LIBOR. In particular RBS denies misconduct in the setting of GBP LIBOR and in its Defence relied on the fact that the regulator had made no findings against it in respect of GBP LIBOR.

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High level documents reporting on LIBOR investigation

The Bank had formed an Executive Steering Committee (ESG) as part of its investigation into the Bank's misconduct. The ESG had created a number of high level documents which summarized the nature and extent of the misconduct. The Bank claimed privilege over these documents on the basis that the ESG's role was solely to receive legal advice. However, the Court concluded that RBS had failed to adequately set out its privilege claim over these documents. In its skeleton, the Bank explained that the role of the ESG was to oversee the investigations and potential litigation. This was broader than the previous description of its role. The Court accepted PAG's argument that based on this wider description; it was hard to believe that all of the ESG meetings had been for the sole purpose of the imparting legal advice. As such, the Court accepted that some of the documents may not be privileged. However, because RBS claimed that each document had been individually reviewed for privilege the Court did not order inspection of these documents but instead ordered for the documents to be produced to the Court for it to review.

Settlement communications with the FSA

The Court held that the public policy to promote settlement discussions on which the without prejudice rule is based is capable of applying to settlement communications between the FSA and a firm. Accordingly, in principle, there was a right analogous to the without prejudice rule which can apply to communications between a firm and the FCA which form part of genuine settlements discussions. Importantly, the fact that a Final Notice had been issued did not mean that privilege was lost in respect of any such settlement communications. This is a welcome development for firms who engage in settlement discussions with the FCA.

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However, on the facts of this case, the Bank had effectively waived its right to rely upon the rule because the Bank advanced a positive position in its Defence that the regulators had not found misconduct relating to GBP LIBOR. RBS had therefore put in issue the basis on which the regulatory findings were made. "Justice" demanded that the communications with the FSA which led to the Final Notice had to be disclosed by the Bank.

Non-waiver

During the course of the LIBOR investigation RBS provided certain documents containing legal advice to the regulator. PAG argued that confidence and therefore privilege in these documents was lost as a consequence of this disclosure.

The Court held that in principle, privileged material could be disclosed to a regulator on a confidential, "no waiver basis" (i.e. the English law principle of limited waiver of privilege could apply in dealings with regulators). The principle applied notwithstanding the fact that the regulators had extensive powers to use or publish those documents (although of course if those documents were in fact published by the regulator privilege would be lost). This is a welcome clarification.

However, on the facts of this case, the Court held that RBS had waived privilege waived because it had placed reliance upon regulatory findings in its Defence. The Court therefore ordered inspection of these documents noting that: "*RBS really cannot have it both ways. It cannot on the one hand rely on absences from the regulators' findings as indicating the limits of its misconduct and yet on the other hand seek to maintain as privileged what it put to them*".

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Practical points

There are a number of practical points which arise from this case for financial institutions:

- Banks should give careful consideration to the role of internal committees established to oversee regulatory investigations. In circumstances where that role extends beyond solely receiving legal advice, then documents created or received by the internal committee may not be protected by privilege. Equally, a law firm's role may extend beyond providing legal advice and documents created during a fact finding exercise may also be disclosable.
- The role of the internal committee should be described consistently in court documents and correspondence.
- Banks should consider carefully the consequences of deploying regulatory findings in civil claims. Confidential settlement communications with a regulator may not be protected from inspection if the basis of the settlement is an issue in dispute.

ISDA CASES

Case 2: English law governed ISDA swap held null and void by a breach of mandatory Italian financial services law

In the case of *Dexia Crediop S.p.A. v Comune di Prato* [2015] All ER (D) 20 (Jul), the Court considered the application of Italian financial services law to a swap governed by English law entered into under an ISDA Master Agreement.

Dexia is an Italian bank. The defendant, Prato, is an Italian local authority with responsibility for the municipality of Prato in Tuscany. Dexia advised Prato generally on the restructuring of the

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municipality's debt during the period 2002 to 2006. As part of this arrangement, Dexia and Prato entered into a master agreement based on the ISDA 1992 Multicurrency – Cross Border form. The Agreement was governed by English law and contained a jurisdiction clause in favour of the English courts.

Dexia and Prato entered into 5 interest rate swaps which were restructured over time and culminated in a 6th swap entered into on 29 June 2006 with an initial notional sum of €67.5 million. From December 2010 onwards, Prato did not meet its obligations under Swap 6 and Dexia claimed for the unpaid amounts.

Prato ran various defences, including that it had lacked capacity to enter into the swaps and that the swaps contravened Italian local government law. These defences failed and we do not look at them in any detail in this Update.

However, the court concluded that, under English conflict of law principles, mandatory rules of Italian financial services law applied to the swaps. This finding had important consequences in relation to the validity of the swaps and we consider the court's reasoning in some detail.

Application of Italian financial services law

The court observed that, in circumstances where the parties had agreed that English law would apply to the ISDA, ordinarily provisions of Italian financial services law and Italian civil law would not be applicable to the swaps.

In the present case, however, the contractual dealings between the parties all took place during the period in which the Rome Convention was incorporated into the law of the United Kingdom by

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the Contracts (Applicable Law) Act 1990. Under Article 3(3) of the Rome Convention, the fact that the parties have selected a foreign law shall not, "*where all the other elements relevant to the situation*" at the time of contracting are connected with one country, prejudice the application of certain "mandatory rules" which cannot be derogated from by contract under the laws of that country.

This distinction was crucial. If Article 3(3) applied it would be open to Prado to rely on certain Italian laws notwithstanding the English law choice of law clause. Not surprisingly, there was a dispute between the parties as to whether the "*elements relevant to the situation*" (i.e. the entering of the swaps) were solely connected with Italy. Prato relied on the fact that Italy was where both parties were incorporated, where the parties communicated with each other, where the swaps were entered into, and where the obligations under the swaps had to be performed. By contrast, Dexia identified two elements that it argued connected the swaps outside Italy. In particular, it argued that (i) ISDA was a standard form contract used for derivative transactions in the international capital markets; and (ii) pursuant to the swaps with Prato, Dexia entered into back-to-back hedging swaps with a bank outside Italy.

The Court considered the arguments by Dexia to be misconceived. Whilst the ISDA was an international standard form agreement, it did not follow that this amounted to an "*element relevant to the situation*" which was connected to a country other than Italy. Nor was Dexia's decision to enter into back-to-back swaps with a non-Italian counterparty. This was immaterial to Prato and there was no contemplation that a non-Italian entity would take over obligations of either party. Therefore, neither of Dexia's objections were valid and, accordingly, Prato was entitled to rely upon provisions of Italian

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financial services law which constituted "mandatory rules" for the purposes of the Rome Convention.

Contravention of Italian financial services law

In light of the above finding, the Court was required to determine whether the swaps contravened the relevant Italian financial services law.

Prato relied upon two sets of provisions concerning financial services known as *Testo Unico della Finanza* ("**TUF**"). Essentially, these provisions required those offering financial services to inform investors of a seven day cooling off period (TUF 30.6); and that a failure to do so rendered the contracts null and void (TUF 30.7).

The court held that Dexia breached these provisions. Accordingly, Swap 6 was null and void.

The court noted that this outcome was particularly hard on Dexia but that the relevant Italian financial services law was intended to provide greater protection in favour of the investor which translated into a less advantageous position for the investment provider.

Comment

This result may come as a surprise to practitioners who assume that if they have selected English law and an English jurisdiction clause in the ISDA Master Agreement, they need not worry about the applicability of foreign law.

The court characterised what constituted "*elements relevant to the situation*" relatively narrowly, and without citing authority. It remains to be seen whether such a narrow characterisation will prevail in other cases.

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In any event, this case acts as a timely reminder that where all other factors point in favour of another jurisdiction (in this case Italy), regard must be had to the local mandatory rules which may conflict with English law. Parties should consider explicitly referring to specific “*elements relevant to the situation*” (perhaps in a contract’s recitals) to increase the chances of avoiding local mandatory rules. Additionally, Article 3(3) of the Rome Convention has– in substance – been replicated in the Rome I Regulation and so this risk will apply equally to contracts entered into after December 2009.

Case 3: Late delivery of calculation notice not ineffective

In *Goldman Sachs International v Videocon Global Ltd & Anor* [2014] EWHC 4267 (Comm) (19 December 2014), Goldman claimed for sums due in relation to two currency swaps following Early Termination. Videocon refused to pay on the basis that there had been a breach of section 6(d) of the ISDA Master Agreement in that the Notice had not been provided “*on or as soon as reasonably practical*” following the Early Termination Date.

The court held that the purpose of the notice and statement required by clause 6(d) is twofold.

1. First, it is to provide the paying party with an explanation of the sum claimed so that he can understand it and, if he wishes, check it.

2. Second, it is to inform the paying party of the account into which the sum must be paid so that he can effect payment.

Once sufficient details of both matters have been given the notice is effective and the sums due become payable. The fact that it was not served "*on or as soon as reasonably practicable*" following the Early

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Termination Date does not render the notice ineffective. It merely renders it "late".

A construction of the clause which rendered the sum not payable due to the late service of the notice lacked any commercial sense. By contrast there was commercial sense in a construction pursuant to which a notice is effective if it provides the paying party with the information required by clause 6(d). However, the provision of a late notice was not devoid of legal consequence. It was a breach of contract and so it may found an action in damages if the delay caused loss. In reaching this decision, the Court's approach was consistent with the policy that the Court is to give effect to, rather than invalidate, commercial contracts.

Case 4: Backdated quotations under the "Market Quotation" formula rejected

The case of *Lehman Brothers Finance SA v Sal Oppenheim Jr & Cie KGAA* [2014] EWHC 2627 (Comm) arises from the collapse of Lehman Brothers, but is of wider interest to participants in the OTC derivatives market. The dispute concerned the amounts properly due arising out of Automatic Early Termination ("AET") of four option transactions governed by the ISDA Master Agreement (1992 edition). The parties had elected the "Market Quotation" formula for calculating the close out sums due upon Early Termination. The dispute concerned whether the Defendant had complied with the requirements of "Market Quotation".

Market Quotation requires the determining party to "*request each Reference Market-maker to provide its quotation to the extent reasonably practicable as of the same day and time…. on or as soon as reasonably practicable after the relevant Early Termination Date.*"

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In this case AET had occurred on 15 September 2008 when Lehman collapsed. The options referenced the Nikkei Index which was closed on that day, but the value of the options rose in Lehman's favour. The Defendant calculated the sum due on the basis of quotations that it represented it had received on 12 September 2008 (i.e. before AET). This approach was found to be inconsistent with the requirements of Market Quotation because:

- They were retrospective valuations, not actual quotations;
- They were not quotations for a "Replacement Transaction"; and
- The quotations must be a "live" quotation capable of being taken up there and then. A quotation before AET could not be "live";

Given that the wording of the Agreement clearly requires that a quotation is obtained after the Early Termination Date, the judge's findings in this regard are not surprising. There are however of additional points of principle that arise out of the judgment that are of interest.

Application of the "Value clean principle" to backdated quotes

The rationale for providing quotations for a Replacement Transaction is that the Non-Defaulting Party is "made whole" for the loss of the bargain. There are a number of authorities which make clear that the Non-Defaulting Party's valuation of loss must be valued on an assumption that, but for termination, the transaction would have proceeded to a conclusion.

Accordingly, the quotation for a Replacement Transaction is made on the basis that all conditions precedents have been fulfilled (the "*Value clean principle*"). Oppenheim argued that the value clean principle should be extended so that the option should be valued not

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only on the basis that there was no Event of Default or Termination but on the basis that any effect on the market should be disregarded or ruled out. This proposition was rejected as unarguable because:

(i) it was wholly contradictory to the clear words of the contract, which provides for valuation (by the chosen route of Market Quotation i.e. pricing for a Replacement Transaction) on or after the Early Termination Date, and certainly not before it; and

(ii) there was no purpose to it, as the *Market Quotation* route makes the Non-Defaulting Party "*whole*". Whether the market goes up or down after the event of termination, the Non-Defaulting Party will pay or receive a sum which puts him in exactly the same position as at that date.

The Second Gateway to Loss

Under the terms of the ISDA Master Agreement, the Non-Defaulting Party is entitled to apply the Loss formula for calculating the sums due if Market Quotation would not "*produce a commercially reasonable result*". In the event, Oppenheim decided to enter into some alternative hedging transactions and argued that this was a reasonable alternative to following the Market Quotation route. The judge rejected this approach as turning the contract on its head: it was not a question as to whether an alternative was reasonable, but that the Non-Defaulting Party must follow the contractually agreed obligation unless he can show that complying with it would be unreasonable. In this case, Oppenheim failed to show that at the relevant time that it had formed a belief that Market Quotation would not have produced a commercially reasonable result and, even it had, that belief could have been challenged. Therefore the gateway to Loss was not available in this case.

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Case 5: Calculation of Loss upon automatic early termination

The case of *Fondazione Enasarco v (1) Lehman Brothers Finance S.A. and (2) Anthracite Rated Investments (Cayman) Limited* [2015] EWHC 1307 (CH) is another case arising out of the demise of Lehman Brothers. The case concerned the calculation of "Loss" under the ISDA Master Agreement (1992 edition) arising as a result of the AET of a put option triggered by the collapse of Lehman Brothers. In short, following AET, a replacement put option was obtained from Credit Suisse as at 6 May 2009, albeit on terms which were in some respects different to the original put option with Lehman Brothers. The Claimant calculated its Loss at USD61.5 million. This sum represented the difference in the price between the original put option and the replacement put option.

Calculation of loss by reference to the cost of a replacement transaction is expressly contemplated and permitted by the definition of "Loss" in the ISDA Master Agreement. The issue in dispute was, therefore, when could a replacement transaction have been sourced, at what price and on what terms. In deciding this issue, the Court identified the following key points that will be of interest to practitioners:

- **Reasonable determination of loss**. In determining whether a non-defaulting party has "reasonably determined" its Loss, that party is not required to comply with some objective standard of care as in a claim for negligence, but must not arrive at a determination which no reasonable non-defaulting party could come to. It is essentially a test of rationality as in *Wednesbury*.
- **Earliest practicable date for a replacement transaction**. "Reasonably practicable" is not the same as "possible". To identify the first reasonably practicable date requires a consideration of all

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the circumstances. Replacing the put option was a complex and time consuming process, particularly in the changed financial conditions following the collapse of Lehman Brothers. In these circumstances, it had not been practicable to obtain quotations for a Replacement Transaction earlier than May 2009 (and in any event would have made no difference to the price of a replacement put option).

- **The requirement for the Replacement Transaction "Market Quotation" does not require the replacement transaction to be on identical terms to the terminated transaction**. The definition requires the replacement transaction to preserve "*the economic equivalent of any payment or delivery*". The focus is on the payment to be made under the terminated transaction, not on the prospect of performance by the counter-party. It is not necessary therefore to obtain quotes from a bank of an equivalent rating to the defaulting bank.
- **Hypothetical prices of replacement Transactions as at 15 September 2008 were of no assistance**. Monte Carlo simulations (produced by way of expert evidence) were not a method used in practice by banks to price derivatives products. The evidence of the uncertain state of the markets following the collapse of the Lehman Brothers group and the financial crisis showed that it was particularly appropriate in this period to look to prices actually quoted for a transaction, rather than any hypothetical prices of what might have been obtained at an earlier date. Accordingly, "quotations" within the meaning of Loss meant a real offer that a broker dealer was willing to contract at the time of the quotation (see our discussion of *Lehman Brothers Finance SA v Sal Oppenheim Jr & Cie KGAA* above for further details).
- **Earliest practicable date for Calculation Statement**. Section 6(d) of the ISDA Master Agreement requires the non-defaulting

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party to provide its Calculation Statement on or as soon as reasonably practical following early termination. Enasarco was found to have breached this requirement by delivering its statement in September 2009. However, this delay had no impact upon the calculation of Loss.

CONTRACTUAL ESTOPPEL

Case 6: Dutch housing association estopped from disputing capacity to enter derivative transactions governed by the ISDA Master Agreement

In *Credit Suisse International v Stichting Vestia Groep* [2014] EWHC 3103, the Bank claimed for sums due under an ISDA Master Agreement (2002 edition), including a Credit Support Annex (CSA). The Bank claimed that it had duly terminated the ISDA Master Agreement after Vestia had failed to provide security due under the CSA and accordingly the Early Termination Amount fell due. Vestia defended the claim primarily on the basis that it did not have capacity to enter some of the derivative transactions.

Vestia is a Dutch Housing Association (SHA). It was common ground that a SHA had the capacity to enter into "hedging transactions", not because Vestia's objects directly include such activity but because, under Dutch common law, it was a "secondary act" that is a means of achieving a core object. Vestia pleaded that it only had capacity to enter into swaps and swaptions to hedge against "borrowing liabilities". The Court rejected this approach finding that there was no principled reason that only swaps and swaptions were to be regarded as hedging instruments and could not be distinguished from other kinds of hedging instruments. Further, there was no principled reason for restricting the risks against which

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Vestia might protect itself provided the hedging transaction was consistent with achieving the core object.

The Court determined that the question of whether a derivative transaction was within Vestia's capacity really depends on whether Vestia was acquiring a hedging instrument in the broad sense depending on the nature and circumstances of each of the contracts. In light of this reasoning, the court analysed the nature and effect of each of the disputed transactions. In broad terms, the Court found that Vestia had capacity to enter into transactions or combinations of transactions which had the effect of mitigating Vestia's exposure to interest rate movements (such as a swap and swaption which fixed and reduced the amount of interest that Vestia had to pay). Conversely, Vestia did not have capacity to enter into transactions which aggravated its exposure to interest rate movements as such transactions could not be characterized as "hedging contracts".

Having found that Vestia did not have capacity to enter into some of the derivative transactions, the Court was next required to determine the consequences of incapacity. This was a question of common law as the protections afforded by sections 39 and 40 of the Companies Act 2006 (which prohibit companies disputing the validity of acts entered into in good faith) did not apply because Vestia was not a company. The Court found that the *ultra vires* contracts were invalid in that they were outside Vestia's objects and further that Vestia's directors had no authority to make them.

However, Credit Suisse raised various further arguments based on the terms of the ISDA Master Agreement and the Management Certificate. In particular, the Bank sought to rely on the representations relating to Vestia's "Power" to enter the transactions under Section 3(a) of the ISDA Master Agreement and also the "Additional Representations" in section 3 of the Schedule to the

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ISDA Master Agreement which, among other things, warranted that Vestia's entry into the transactions were in compliance with its objects.

The Court held that the statements in section 3(a) were intended to be mere representations of fact and not contractual undertakings. These representations did not assist the Bank as they could not give rise to a contractual estoppel. However, the "Additional Representations" in the Schedule to the Master Agreement which were negotiated by the parties were considered to be contractual warranties. The Additional Representations unambiguously refer to Vestia warranting to Credit Suisse the matters stated therein, and the parties clearly intended them to take effect as contractual undertakings as well as representations. The effect of this was that the parties had agreed that a particular state of affairs should form the basis for their agreement. Accordingly, Vestia was estopped from disputing liability to Credit Suisse under the ISDA Master Agreement on the grounds that contracts were outside its capacity. The court also found that Vestia was in breach of the warranty such that even if there was no contractual estoppel, Credit Suisse was entitled to damages for breach of warranty in any event.

Case 7: "Basis clause" effective at excluding liability for negligent advice in connection with sale of an interest swap

With on-going FCA investigations into the alleged misselling of interest rate hedging products, the High Court's findings in *Crestsign Ltd v NatWest and RBS* [2014] EWHC 3043 (Ch) are significant to a number of financial institutions.

The case concerned the liability of RBS for negligence in respect of the sale of a 10 year "step up" swap sold to Crestsign (a small

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commercial property company) in connection with the refinancing of a 5 year secured loan facility provided by Natwest.

The Issues

1. **Did the banks owe a duty to use reasonable skill and care in giving advice?**

The Bank provided Crestsign with various documents (including the Terms of Business) which stated that the Bank would not provide Crestsign with advice.

The Court was required to analyse the effect of these contractual provisions. In doing so, the Court referred to the reasoning in *Raffeisen Zentralbank v. Royal Bank of Scotland plc* [2011] 1 Lloyds Rep 123 in which Clarke J gave helpful examples of different types of clauses.

- First "sophisticated commercial parties" should generally be free to accept terms which define the factual basis on which their dealings take place and what statements can or cannot be relied upon by the receiving party. These are "basis clauses" which fell outside the scope of UCTA and it was undesirable for the court to strike down freely agreed terms.
- At the other end of the spectrum, is the example of a car dealer who says a car is perfect and then gets the buyer to agree that no representation has been made or can be relied on, describing this "*as a retrospective attempt to alter the character and effect of what has gone before*" and thus in substance is an exclusion clause. As Clarke J put it: "*the key question… is whether the clause attempts to rewrite history or parts company with reality*"

The judge found that in this case, the Bank "*went out of its way in the documents to ensure that an [advisory] duty would not arise*" and

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although Crestsign was not a large and sophisticated party, it was not in a position akin to a buyer of a second hand car and the basis clause did not part company with reality. Accordingly Crestsign was estopped from asserting the existence of any advisory duty and the claim failed.

2. Was the bank in breach of the duty in advising on the suitability of the swap?

Interestingly, the Court also considered the alleged breach of duty in the alternative in case it was wrong with respect to the effect of the basis clause.

The Court found that the Bank had been negligent because the Swap was in fact unsuitable in that it carried unacceptable risk. The judge expressly stated that the duty in common law and the COBS duties were not "co-terminous" and his decision was not based on any breach of COBS. Indeed, the judge's finding of negligence was based on the finding that the Swap was in fact unsuitable as opposed to the regulatory test to ensure that reasonable steps were taken to make a suitable recommendation. Therefore, on the facts of this case, the court appeared to find that the duty was higher that the regulatory equivalent (although the judge did not say this expressly).

Commentary and Practical Points

- This is another example of the English Court's willingness to uphold a bank's ability to disclaim advisory duties to its customers and will be of comfort to bank's facing potential mis-selling claims.
- The case provides useful guidance on the different effects of basis clauses and exclusion clauses. The court held that commercial

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parties are legitimately able to define their relationship to avoid disputes, particularly where a salesman may cross the line in giving advice. In the judge's words, the practical effect of a basis clause is that "*although I recommend one of these products as suitable, the banks do not take responsibility for my recommendation; you cannot rely on it and must make up your own mind.*" This, in the judge's view, was not unrealistic. Given that exclusion clauses are subject to challenge under UCTA, the distinction between a basis and exclusion clause (which can involve the drawing of fine lines) is likely to be the subject of further litigation.

- The parties in this case were not of equal bargaining power but not so unequal that the commercial agreement would not be upheld. The case illustrates that the imbalance needs to be material for the court to unpick the agreement.

INVESTMENT BANKING

Case 8: No implied term to obtain best possible price in forced sale
The dispute in *Rosserlane v Credit Suisse International [2015] EWHC 384 (Ch)* arose out of the sale of a stake in the Shirvan Oil Company, which operated a well-established offshore oil field in Azerbijan. CSI provided a short-term loan of $127m to the Claimant to replace existing finance and to enable the Claimant to sell its stake in Shirvan (held by a subsidiary of the Claimant called CEG). The parties entered into various other agreements including (i) a security agreement giving CSI security over Shirvan; (ii) an M&A agreement appointing a Credit Suisse entity as adviser to it in its disposal of CEG; and (iii); a Participation Agreement which gave CSI an "equity upside" in the sale of CEG over certain value thresholds. The claim arose out of CSI's duty under this third agreement.

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The Participation Agreement gave CSI a right to force a sale if CEG failed to sell Shirvan before a particular date with a guarantee that the sale proceeds would not be less than $180m. In the event, Shirvan was sold for $245 million.

The Claimant argued that Shirvan should have been sold for much more and that CSI breached an implied term that the Bank owed a duty "*to take … reasonable care so as to seek to obtain the best price reasonably obtainable, or alternatively a fair, true and proper market price upon such sale …..*". The basis for this implied term was that CSI acted as CEG's agent and was subject to a duty to take reasonable care to obtain the best price reasonably obtainable or, alternatively, that where a party has the power to sell another's property the law imposes a general duty to take reasonable care as to the price achieved.

The claim was rejected. The Participation Agreement was a self-standing, freely negotiated commercial agreement and the bank was exercising its right to sell pursuant to the terms of that agreement. There was therefore no basis to imply the terms alleged by the Claimants.

COMMERCIAL COURT DEVELOPMENTS

Commercial Court's Financial List

Following a brief consultation period, Lord Chief Justice Thomas has announced that an important new regime will be introduced to resolve high value or complex financial disputes.

This new regime (in force from 1 October 2015) will be known as the Financial List and it will apply to proceedings where amounts claimed are in the region of £50 million or more and/or which raise

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issues of general importance to domestic and international financial markets. It is of note that claims that could fall under the new regime include not only claims in relation to loans, banking transactions, financial products, bonds and securities, but also claims relating to insurance, re-insurance and professional negligence where they raise points that particularly affect the financial markets.

A new approach to managing complex financial disputes.

The introduction of this list marks a sea-change in the way that complex financial disputes will be managed. While the introduction of the Commercial Court has significantly improved the way in which business disputes progress through the courts, its relatively low value threshold and the wide range of matters it addresses on a daily basis has meant that the management of particularly complex matters could be improved upon.

If the proposals in the Consultation Paper are adopted, there will be three primary advantages for litigants.

First, there will be a single "docketed" judge who will manage the case all the way from the pleadings to enforcement if necessary, and who will be responsible for granting ancillary measures and relief as appropriate. This will allow for efficient case management and uniformity, building on the current procedures that exist in the Commercial Court for the management of heavy cases.

Second, cases that are managed in the Financial List will be managed by any one of ten or more experienced judges who will be specifically trained on an ongoing basis on financial market issues and developments.

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Third, and most important, provision has been made for a new pilot test case procedure. This procedure features the introduction of "qualifying claims" by parties with opposing interests without the need for an actual dispute. "Qualifying claims" are described as claims that raise novel market issues and in relation to which there is no previous authoritative English precedent. This test case procedure will also grant standing to relevant trade bodies and associations to make representations and the general rule will be that there will be no order as to costs. This is likely to be attractive to international litigants who are able to establish jurisdiction in England; no other established court has a similar procedure that will avoid costly and time consuming litigation before disputes have even arisen, without the risk of paying adverse costs.

Implications

The introduction of this new financial list is an important innovation. It marks the English courts' clear invitation to international market actors by offering a premier, sophisticated court alternative in light of increased competition from other dispute resolution forums such as the Singapore International Commercial Court. It will be surprising if the introduction of this list does not serve to consolidate and expand London's status as the preferred venue for the resolution of international disputes – it is difficult to beat the tripartite attraction of an experienced corpus of expertly trained judges, a quick and efficient court process, and decreased costs risks.

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Section C: US banking litigation update

RESIDENTIAL MORTGAGE BACKED SECURITIES LITIGATION

Case 1: Named Plaintiffs lack standing to assert class-claims on behalf of trusts in which they did not invest

In *Retirement Board of the Policemen's Annuity and Benefit Fund of the City of Chicago v. Bank of New York Mellon*, 775 F.3d 154 (2d Cir. 2014), the Second Circuit addressed whether plaintiffs had standing to sue on claims for breach of fiduciary duty, breach of contract, and statutory claims relating to investments in residential mortgage backed securities ("RMBS"). The Court held that the named plaintiffs in the putative class action lacked standing to assert claims on behalf of RMBS trusts in which the named plaintiffs did not invest.

The named plaintiffs were pension funds that had invested in 530 RMBS trusts between 2004 and 2008 for which the defendant acted as trustee. Plaintiffs alleged losses arising out of defendant's breaches with respect to those trusts. Plaintiffs sought to assert claims not only on behalf of those 530 trusts, but also on behalf of hundreds of other trusts in which it did not invest.

Class standing ensures that the named plaintiffs' litigation incentives are sufficiently aligned with those of the absent class members. In a putative class action, in order to have standing to assert claims on behalf of the class, a plaintiff must plausibly allege:

> (1) that he personally has suffered some actual injury as a result of the putatively illegal conduct of the defendant, and

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> (2) that such conduct implicates the same set of concerns as the conduct alleged to have caused injury to other members of the putative class by the same defendants.

After ruling that the first prong was satisfied, the court found that the plaintiffs failed to satisfy second prong of the test for claims on behalf of trusts in which plaintiffs did not invest because defendants' conduct had to be examined with respect to each trust and liability had to be proved on a loan-by-loan and trust-by-trust basis.

OTHER DEVELOPMENTS IN SECURITIES LAW

Case 2: Pleading standards in fraud and negligence claims

In *Financial Guaranty Insurance Company v. Putnam Advisory Company, LLC*, 783 F.3d 395 (2d Cir. 2015), FGIC, a credit protection insurer, sued Putnam in its capacity as a manager of a collateralized debt obligation. FGIC contended that Putnam misrepresented its management of the CDO to induce FGIC to provide financial guaranty insurance for the CDO. According to FGIC, Putnam stated that it would choose the collateral for the CDO independently and in the interest of long investors. However, Putnam actually allowed a hedge fund that maintained significant short positions in the CDO to control the collateral selection and acquisition process. Two of FGIC's most serious allegations were that the hedge fund selected a higher percentage of high-risk loans for the CDO's asset portfolio than Putnam had promised FGIC, leading to a higher probability of default, and that the hedge fund stood to gain more if the CDO defaulted. FGIC alleged that it incurred liability of up to $900 million when the CDO defaulted.

FGIC sued Putnam for fraud, negligent misrepresentation, and negligence. The District Court dismissed FGIC's fraud claim because

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it did not adequately plead loss causation, and dismissed FGIC's negligence claims because the complaint did not allege a special or privity-like relationship between FGIC and Putnam.

On appeal, the Second Circuit overturned the District Court, holding that FGIC only had to allege facts to raise a reasonable inference that the hedge fund's overall involvement caused an ascertainable part of FGIC's loss, not that its involvement was the exclusive cause of the loss. The court held that FGIC had pleaded sufficient specific facts (when considered collectively) to allege that Putnam's misrepresentations and omissions caused at least some of the economic harm FGIC suffered.

With respect to the negligence claims, the Second Circuit held that although FGIC and Putnam were not in contractual privity, FGIC had plausibly alleged non-contractual privity based on the relationship between FGIC and Putnam, wherein Putnam allegedly made representations that it would select and manage the assets for the CDO, FGIC relied on these statements, and that the CDO would not have closed without the credit protection FGIC provided. As a result, Putnam understood that FGIC would rely on Putnam's care and competence in managing the portfolio. The fact that Putnam was not acting as a financial advisor or in a fiduciary capacity to FGIC did not preclude finding a special relationship between the two companies.

Case 3: Item 303 omissions can give rise to a securities fraud claim
In *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94 (2d Cir. 2015), in a matter of first impression, the Second Circuit held that the failure to make a required disclosure under Item 303 of Regulation S-K in a 10-Q filing could serve as a basis for a Section 10(b) fraud claim under the Securities Exchange Act of 1934.

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The case arose out of a proprietary trade executed by Morgan Stanley in which the company maintained a short position and long position consisting of credit default swaps on collateralized debt obligations backed by mezzanine tranches of subprime residential mortgage-backed securities. When the subprime housing market collapsed in 2007, Morgan Stanley's swap position declined and it lost millions of dollars on the proprietary trade. The plaintiffs alleged, among other things, that the defendants made material omissions in their 10-Q filings by failing to disclose the existence of its long position, that the company had sustained significant losses on that position, and that the company was likely to incur significant losses on its long position in the future. These disclosures were necessary under Item 303, which requires companies filing SEC-mandated reports to "describe any known trends or uncertainties … that the registrant expects will have a material … unfavorable impact on revenues or income from continuing operations."

Having previously held that failing to comply with Item 303 by omitting known trends or uncertainties from a registration statement or prospectus is actionable under Sections 11 and 12(a)(2) of the Securities Act of 1933, the Second Circuit found that Item 303's affirmative duty to disclose can also serve as the basis for a securities fraud claim under Section 10(b). Because 10-Q filings are mandatory filings that speak to the entire market and give investors an opportunity to view the company through the eyes of management, the court posited that a reasonable investor would view the absence of an Item 303 disclosure as implying the non-existence of negative trends that could have an unfavorable impact on the company's revenues. The court ruled that Item 303 imposed a duty to speak such that an omission could create Section 10(b) liability.

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The court further held that failing to make a required disclosure under Item 303 was not, by itself, sufficient to state a claim for securities fraud under Section 10(b). Since only material omissions are actionable under Rule 10b-5, the court ruled any Item 303 omission giving rise to Section 10(b) liability had to pass the materiality test required of forward-looking disclosures set forth in *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988) (balancing the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of company activity).

The court ultimately affirmed dismissal, finding that although duty to disclose was adequately pleaded, the complaint failed to plead scienter.

Case 4: Alleging material misrepresentations and omissions
In *IBEW Local Union No. 58 Pension Trust Fund and Annuity Fund v. Royal Bank of Scotland Group, PLC*, 783 F.3d 383 (2d Cir. 2015), investors who had acquired American Depository Shares ("ADS") from RBS brought a putative class action under Section 10(b) and Section 20(a) of the Securities Exchange Act of 1934, alleging that RBS and certain executives had made fraudulent statements to investors about RBS's exposure to subprime assets, the success of RBS's acquisition of ABN AMRO, and RBS's Rights Issue announcement to raise capital.

The court held that plaintiffs could not plead a claim under Section 10(b) based on the exposure statements because:

- Statements regarding RBS's exposure to subprime assets made before the class period were not actionable since there was no duty to update or correct the statements;

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- Certain alleged omissions were quantitatively immaterial under the SEC's determination of materiality, as they constituted less than 4% of RBS's total asset backed securities exposure and less than 1% of its total assets, and other qualitative factors did not favor treating these statements as material; and
- Statements in RBS's 2007 annual report were not fraudulent because the report did not omit $66 billion in assets as the plaintiffs alleged.

The court held that RBS's statements regarding its acquisition of ABN AMRO were inactionable puffery. In order to be actionable, statements of corporate optimism must be worded as guarantees and be supported by specific statements of fact, or the speaker must not genuinely or reasonably believe them. RBS's statements that "[t]he integration of ABN AMRO is off to a promising start" and "we are happy we bought what we thought we bought" did not meet those requirements.

Case 5: Pleading scienter under Section 10(b)
In *Owens v. Jastrow*, 2015 WL 3649823 (5th Cir. 2015), the Fifth Circuit examined the application of heightened pleading standards to allegations of scienter in stating a claim for violation Section 10(b) of the Securities Exchange Act of 1934.

Plaintiffs, representing a putative class of investors in Guaranty Financial Group, alleged, among other things, that the defendants made materially false and misleading statements regarding Guaranty's assets in SEC filings and public comments. The Private Securities Litigation Reform Act ("PSLRA") imposes heightened pleading standards on plaintiffs bringing Section 10(b) claims, requiring plaintiffs to state specific facts giving rise to a strong inference that the defendant acted with the intent to deceive,

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manipulate, or defraud, or was severely reckless in its actions. The court held that:

- When assessing scienter, a court must view the allegations "holistically," undertaking a two-step inquiry first viewing allegations in isolation, and then collectively, is permissible; and
- Allegations attributed generally to "individual defendants" or "bank executives" (sometimes known as "group pleading") did not meet the heightened pleading requirement of the PSLRA because such statements do not apprise each defendant of his or her particular role in the fraud.

The court found that the specific allegations concerning knowledge by Guaranty's executives of Guaranty's undercapitalization, although potentially probative of motive and opportunity, failed to create a strong inference of scienter. Similarly, knowledge of alleged "red flags" concerning the valuation of mortgage-backed securities did not create a strong inference of scienter because representations were made before the red flags became apparent and because Guaranty publicly disclosed that its valuations were made based on internal models, the accuracy of which investors could judge for themselves. Finally, the magnitude of the alleged misstatements, including a 100% overvaluation of the company's mortgage-backed securities portfolio, only slightly contributed to an inference of scienter, because the valuation involved subjective accounting concepts that could yield a wide range of reasonable results.

The court also ruled that the alleged misconduct of individual executives did not meet the heightened pleading required to allege scienter. These allegations included that two of the executives were aware of internal warnings that Guaranty's valuation models were severely flawed, and that despite not being informed of problems with Guaranty's internal valuation models, another executive

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certified that Guaranty's SEC filings complied with GAAP rules even though its internal valuation models were flawed. In the court's view, none of these allegations individually or collectively raised a strong enough inference of scienter for the plaintiffs' complaint to survive a motion to dismiss.

FINRA RULE 13204 AND ARBITRABLE CLAIMS

Case 6: Lloyd v. J.P. Morgan Chase & Co.

In *Lloyd v. J.P. Morgan Chase & Co.*, 2015 WL 3937978 (2d Cir. 2015), the Second Circuit held that despite an arbitration clause in an employment contract, FINRA Rule 13204 barred the arbitration of the plaintiffs' class and collective action claims against J.P. Morgan Chase.

Plaintiffs, a group of former financial advisers of Chase Investment Securities Corp., alleged Chase's designation of financial advisers as overtime-exempt violated the New York Labor Law, the New Jersey State Wage and Hour Law, and the Fair Labor Standards Act. The plaintiffs brought state law claims as a putative Rule 23 class and brought their FLSA claims as part of a collective action. Defendant moved to compel arbitration based on an arbitration clause in the employment contract that mandated arbitration by FINRA rules for claims arising out of or in connection with the business activities of defendant, and that prohibited class or collective action. The district court denied defendant's motion.

The arbitration clause stated:

Any claim or controversy concerning you arising out of or in connection with the business activities of [Defendant], your activities and/or your appointment as a registered representative or your employment and/or

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the termination thereof required to be arbitrated by the FINRA Rules shall be resolved by individual (not class or collective) arbitration in accordance with the Code of Arbitration Procedure of the FINRA . . ., and in accordance with applicable law. . . . Further, no claims shall be arbitrated on a class or collective action or collective or class-wide basis.

The Second Circuit addressed whether the arbitration clause incorporated FINRA Rule 13204, and if so which version of Rule 13204 the parties had agreed to when they made the contract, because Rule 13204 had been amended in the time between the signing of the agreement and the dispute. The old FINRA rule barred the arbitration of class actions, while the new rule barred the arbitration of class actions and collective action claims.

The Second Circuit acknowledged that the presumption of arbitrability mandated by the Federal Arbitration Act applied only to the extent that the arbitration agreement was ambiguous about whether it covered the dispute at hand. If the parties did not intend to arbitrate, that intent could not be overcome by the presumption of arbitrability. Therefore, the court focused on whether the arbitration clause reflected the parties' intent to arbitrate the plaintiffs' claims.

Reviewing the arbitration provision's language and grammatical construction, the Court concluded that the parties did not intend to arbitrate the plaintiffs' class and collective action claims. The court started by saying that "required to be arbitrated by the FINRA Rules" was the disputed phase, and the question was which words that phrase was intended to modify in the sentence, "Any claim or controversy concerning you arising out of or in connection with the business activities of [defendant], your activities and/or your appointment as a registered representative or your employment and/or the termination thereof …".

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The court reasoned that because the amended Rule 13204 barred class and collective action claims, the question was whether the phrase “required to be arbitrated by the FINRA Rules” applied to the whole category of claims or controversies (meaning that the plaintiffs’ claims could not be arbitrated at all) or whether it only applied to claims arising out of the plaintiffs’ employment (meaning that the plaintiffs claims arising out of Chase’s business activities or the plaintiffs’ activities as registered representatives could be arbitrated).

Grammatically, the court held that the natural reading of the sentence was that “concerning you,” “arising out of or in connection with the business activities…” and “required to be arbitrated by the FINRA Rules” all modified claim or controversy. Therefore, according to the court, only a claim or controversy that satisfied all three criteria was required to be resolved by arbitration. Because FINRA Rule 13204 precluded the class and collective from being arbitrated, the plaintiffs’ claims fell outside the scope of the arbitration clause.

Substantively, the court held that this reading was the most sensible. Because the arbitration clause required the whole category of arbitrable claims to be arbitrated in accordance with FINRA Rules, it was logical that the clause incorporated the limitations of the FINRA rules as to the scope of arbitrable claims. If the set of arbitrable claims consisted only of claims required to be arbitrated by FINRA rules, then those claims could always be arbitrated according to FINRA Rules.

The court also held that the new version of FINRA Rule 13204 applied to the dispute. This was because, in the court’s view, any other reading was nonsensical. If the old rule applied to this dispute,

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then it would allow the arbitration of collective action claims and the plaintiffs' collective action claims would have to be arbitrated by FINRA according to the court's reading of the arbitration clause. However, the new Rule 13204, which is binding on FINRA arbitrators, prohibits the arbitration of collective action claims. Therefore, if the old rule were applied, the collective action claims would be required to be arbitrated by FINRA, which would have no authority to hear those claims. Because this could not have been the parties' intention, the court held that new FINRA Rule 13204 applied to the dispute.

Case 7: Cohen v. UBS Financial Services, Inc.
In *Cohen v. UBS Financial Services, Inc.*, 2015 WL 3953348 (2d Cir. 2015), the Second Circuit held that a UBS employee was precluded from bringing putative class and collective wage-and-hour based claims, and was required to submit his individual claims to FINRA arbitration.

Cohen was a financial advisor employed by UBS, who consented by contract to arbitrate "claims concerning compensation, benefits, or other terms or conditions of employment" before FINRA and to waive "any right to commence, be a party to or an actual or putative class member of any class or collective action arising out of or relating to his employment with UBS." Despite the clause, Cohen initiated a putative class and collective action against UBS, asserting wage-and-hour claims under the Fair Labor Standards Act and various California laws. Cohen admitted that the arbitration agreement applied to his claims but argued that FINRA Rule 13204 barred enforcement of the arbitration clause. The district court granted UBS's motion to compel arbitration. Cohen then appealed, arguing that Rule 13204 was a contrary congressional command that barred UBS from enforcing the arbitration agreement and his waiver of class and collective action procedures.

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The Second Circuit rejected Cohen's claim. In order to establish that Rule 13204 barred enforcement of the arbitration provision, Cohen had to show that enforcement of the arbitration clause would contradict Rule 13204 and that Rule 13204 was a congressional command. Without addressing whether Rule 13204 was a congressional command, the court held that enforcing the arbitration clause would not contravene Rule 13204.

Citing the language of the Rule, the court found that even though Rule 13204 barred the arbitration of a claim so long as it was embedded in a class or collective action, the Rule said nothing about class action and collective action waivers and could not be read to bar the enforcement of those waivers. According to the court, clauses (a)(1) and (b)(1) of Rule 13204 were inapplicable to Cohen because those clauses only made FINRA arbitration forums unavailable for class action claims and UBS was not trying to compel arbitration of those claims. The court also said that section (a)(2) and (b)(2) were inapposite because they barred FINRA arbitration of claims that were subject to parallel proceedings in federal courts. But, as the court held, there was no risk of duplicative proceedings here, because UBS sought FINRA arbitration instead of federal litigation.

In dismissing Cohen's claim, the court provided important guidance on the differences among agreements to arbitrate and the waiver of the right to assert claims in class or collective action form. An arbitration waiver is a promise to forgo certain procedural mechanisms in court. An arbitration agreement, on the other hand, is a promise to have a dispute heard in a forum other than a court. In the court's view, Rule 13204 restricts arbitration agreements and not arbitration waivers.

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Thus, the court held that Rule 13204 did not prohibit the enforcement of pre-dispute waivers of class and collective action claims. Since Cohen waived his right to bring his claims as a class or collective basis, only his individual claims, which were undisputedly covered by the arbitration provision, remained.

Takeaway

Second Circuit Judge Dennis Jacobs wrote the opinions in both *Lloyd* and *Cohen*, which were issued one day apart. In footnote 4 of *Cohen*, Jacobs explained the difference between the two cases: *Lloyd* featured a dispute over whether an arbitration clause, which incorporated Rule 13204, covered the plaintiffs' claims (the court held that it did not). By contrast, in *Cohen*, the plaintiff invoked Rule 13204 to bar the enforcement of an arbitration clause that admittedly covered his claims. *Cohen* also involved a waiver of the right to bring class and collective action claims in court while the *Lloyd* plaintiffs only waived class and collective arbitration.

There are two takeaways: first, if a FINRA-member employer wants to avoid disputes over what its arbitration clause covers, it should draft the provisions in its employment contract carefully, such that the contract explicitly states which activities the arbitration clause is intended to cover. Second, FINRA-member employers can avoid potential litigation and subsequent questions about the scope and applicability of FINRA rules if their employees agree to waive their rights to assert class and collective action claims. Plaintiffs, on the other hand, are better off attempting to dispute whether the arbitration clause covers the claim instead of trying to use FINRA rules to extricate themselves from an arbitration agreement that definitely applies.

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INCREASED USE OF ADMINISTRATIVE PROCEEDINGS BY THE SEC

The Administrative Procedure Act ("APA") authorizes agencies, such as the Securities and Exchange Commission and the Commodity Futures Trading Commission ("CFTC"), to bring administrative proceedings before an Administrative Law Judge ("ALJ"). Unlike cases adjudicated in federal courts, SEC administrative proceedings usually occur at an expedited pace due to the Commission's own practice rules, such as requiring an evidentiary hearing to occur within four months of serving an individual with an Order Instituting Cease-And-Desist Proceedings. If a plaintiff loses in an administrative proceeding, she can petition to review the SEC's order in the Court of Appeals for the circuit in which she resides, has a principal place of business, or in the District of Columbia Circuit.

Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the SEC is now authorized to bring civil claims in internal administrative proceedings against non-regulated individuals and entities. Previously, the SEC could impose civil penalties against non-regulated individuals and entities only in a federal district court. Consequently, the SEC has increased its use of administrative proceedings.

District court's subject matter jurisdiction to hear constitutional challenges to SEC administrative proceedings

In *Tilton v. S.E.C.*, 2015 WL 4006165 (S.D.N.Y. June 30, 2015), plaintiffs Lynn Tilton and her company Patriarch Partners, LLC sued for a preliminary injunction to stop an administrative proceeding the SEC brought against the plaintiffs for violations of federal securities laws. In seeking to enjoin the administrative proceeding, plaintiffs alleged that the administrative method of appointing and removing

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the SEC's ALJs is unconstitutional under the Appointments Clause in the U.S. Constitution.

The SEC opposed the motion for preliminary injunction, asserting that the district court did not have subject matter jurisdiction. The court agreed, holding that there was no basis to bypass the congressionally created remedial scheme, which first requires adjudication by administrative proceeding, and which then may be appealed to U.S. federal courts. The court stated in dicta that plaintiffs are not treated unfairly even if they are required to first raise their claims through the administrative proceeding.

The court noted that there is some disagreement among district courts over the question of subject matter jurisdiction addressed by *Tilton*. The courts in *Spring Hill Capital Partners, LLC v. S.E.C.*, No. 15–CV–4542 (ER) (S.D.N.Y. June 26, 2015), and *Beho v. S.E.C.*, 2015 WL 905349 (E.D. Wis. Mar. 3, 2015), agreed that federal courts lacked subject matter jurisdiction to address plaintiffs' claims before an administrative law judge rendered a final judgment. In *Hill v. S.E.C.*, 2015 WL 4307088 (N.D. Ga. June 8, 2015), and *Duka v. U.S. S.E.C.*, 2015 WL 1943245 (S.D.N.Y. Apr. 15, 2015), however, the courts found that the federal district courts *did* have jurisdiction, and therefore the plaintiffs were not required to bring their claims before the administrative law judge as a preliminary matter.

CONFLICTS OF INTEREST IN INVESTMENT BANKING

Case 8: RBC Capital Markets LLC found liable for aiding and abetting board of director's breach of fiduciary duty

In 2012, the Delaware Chancery Court criticized Goldman Sachs for its role in the merger between El Paso Corp. and Kinder Morgan, Inc. In a suit seeking to enjoin the merger, it was revealed that Goldman not only advised El Paso on the deal, but also owned nearly 19% of

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Kinder Morgan. While the Court found no basis on which to enjoin the merger, Goldman was ultimately denied its advisory fee when the parties reached a settlement.

In 2014, two years after the *El Paso* opinion, in *In re Rural Metro Corp.*, 88 A.3d 54 (2014), the Delaware Chancery Court found after a trial on the merits that investment bank RBC Capital Markets LLC "knowingly participated" and aided and abetted the board of directors of Rural/Metro Corporation in breaching their duty of care in the course of the company's merger with an affiliate of private equity firm Warburg Pincus LLC.

Rural/Metro, a national provider of fire protection and ambulance services, was considering strategic alternatives in 2010. RBC was retained as the advisor for Rural/Metro's board in exploring various options. As RBC and one of the directors started the company on a path towards its ultimate sale, RBC did not disclose to Rural/Metro that it sought to leverage its sell-side position in advising Rural/Metro to secure lucrative buy-side roles in financing a different deal for Emergency Medical Services Corp. ("EMS").

In pursuing the sale of Rural/Metro, RBC thought it could design the Rural/Metro bid process such that the ultimate buyer of EMS would also seek to acquire Rural/Metro to take advantage of synergies. In the face of a bid deadline, the private equity firm that purchased EMS asked for additional time to formulate a bid for Rural/Metro to consider potential synergies. The board declined to extend the deadline. Ultimately, Warburg was the only bidder, in part because of conflicts that arose for other private equity firms that had evaluated the EMS deal.

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RBC, pursuing a completed transaction at all costs, withheld valuation information from the board during the bid process, and when preparing its fairness opinion on the Warburg transaction, worked to lower its analysis so that Warburg's bid looked more attractive. It simultaneously pursued a piece of the buy-side financing on the deal from Warburg.

The court found that the board breached its duty of care in approving the sale without proper analysis, and held that a third party could aid and abet a breach of duty of care. RBC did so by "creat[ing] the unreasonable process and information gaps" that constituted the board's breach. RBC misled the board about the merger and created an "information vacuum," wherein the board did not have access to critical information about the proposed sale. It also failed to disclose its pursuit of buy-side financing on the EMS deal, and more egregiously, its pursuit of buy-side financing from Warburg on the Rural/Metro deal.

Collectively, the court held that RBC's actions significantly impacted Rural/Metro's ability to make an informed decision on the valuation of its own company. Pursuant a subsequent determination, 102 A.3d 205 (Del. Ch. Oct. 10, 2014), RBC was ordered to pay Rural/Metro's former shareholders $75.8 million, representing 83% of the class's damages.

Takeaway

Today, it is not uncommon for large investment banks to provide corporate advice to entities on both sides of a corporate sales process. In such a situation, banks are required to put up a "Chinese wall" between their different divisions in order to prevent confidential information from leaking, and to avoid a conflict-of-interest from tainting advice given to companies. It is unclear, however, how

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stringently investment banks adhere to these obligations, especially in the face of collecting enormous financial fees.

In order for investment banks to avoid liability for conflict of interest in such situations, they must:

- Ensure they have adequate internal policies that prevent sharing of confidential information between various banking divisions;
- Exercise full and fair disclosure to their clients regarding potential conflicts-of-interest; and
- Remember their role in advising their client's board of directors, who ultimately owe a fiduciary duty to the company's shareholders.

CIVIL LIABILITY FOR BANKS UNDER THE ANTI-TERRORISM ACT

Case 9: Bank found liable under Anti-Terrorism Act
In *Linde v. Arab Bank, PLC*, No. 04-CV-2799 BMC VVP, 2015 WL 1565479 (E.D.N.Y. Apr. 8, 2015), plaintiffs included American citizens who were the victims or related to the victims of terrorist attacks in Israel. Plaintiffs brought suit under the Anti-Terrorism Act ("ATA") against Jordan-based Arab Bank for its role in processing transactions for Hamas.

The civil provision of ATA, Section 2333(a) states:

> *"Any national of the United States injured in his or her person, property, or business by reason of an act of international terrorism, or his or her estate, survivors, or heirs, may sue therefor in any appropriate district court of the United States and shall recover*

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> *threefold the damages he or she sustains and the cost of the suit, including attorney's fees."*

Under the ATA, plaintiffs had to prove that (1) Arab Bank actually engaged in the financial and administrative transactions alleged, (2) it did so knowingly and intentionally, *i.e.*, with the purpose of financing or incentivizing the terrorist acts alleged, and (3) the bank's actions were a substantial factor in causing plaintiffs' injuries.

Plaintiffs presented evidence that multiple transfers had been wired through Arab Bank to various individuals allegedly associated with Hamas in connection with 24 separate attacks. Further, 11 charities that were founded by senior Hamas leaders or had Hamas leaders on their boards had money funneled to terrorist groups via Arab Bank. Plaintiffs also submitted videotaped deposition testimony of numerous bank employees, one of whom described a letter from Arab Bank addressed to the "Saudi Committee for Support of the Intifada Al Quds," which stated that it was issuing payments to the families of deceased individuals who had died by martyrdom. The jury found that the defendant knowingly provided financial services to Hamas by providing financial services to the charities and the Saudi Committee.

On post-trial motions, the court found insufficient evidence to link two of the 24 attacks to Hamas (the remaining 22 attacks were unchallenged), Arab Bank had also argued that the evidence presented by plaintiffs was insufficient to establish scienter or causation, but the court disagreed.

Because Section 2333(a) provides treble damages, plaintiffs are required to prove intentional misconduct. Although the bank argued that "intentional misconduct" required "an evil motive" or "intent to harm someone," the court held that intentional misconduct required

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showing that the bank "knew that it was providing material support to Hamas," or deliberately closed its eyes to the fact that it was providing material support to Hamas, "and also knew that Hamas engaged in terrorist activity". The court found that the evidence presented by plaintiffs met this standard.

Arab Bank also argued that the evidence failed to show that specific dollars passing through the bank funded the attacks that injured plaintiffs. Under the ATA, however, plaintiffs are not required to show "but for" causation. While plaintiffs were not required to trace specific funds transfers to any terrorist attack, they identified payments to the immediate relatives of suicide attackers who perpetrated four of the terrorist attacks at issue. Further, the fact that the families of dead Hamas terrorists would be financially rewarded was a "substantial factor" in the terrorists carrying out the terrorist attacks.

The damages portion of trial is currently scheduled for August 2015.

Case 10: Second Circuit clarifies intent standard under ATA
In *Weiss v. Nat'l Westminster Bank PLC*, 768 F.3d 202 (2d Cir. 2014), the Second Circuit vacated and remanded the lower court's grant of defendant's motion for summary judgment to determine whether the bank possessed the mental state required for liability under ATA.

Weiss involved a suit by the victims and estates of victims of 15 terrorist attacks in Israel and Palestine against the UK-based National Westminster Bank. Plaintiffs alleged that defendant aided and abetted the murder and attempted murder of American citizens and transmitted funds used to support terrorist activities by doing business with Interpal, a London-based charity with links to Hamas. The court held that under the ATA, plaintiffs were not required to

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show that the bank engaged in "*terror financing*," but rather financing of a "*terrorist organization*," regardless of the character of activities being financed. In other words, plaintiffs had to demonstrate only that "the bank had actual knowledge that, or exhibited deliberate indifference to whether Interpal provided material support to a terrorist organization, irrespective of whether the support aided terrorist activities."

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Section D: UK regulatory update

The Senior Managers Regime: U.K. Regulators Overhaul Individual Accountability in the Banking Sector

The linchpin of the new landscape of individual accountability drawn-up by the U.K. Financial Conduct Authority ("**FCA**") and Prudential Regulatory Authority ("**PRA**") is the Senior Managers Regime ("**SMR**"), which comes into force on **6 March 2016**. The SMR replaces the existing Approved Persons regime and will apply to high-level individuals at U.K. banks, building societies, credit unions, PRA designated investment firms as well as U.K. branches of overseas banks.

The SMR implements a function over form approach; anyone who manages a regulated activity which involves risk of serious consequence for the firm, its customers or other interests in the U.K. (a "**Senior Management Function**") will be a Senior Manager, irrespective of their title.

The widely drawn definition of Senior Management Functions will also mean that non-executive directors and individuals from other group entities will, depending on their allocated responsibilities, be Senior Managers. Firms will, therefore, need to carefully consider and identify their allocation of responsibilities. This process will be channelled by the new requirement that firms systematically document those allocations.

First, a Statement of Responsibility must be submitted as part of the approval process for each Senior Manager, clearly identifying the regulated activities for which they are responsible. Senior Managers will be obliged to take positive steps to prevent breaches of those

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responsibilities. The move, therefore, aims to improve regulatory outcomes in two ways:

i. by forcing individuals to focus their attention more keenly on their personal regulatory responsibilities; and

ii. by providing regulators a clearer avenue through which to bring individual enforcement action.

Second, firms must produce, regularly review and update, Responsibility Maps detailing management and governance structures within the firm, demonstrating to the regulators that there are no gaps or excessive overlap in the allocation of internal oversight.

By creating this mandatory paper trail, the regulators hope that if things do go wrong they can more easily identify which individuals were, or should have been, responsible for those failings than in the past. While as a matter of good governance, many firms will already have similar arrangements in place, they should still take care to ensure that any existing processes adequately meet the regulators' latest demands.

Presumption of Responsibility

The most controversial aspect of the new regime is, however, the presumption of responsibility against Senior Managers. Introduced to make it easier to bring enforcement action against those who have overseen serious regulatory failures, a Senior Manager will be guilty of misconduct if their firm contravenes its regulatory obligations unless they can demonstrate that they, as an individual, took the necessary steps to avoid the contravention.

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While this reverse burden of proof has drawn criticism, it remains intact following the regulators' consultation process. Should it come into force in March 2016, those holding significant functions in the financial services sector in the U.K. will, more than ever, have a vested interest in ensuring that (i) their firm's risk management systems are as robust as possible and (ii) that they, as individuals, fully engage with the risks faced by their organisations in a proactive and responsive manner at all times.

Senior Managers should refer back to their Responsibility Statements on a regular basis and document their actions and decision-making process as a matter of course, and not merely when issues arise. Equally, firms should ensure that they give their Senior Managers the tools necessary to enable them to discharge their duties.

New Criminal Offence

In extreme circumstances, Senior Managers will also face the risk of criminal sanction. Under the new regime, there is a criminal offence of reckless misconduct leading to a firm's failure, punishable by up to seven years in prison and/or an unlimited fine. A Senior Manager will commit the offence where:

i. they take a decision, or fail to prevent another taking a decision, that leads to the failure of the firm or another firm in its group structure;

ii. they were aware that it may have that consequence at the time in question; and

iii. their conduct falls below what would have been reasonably expected of a person in their position.

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While it is likely that there would be significant evidentiary difficulties in establishing the necessary elements of the offence and the circumstances in which it can be invoked are narrow, it emphasises the U.K. regulators' broader message that they will hold individuals to account when things go wrong.

Certification Regime

It is not, however, only high level employees that come under increasing scrutiny in the new regulatory landscape. The new Certification Regime will require firms to assess annually whether any employee who could pose a risk of significant harm to the firm or its customers is fit and proper to perform their role.

At present, the onus for conducting such an assessment lies principally with the FCA, however, the new regime transfers responsibility to firms themselves. In doing so, the regulators will have another avenue to attack firms when things go wrong i.e., by arguing that their assessment regime was inadequate and inadequate systems and controls were in place highlighting once more the culture of ever increasing regulatory oversight in the U.K.

GOING FORWARD

The Senior Managers and Certification Regimes place new burdens on firms and individuals working in them alike. Many firms will need to radically overhaul their internal processes to reflect the new requirements and implement new compliance, human resources and legal work streams to accommodate them.

Firms are, however, likely to come under pressure not only from their direct regulatory obligations but also individual employees' demands. With ever increasing stakes for Senior Managers when things go wrong, it likely that what they expect of employers in terms of resources and access to information both before and after

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failings occur will be greater than ever before and firms will need to adapt.

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Section E: UK competition law update

FCA given competition law enforcement powers

The *Financial Services Act 2012* gave the Financial Conduct Authority ("FCA") a strong new mandate to promote effective competition in the interests of consumers in the markets for regulated financial services. That operational objective sits alongside the FCA's other objectives: to secure an appropriate degree of protection for consumers, and to protect and enhance the integrity of the UK financial system.[1]

From 1 April 2015, amendments introduced by the *Financial Services (Banking Reform) Act 2013* gave the FCA additional concurrent powers to enforce competition law alongside the UK's primary competition regulator – the Competition and Markets Authority ("CMA") that strengthen its existing mandate to regulate the UK financial services sector.

While the FCA has rightly been stressing that adherence to competition law has always been a requirement, its new powers give the FCA an active role in investigating and enforcing against breaches of UK and EU competition law. The FCA also has new powers to conduct market studies under the *Enterprise Act 2002* ("EA 2002") and to make references to the CMA for a more in-depth market investigation. These powers are additional to the FCA's ability to use its powers under FSMA in pursuit of the competition objective.

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[1] Sections 1C to 1E Financial Services and Markets Act 2000 ("FSMA 2000"), as amended.

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As such, the effect of the changes is to bring the FCA into line with other of the UK sectoral regulators, such as Ofgem (gas and electricity), Ofwat (water and sewerage) and Ofcom (electronic communications and post) – something that HM Government had initially held back from when the FCA's future remit was originally being debated.[2] The main differentiator between the FCA and these other sectoral regulators is that in the main they were created with the aim of safeguarding the consumer interest in liberalising markets with newly privatised industries, whereas the expansion of the FCA's remit is part of a wider reform of financial regulation in the UK.

The FCA has taken a number of steps in anticipation of having a concurrent competition law enforcement remit. Over the last year, it has made several internal changes, in close cooperation with the CMA, including building a dedicated competition department of around 50 staff. The department has already launched several market studies – including its first wholesale market study into investment and corporate banking.[3] A study looking into asset management is expected later in 2015.

FCA guidance published

Importantly, the FCA published final guidance on the procedural aspects of how it intends to use its powers on 15 July 2015. The guidance documents have not changed significantly from the draft versions that the FCA published in its January 2015 consultation

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[2] The FCA sits alongside the other sectoral regulators that also have a duty to promote competition as a member of the recently established UK Competition Network, which was in turn created to be a forum for exchange of information and best practice.

[3] Notably, however, the FCA elected to conduct its wholesale market study under FSMA (i.e. under regulatory, rather than competition powers).

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paper.[4] That leaves a number of open questions as between the FCA's approach to exercising its competition enforcement powers and its other powers and processes, as well as with the approach to competition enforcement taken by the CMA.

- Concerns were raised during the consultation process with the FCA's proposed amendment to the "self-reporting" Principle 11 to oblige authorised firms to report actual or possible infringements of competition law. The concerns raised related in particular to timing, scope, whether the duty might conflict with the privilege against self-incrimination, and the interaction with the competition leniency policy. In response the FCA has made a number of clarifications about the extent of the obligation. In particular, the FCA has modified its proposed rule change to bring it into line with other existing reporting requirements by introducing the qualification that only "significant" infringements need be reported, and that the rule has no retroactive effect. A firm will now be required to notify the FCA if it "*has or may have committed a significant infringement of any applicable competition law*" and "*… as soon as it becomes aware, or has information which reasonably suggests, that a significant infringement has, or may have, occurred*".[5] The guidance further clarifies that the disclosure obligation applies to infringements by the regulated firm itself (i.e. the authorised legal entity), and not to that firm's unregulated activities, unless such a breach may directly or indirectly affect the authorised firm.
- The FCA has rejected concerns raised that there is a further tension as to how the reporting obligation works within the

[4] *CP15/1: FCA Competition Concurrency Guidance and Handbook Amendments.*

[5] SUP 15.3.32.

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framework of the leniency system in cartel cases. The CMA's leniency policy allows companies to decide whether or not to self-report competition law infringements. In return, the reporting firm may benefit automatically from full immunity from fines and protection for employees from criminal prosecution – provided there is no pre-existing investigation. The FCA recognises, however, that notification under Principle 11 increases the prospect such an investigation will already have been launched with the consequence that the CMA will have discretion in deciding whether to award immunity on any subsequent application. Disclosure to the FCA by one party to a cartel may therefore have implications both for the reporting firm and for any other parties also considering a leniency application.

- The other point at which the reporting obligation appears potentially at odds with the established leniency system is in respect of criminal prosecutions. The CMA's practice is that cooperating individuals should receive protection from personal sanctions in the form of immunity from criminal prosecution and/or protection from director disqualification proceedings. The FCA will not prosecute the criminal cartel offence and therefore cannot offer protection to individuals. The FCA has made clear in its guidance that firms considering whether the criminal cartel offence is relevant, which for conduct after 1 April 2014 no longer requires proof of dishonesty, should therefore consult the CMA in order to ensure that they do not prejudice the ability of their employees to benefit from immunity or leniency.
- Another significant difference in approach is with respect to the FCA's settlement procedure, which allows firms to admit liability in return for a more streamlined investigation and reduced penalty. Whilst the discounts on offer are consistent with CMA

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> guidance, the FCA approach differs in as far as the settling party may be required to waive the right to a subsequent appeal to the Competition Appeal Tribunal. In contrast, the CMA expressly permits a settling party the option of appeal. That is an important – although rarely exercised safeguard – as it protects against the eventuality that the final infringement decision does not reflect the basis on which the earlier settlement was made. The FCA notes in its response to the issues raised by the consultation that this was heavily commented upon, but that it has decided to proceed as originally proposed.

The FCA has, at least unofficially, been indicating that it will continue its principles-based approach to regulation and encourage an open dialogue, rather than applying its concurrent powers prescriptively. The next months and years will therefore be crucial in understanding what burden the new regime places on regulated firms and banks. A real concern will be that the UK financial services sector is not subject to a more onerous standard of competition law compliance than the rest of the economy.

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Section F: Hong Kong privilege litigation update

Hong Kong's Court of Appeal rules "Dominant Purpose Test" to apply in legal advice privilege, rejects U.K's restrictive approach

In the case of *Citic Pacific Limited and Secretary for Justice and Commissioner for Police* CACV 7/2012, the Court of Appeal provided welcome clarification on the protection of legal professional privilege ("**LPP**") in Hong Kong by providing that the "Dominant Purpose Test" was the correct test for determining whether LPP applied. The case also provided helpful guidance on proper procedure in relation to dealing with claims for LPP.

Back in 2009, a magistrate issued several search warrants authorizing the seizure of a large number of documents at the plaintiff's premises. A blanket claim of LPP was made in respect of all the materials seized, which resulted in the documents being sealed pending determination of LPP by the courts.

At the Court of First Instance, the Honorable Justice Wright followed the English decision of *Three Rivers District Council v Governor and Company of the Bank of England (No. 5)* [2003] QB 1556, which caused an uncomfortable stir amongst the legal industry in Hong Kong. In the *Three Rivers* case, the English Court of Appeal decided that internal communications between employees were equated with information from third parties, and thus not protected by LPP, even if such communications were preparatory to consultation with solicitors. Thus, Wright J concluded that employees of Citic were to be regarded as "third parties" and only Citic's group legal department and board of directors were "clients" of the external legal advisers.

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In a joint judgment, three judges of the Court of Appeal overturned this narrow approach, stating that lawyers needed to have relevant information from their clients before proper advice could be rendered, and there was a need to protect the process of gathering such information. To adopt such a restrictive approach of who constitutes the client would hamper the ability of the company to seek and obtain meaningful legal advice if that process could be open to discovery.

The Court said the basic right to LPP was enshrined under Article 35 of the Basic Law, and reiterated that LPP was a fundamental right which courts will jealously protect. In their judgment, they ruled that "Dominant Purpose Test" was to be adopted: "an internal confidential document, not being a communication with a third party, which was produced or brought into existence with the dominant purpose that it or its contents be used to obtain legal advice is privileged from production."

As a result of the decision, LPP can now extend to cover communications between the external legal adviser and the company as a whole, including its employees, if the internal confidential material were produced for the dominant purpose of obtaining legal advice.

The Court also provided helpful guidance for future disputes relating to LPP. These suggestions include:

i. Specifying, with respect to the materials, whether the LPP claimed is legal advice privilege or litigation privilege, and providing a statement or affirmation setting out the basis of the LPP claimed;

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ii. Considering giving a limited waiver to specified personnel or independent counsel from the other side to inspect the documents to resolve the dispute;

iii. Considering appointing an independent lawyer to resolve the claim. If the claim cannot be resolved, either party may apply to the Court for directions.

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Section G: Hong Kong regulatory update

New Independent Insurance Authority to be established to regulate insurers and insurance intermediaries in Hong Kong

In April 2014, the Financial Services and the Treasury Bureau issued a brief to the Legislative Council to kick-start the formal legislative process[6] (by amending the existing Insurance Companies Ordinance, Cap. 41) (the "**Ordinance**"). One of the key proposed amendments is the establishment of a new independent Insurance Authority ("**IIA**") to regulate insurers and insurance intermediaries (i.e. insurance brokers and insurance agents). This is considered an important regulatory reform in the insurance sector, particularly in light of the increasingly sophisticated and complicated insurance products sold in the market.

This article aims to outline some of the powers of the IIA under the legislative proposal.

Licensing and Supervision

Under the legislative proposal, the IIA would supervise insurance intermediaries directly by the introduction of a licensing regime. It is proposed that in future, all insurance intermediaries must first be licensed by the IIA before they can sell insurance products.

The said proposed arrangement would replace the present self-regulatory system, in which insurance brokers are regulated by the Hong Kong Confederation of Insurance Brokers and the Professional Insurance Brokers Association, and insurance agents are

[6] The Legislative Council Brief and the Insurance Companies (Amendment) Bill 2014 can be accessed via http://www.fstb.gov.hk/fsb/iia/eng/otherinfo/doc/iia-lb-160614_e.pdf

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regulated by the Insurance Agents Registration Board established by the Hong Kong Federation of Insurers.

Investigation Powers

The legislative proposal further gives the IIA power to power to investigate (and take disciplinary actions) in the following situations:

(i) contravention of the Ordinance;

(ii) contravention of the terms and conditions of any license granted by the IIA;

(iii) where an act or an omission is or is likely to be prejudicial to the interests of the policy holders, or potential policy holders, or the public interest;

(iv) where a licensed person is involved in fraud, misfeasance, defalcation or other misconduct; and

(v) where a licensed person is considered not fit and proper to be so licensed.

The investigatory powers given to the IIA, as presently proposed, include:

(i) the power to direct any person to produce record or document relevant to the IIA's investigation and provide explanation thereto;

(ii) the power to direct any person to attend interview and answer questions;

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(iii) the power to require written answers to questions raised by the IIA;

(iv) the power to require all assistance in connection with the investigation; and

(v) the power to enter premises, if necessary by force, to search for, seize and remove records and documents.

It is important to note that under the current legislative proposal, a person who is subject to an IIA investigation would not have the right to silence, in that a person would not be excused from complying with the IIA's investigatory requirements by relying on the right against self-incrimination. However, a person under the IIA's investigation may make a claim for privilege against self-incrimination where answers that he/she gives would tend to incriminate him/her so as to prevent the IIA from using those questions and answers against him/her in criminal proceedings. It is expected that the said privilege will not protect a person under investigation in criminal proceedings brought in relation to their failure to comply with an investigation requirement or if they have provided false or misleading information in the course of the investigation (which are statutory offences on their own) or perjury.

Disciplinary powers

Where a person or a corporation is found to have committed misconduct, or where a licensed person is not fit and proper, it is proposed that the IIA take disciplinary actions, including:

(i) revoking or suspending the authorization of an insurer;

(ii) issuing a private or public reprimand; or

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(iii) imposing a fine of HK$10 million, or triple the amount of the profit gained or the loss avoided.

Corroboration with the Hong Kong Monetary Authority

At present, the Hong Kong Monetary Authority ("**HKMA**") is the primary and lead regulator for banks, which also offer insurance services. Under the current legislative proposal, the HKMA will continue to be at the frontline regulator for insurance intermediary activities associated with banks, as the IIA has chosen to delegate its power to the HKMA. However, the IIA would still hold the power to ensure regulatory consistency, and would still remain the single authority to set regulatory requirements, grant licenses and to impose disciplinary sanctions.

Comment

The legislative proposal, as it presently stands, would have profound implications on insurers, insurance intermediaries, financial institutions, and the senior management thereof. It is expected that legal and compliance costs for these institutions would rise once the IIA regime comes into force. These institutions should prepare in advance, in particular, by educating management and employees of the new expectations of them, so as to minimize regulatory and disciplinary risks.

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Debevoise & Plimpton

New York
919 Third Avenue
New York, NY 10022
1 212 909 6000

Washington D.C.
555 13th Street, N.W.
Washington, D.C. 20004
1 202 383 8000

London
65 Gresham Street
London
EC2V 7NQ
44 20 7786 9000

Paris
4 place de l'Opéra
75002 Paris
33 1 40 73 12 12

Frankfurt
Taubenstrasse 7-9
60313 Frankfurt am Main
49 69 2097 5000

Moscow
Business Center Mokhovaya
Ulitsa Vozdvizhenka, 4/7
Stroyeniye 2
Moscow, 125009
7 495 956 3858

Hong Kong
21/F AIA Central
1 Connaught Road Central
Hong Kong
852 2160 9800

Shanghai
13/F, Tower 1
Jing'an Kerry Centre
1515 Nanjing Road West
Shanghai 200040
86 21 5047 1800