Newsletter

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Driving progress
through partnership

Introduction

Dear Colleagues,

2018 has been a year of market volatility, political volatility and regulatory uncertainty. New asset classes, such as cryptocurrencies, and issues such as privacy and cybersecurity have defined the regulatory landscape. Financial institutions, investors and regulators are still grappling with what this all means and how this affects everyday business and financial transactions. As we go into 2019, we can expect that the volatile political landscape will likely create a scenario where many of the answers to pressing questions may either remain uncertain or subjects of strenuous debate. That will mean it is incumbent on financial institutions and operating companies to be especially attentive to basic issues of risk, infrastructure, and compliance, because there could be unforeseen repercussions to all of this in the years to come after the dust settles in places like Washington D.C., Brussels, and London. In short, despite all the talk about regulatory pull-backs, we believe that the current situation presents unpredictable challenges that, unless closely watched and monitored, may go undetected and have lasting implications. Keep watch and good luck in the New Year!

As always, we appreciate and value your feedback, so please feel free to reach out to me directly at dandrews@reedsmith.com.

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Regulation of NPLs: Is there a need?

by Diane Roberts and Dr. Agnes Molnar

In 2017, the European Parliament (Parliament) published a briefing in which it noted that, following the financial crisis, the average ratio of European non-performing loans (NPLs) is decreasing. In December 2016, the NPL ratio in the EU stood at 5.1 per cent (down from 6.5 per cent in 2014 and 5.7 per cent in 2015). However, for EU banks that are "directly supervised significant institutions" the ratio is still in excess of 6 per cent. The briefing also advised that NPLs were held unevenly throughout the EU. In December 2016, Greece and Cyprus still had ratios of around 45 per cent; Bulgaria, Croatia, Ireland, Italy, Portugal, Slovenia and Romania had ratios of between 10 per cent and 20 per cent; and other countries in the EU had ratios of between 3 per cent and 8 per cent. This compares to an NPL ratio of around 1.5 per cent in the United States and Japan. The European Banking Authority (EBA) estimates that European banks have an average NPL ratio of 4.5 per cent as of June 2017.

While exact numbers are difficult to obtain, European banks are estimated to still have approximately €2 trillion of unresolved non-core assets on their balance sheets, and market participants expect to see portfolio transactions in excess of €100 billion in Europe in 2018 as banks continue to withdraw from activities that are deemed to be non-strategic or associated with high capital costs. The EU is concerned about NPLs because they may cause low aggregate profitability, higher capital requirements and higher funding costs, all of which negatively impact credit supply and economic growth.

In its various reports on NPLs, the Parliament noted that (i) some EU banks held inadequate information on borrowers and loans; (ii) information was not always contained in a consistent manner; (iii) in some cases collateral was overvalued; and (iv) in many cases there was inadequate provisioning. These factors were identified as being obstacles to the development of an effective secondary market for NPLs. On a more positive note, the Parliament also found that regulators and supervisors had taken significant steps to strengthen the EU banking sector; in particular, they had assisted in the restructuring of the banking sector in Ireland, Spain and Greece, where banks got credit support through direct state recapitalization or by way of measures to manage impaired assets.

Since the financial crisis, making banks stronger has been one of the main goals of the EU Commission. It has put forward over 50 proposals to increase the resilience of the financial sector and help protect the economy. Moreover, the Commission has been working together with EU Member States to address banks' high level of NPLs, including through setting up ad hoc and system-wide measures to manage impaired assets, compatible with state aid rules.

More recently, the Commission has also put forward several further substantial measures to reduce risks and enhance the resilience of the EU banking sector. For example, in November 2016, the Commission proposed a significant legislative package to review the Bank Recovery and Resolution Directive, the Single Resolution Mechanism Regulation, the Capital Requirements Directive IV and the Capital Requirements Regulation (CRR), with the objective of further reducing risks in the banking sector. That same year, the Commission also adopted a proposal for a directive on preventive restructuring procedures.

Despite all these efforts, the numbers of NPLs remain high. The EU's banking and supervisory authorities are now looking at packages of reform and legislative measures to reduce the stocks of NPLs and prevent their future accumulation. The EU's plan of action and proposals includes, among other things, the following:

- European Parliament: expressed concerns in its Annual Report on the Banking Union (February 2017).
- Council: agreed an action plan (July 2017) to address NPLs. The Council invited (i) the Commission to (A) consider under-provisioning, and (B) foster the development of a secondary market; and (ii) the EBA to issue, by the summer of 2018, (A) guidelines on NPL management for EU banks, and (B) enhanced disclosure requirements on asset quality and NPLs.
- EBA: launched consultation (March 2018) on its general guidelines on NPL management. The EBA also published a discussion paper on risk transfers (September 2017) – developed in response to a mandate to the EBA to monitor the range of supervisory practices, the paper contains a section on the regulatory treatment of NPL securitizations.
- Commission: presented a package of measures in March 2018 on credit servicers, credit purchasers and the recovery of collateral. The aim of these measures would be to provide banks with an efficient mechanism for out-of-court value

recovery from secured loans and would encourage the development of secondary markets where banks can sell their NPLs to investors and make use of specialised credit servicers.

In its latest Financial Stability Review, the ECB noted that securitizations of NPLs could complement outright NPL sales, and reduce the price spread by increasing the number of distressed debt investors. By tranching funding across different risk categories, securitization generally achieves a lower average cost of funding. The ECB further suggests public-private co-investment tools to enhance NPL securitization, such as potential state guarantees on the equity tranches structured as total return swaps or a forward purchase scheme under which the state would finance part of the NPL purchase price. Both tools are aimed at bringing the price of the NPL portfolio closer to the NPL market price.

National asset management companies (AMCs) are also seen to offer mechanisms that can play a role in addressing NPLs, subject to compliance with EU laws (such as EU state aid rules) and adequate funding, control and pricing measures. In its NPL resolution guidance, the ECB highlighted the advantages of the establishment of an AMC at the EU level as it would facilitate raising private funding in the market. Regulators noted that some banks have been liquidated and had their assets successfully transferred to specialized AMCs. AMCs were established in Spain (Sareb), Ireland (Nama), Slovenia (DUTB) and Greece (PQH). The Hungarian Central Bank set up MARK to acquire NPLs collaterised by commercial real estate, but the operation was unsuccessful and MARK was wound up in 2017. AMCs have previously been shown to swiftly clean up NPLs from banks' balance sheets and resolve them over a longer period of time. However, they must be supported by debt enforcement frameworks to achieve better recoveries than the originating banks. The promotion of the early restructuring of viable companies and the easy liquidation of collateral and non-viable companies should be implemented across EU Member States in accordance with local bankruptcy rules. The Commission helpfully published a non-binding technical guidance on how to set up national AMCs.

With a view to addressing data quality, enhancing standardization and reducing information asymmetries, the EBA has developed a series of transaction templates for various loan types. The goal is to ensure the granularity, quality and comparability of NPL data, enabling potential bidders to conduct the financial due diligence and valuation of an NPL portfolio in a transaction context. As the templates are voluntary market standards and not supervisory reporting requirements, only time will tell how the market will embrace them. Homogenization and commoditization are, however, signs of market development. Standard documents (as the use of Loan Market Association documents has shown) can reduce implementation costs and barriers to entry, and widen the investor base.

In its EU-wide action plan, the Commission has stressed the importance of out-of-court enforcement in achieving faster-paced resolution of NPLs. It has proposed a new mechanism for out-of-court accelerated collateral enforcement. Under the proposal, out-of-court enforcement would have to be agreed between a bank and borrower upfront, normally when the loan is granted. This would not be available for consumer loans, or for property serving as the borrower's primary residence. Where this new mechanism has been agreed between the parties, if the borrower defaults on the loan, the collateral would be valued and then sold, with the proceeds going to the creditor. The proposed rules aim to balance the creditor's and the borrower's interests, as the valuation and sale would have to follow certain rules, for example via public auction to ensure a fair price.

The EU's other recent legislative considerations include proposals on credit servicers and credit purchasers. These are intended to create a pan-EU regulatory framework and common standards for 'loan servicers' and to facilitate loan transfers to non-bank institutions, such as requiring Member States to lift any existing restrictions in national law (such as licensing requirements) that prevent loan transfers being made to non-bank institutions. They are also intended to address information asymmetry that is perceived to exist between banks and non-bank institutions in connection with NPL transactions. The proposals include, among other things, imposing (i) a mandatory disclosure standard applicable to sales by loan sellers (over and above the completion of a template); (ii) a requirement on loan sellers to report loan transfers to non-bank institutions; and (iii) a requirement on non-bank institutions to make pre-enforcement notifications to EU authorities.

While largely commendable in their objectives, there are some serious practical concerns and limitations in the proposals regarding the general scope and application of the proposed requirements, including their application to credit agreements originated by EU established bank credit institutions. For example, it is not clear that the legislative scope is restricted to NPLs, so they may inadvertently affect transfers of performing loan portfolios (or single asset loan sales) as well. Regarding the aforementioned mandatory disclosure, reporting and notification requirements and their potential application to syndicated loan market transactions (whether primary and/or secondary), such actions are contrary to the current market practice and may create unintended burdens and liabilities on sellers and buyers alike. Currently, institutional buyers and sellers of loans privately negotiate information disclosure in connection with secondary market transactions. Pre-enforcement notification timing also may be difficult in a syndicated transaction where individual lenders may not meet threshold requirements to be in control of a potential enforcement or be subject to complicated contractual intercreditor arrangements and/or confidentiality constraints. Understanding the consequences for both buyers and sellers of breaching any of these proposed requirements is also critical. Absent clarity, the proposals may actually reduce liquidity in the market and increase transaction costs.

It also is not clear whether the entire facility agreement is brought within the scope of the requirements if the original lending syndicate includes a single EU bank or whether the requirements only apply to that single EU bank's participation. For example, the reporting requirement in respect of a transfer seems in the substantive article to apply to any credit purchaser, but the relevant recital only refers to an EU established bank being required to report a transfer.

The proposed legislative measures regarding loan servicers also seem to be particularly burdensome to non-bank, non-EU incorporated facility agents and security agents in the syndicated loan market. The requirements set out a regulatory framework for entities that are classed as 'credit servicers.' Such entities are required to be incorporated in an EU Member State and authorized in their Member State and are to be subject to a number of requirements. It is unclear whether the definition of credit servicers is only intended to capture loan servicers and debt administrators. As proposed, the widely drafted definition of credit servicer could be read as capturing facility agents and/or security agents, as well as fund managers, in respect of loans originally made by an EU established bank. Although facility agents and security agents that are banks (or possibly only banks established in the EU) are stated to be exempt from the 'credit servicer' regime, a recent trend in the loan markets has been the use of specialist non-bank service providers in the facility agent and security agent role. These entities would presumably fall within the regime and become subject to regulatory requirements. This could place any non-bank agent that is not established in the EU in a difficult position because it will be required to be authorized but will be unable to obtain the appropriate authorization because it is not established in the EU. This could actually dissuade such parties from acting as facility agents or security agents in respect of loans originally made by an EU established bank and limit the pool of potential applicants in an agent replacement situation.

For reasons such as those described earlier, these proposals have potentially unintended adverse consequences for the syndicated loan market as it currently functions. Lobbying efforts by various market participants are underway with a view to clarifying and narrowing the application of the legislative measures to relevant situations.

Notwithstanding the foregoing, the foreseeable implications of the EU's action plan for banks generally include increased complexity and a greater cost to holding NPLs, a more prudent approach to riskier lending with more stringent credit assessments, the development of detailed NPL strategies and increased externalization in the servicing of NPLs. For investors, improvements would include fewer barriers to entry, more transparency and faster collateral recovery and servicing. The market itself is also expected to evolve as it would have a wider investor base and a more liquid secondary market. The ECB expects that we will see more and more creative transaction structures benefiting from synthetic portfolios or risk transfers. It considers that NPLs are among the biggest vulnerabilities in the banking sector and it remains committed to addressing market impediments.

In its conclusions on the action plan to tackle NPLs in Europe, the Council stressed that a comprehensive approach, combining a mix of complementary policy actions at the national and European level, is the most appropriate and effective way to address the existing stocks of NPLs as well as the emergence and accumulation of new NPLs on bank balance sheets. The four following policy areas are at the forefront of this approach: (i) supervision, (ii) structural reforms of insolvency and debt recovery frameworks, (iii) the development of secondary markets for distressed assets, and (iv) fostering the restructuring of the banking system. As some action plans have not yet been implemented or are only observed on a voluntary basis, we must await the reshaped regulatory landscape for NPLs. More importantly, we look forward to seeing faster-paced NPL resolution. However, this should not be at the cost of disturbing currently established loan market practices, which could result in negative unintended consequences for the loan market and less liquidity in not only the distressed market but also the par.

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Community bankers take heed: As M&A and other opportunities expand, best practices must remain a priority

by Don Andrews

In May 2018, the Economic Growth, Regulatory Relief, and Consumer Protection Act was signed into law, which modified and rolled back some provisions of the Dodd-Frank Act that were implemented following the 2008 recession. Undoubtedly, these reforms will impact how banks of various sizes as will conduct business, though the extent of that impact is uncertain.

The headline news has been relief from annual stress-testing for banks holding $50 billion in capital. The Act changed the threshold for capital planning and stress-testing requirements from $50 billion to $250 billion (with banks holding over $100 billion in assets subject to an 18-month transitional period and additional testing in certain cases). Banks approaching the $50 billion level can now pursue potential acquisitions and strategic combinations that may push them over that line – these deals were previously avoided because of the increase in costly and time-consuming regulation imposed at the $50 billion level. Indeed, People's United (a Connecticut-based institution with $44 billion in assets) announced in mid-June 2018 its acquisition of First Connecticut Bancorp and Farmington Bank and we expect more announcements to follow in the remainder of 2018.

Benefits for community banks

The broader impact of the regulation affects community banks. Those banks ranging in size $1 billion to $10 billion in assets (over 500 banks in the United States in 2017) will gain benefits from the new regulation, including:

- For banks under $10 billion, compliance with a simplified community bank leverage ratio of 8 percent to 10 percent will replace all risk-based capital and leverage ratio requirements for the institution to be considered well capitalized.
- Federal Deposit Insurance Act (FDIA) call reporting requirements will be reduced for depository institutions with assets of less than $5 billion.
- Banks under $10 billion will be exempt from the Volcker Rule restrictions on investments, so long as total trading assets and trading liabilities are five percent or less of total assets.
- The consolidated asset threshold for qualification for a lengthened 18-month examination cycle by prudential regulators is raised from $1 billion to $3 billion for "well-managed, well-capitalized" banks.
- The "small bank holding company" access to debt financing for acquisitions will now apply to banks with $3 billion in assets (changed from $1 billion in assets).

With these and other changes in the new legislation, management and advisors have taken a rosy view of potential acquisitions and strategic combinations. Community banks will have more cost savings from the decrease in regulation and their management teams will have more time and capacity to focus on growing their core business, evaluating potential merger partners, and pursuing strategic initiatives in fintech.

Risk management and compliance remain important

Nonetheless, while enthusiasm and a bullish outlook on the sector can be beneficial for both banks and their customers, bank boards and management must balance exuberance with pragmatism and cannot turn their attention away from maintaining a steadfast compliance program. Banks looking at acquisition growth (whether as target or acquirer) are aware of the regulatory approval required after signing an agreement – a process that includes providing extensive information (regarding each party in the transaction) to bank regulators to receive approval under applicable statutes. When this process is delayed or in the worst case denied, the parties incur reputational damage, economic cost and potential hits to stock value.

Without fully understanding what the new legislation does and, more importantly, what it does not do, banks may be lulled into an over-confidence that could result in missed opportunities. The legislation has done away with many of the onerous regulations that inhibited growth for smaller and mid-size banks. For instance, since the overwhelming number of community banks do not engage in the kind of proprietary trading contemplated in the Volcker Rule, smaller banks either spent significant resources proving a negative or were required to sell off investments at a loss to remain in compliance.

That, however, does not mean that banks are excused from having to undertake the basic blocking and tackling fundamental to any robust compliance program. Risk management is the foundation of that effort. Banks should not view risk management as some disembodied “one-off” that has no correlation to their basic products and services. Like any business, banks need to understand the risks involved with their core businesses in order to thrive and make intelligent strategic decisions. Without thoughtful risk assessment, compliance resources – which are scarce for smaller banks – are wasted pursuing required testing that may have no material correlation to the fundamental risks of the institution. Without an appropriate risk management program and governance structure in place, banks are continually surprised when weaknesses rear their ugly head, usually at the most inconvenient times, such as when they are trying to effect a merger or launch a new business initiative.

Regulators have a role to play, a role that has not been diminished by the passage of this new legislation. While certain regulations have been removed for smaller banks, and regulations are moving toward being more “right-sized” to the institution, the priority remains for banks and financial institutions to invest and believe in robust risk and compliance controls, anti-money laundering controls, and governance structures. Daily decision-making at the senior management and board level should be based on reliable data from their risk and compliance teams, as well as operational areas. Supervisors and operational heads need to be risk managers more than ever before if their organizations are to take advantage of exciting new opportunities. The institutions that take seriously their risk and compliance obligations will pass muster with the regulators who must approve mergers and new business initiatives, and will leave behind their counterparts who have misread the landscape. Risk management and thoughtful corporate governance are tools by which banks will reap the benefits of the competitive landscape.

Things to consider

In sum, community and regional banks that aspire to expand their footprint through mergers or acquisitions should follow the simple guidelines below:

- Ensure that the bank has an enterprise risk management program that determines critical risks for the institution, and how each of the risks is being addressed
- Ensure that there is an experienced team internally and externally that can advise and understands these risks
- Ensure that the compliance management system is based upon a true risk assessment for the institution in order to properly employ resources
- Ensure that business leaders are risk owners and able to identify and mitigate risks in their respective areas
- Ensure there is a repeatable governance structure that informs senior management and the board in daily decision making
- Ensure that appropriate follow up takes place as a result of this effort

Should these very clear rules of the road be followed, this will be an exciting time for smaller banks and financial institutions. The doors are open - banks now need to follow up to push through them.

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How to solve a problem like cryptocurrencies

by Claude Brown

When you have spent the last 10 years ensuring the continued health and stability of the global financial system and are about to hang up your superhero suit (or at least put it in for a dry clean and press), the appearance of a piece of kryptonite-like innovation can be irritating.

As the Financial Stability Board (FSB) prepares to do a mini fist pump, starts to wind down some of its committees, and to shift gear from full-on regulatory change to review and reflective evaluation, cryptocurrencies appear like Banquo's ghost as a reminder that not all potential sources of financial instability have material form.

So, what to do about cryptocurrencies if you are charged with ensuring the stability of the financial system? One approach is to belittle them – literally. You could point out that, next to the behemoth of the conventional financial markets, they are insignificant and therefore no more than a fiscal curiosity, while hoping that their growth won't prove you wrong.

Alternatively, you could scorn them by pointing out that, although their proponents hail them as "the new money," they are not "proper money" like traditional currencies. However, this line of argument masks an uncomfortable truth that, since the demise of the gold standard, all currencies, crypto or otherwise, are in fact "fiat" and therefore rely on a vote of confidence by their users – it's just that the traditional currencies currently have more votes. You could always take a narrow view of your job and decide that your role is solely to maintain the stability of the banking system and you achieve this by the simple act of banning banks from holding cryptocurrencies. If no bank holds a cryptocurrency then no bank will be affected by a cryptocurrency crisis. Of course, this does rather depend on (a) all the other members of the regulators' club adopting the same approach as you and (b) you being right.

The problem is that, even if any or all of these approaches work for central bankers, cryptocurrencies still have the capacity to rain on the FSB's 10th anniversary parade. You may well have made sure that your industrial-scale fiscal warehouse is mouse-proof but that won't necessarily stop the mice eating the contents of the financial larder of the private householder living next door. So, at the same time as the wholesale banking regulators are asserting that their banking system is not under threat from any instability caused by cryptocurrencies, the retail market regulators have to deal with their impact on their markets and retail investors. True, headline losses by cryptocurrency investors, even in significant numbers, or the collapse of a cryptocurrency exchange will not take us back to 2007. But it would have a corrosive effect on the reputation of financial regulators, in an age when unitary regulators are the fashion. It would be a hollow victory if the systemic integrity of the banking system was preserved by regulatory bodies that no longer had the public's confidence.

It would be reasonable to assume that the woes of retail investors, when amplified through the megaphone of the media and public opinion, would be a call to arms for the politicians. Yet there are no signs of their offering regulators an arsenal to protect the investing electorate from the effects of a potential cryptocurrency bubble bursting, or of hardcore lobbying by regulators for extended powers to stop the bubble forming.

Of course, there are those who point to history and the fact that the U.S. securities acts were passed after 1929 and not before, or that the Bank of England was the consequence of the South Sea Bubble and not its precursor.

However, it is more than just the fact that the owl of Minerva flies at dusk; politicians in many countries are in the vanguard of promoting cryptocurrencies or at least economic conditions that are favorable to them. True, China and South Korea have banned them and there are those countries such as Japan and Gibraltar that have deliberately created legislative regimes to attract cryptocurrencies.

That said, they are outnumbered by those countries whose politicians are keen to create regulatory environments that, if not specifically designed for cryptocurrencies, are nurturing of them. In fairness, these initiatives are part of broader plans for the promotion of new technologies of which fintech is just one part. Their reasoning is understandable – stagnating economies, revitalizing regions that have been left behind by globalization, and the desire to be associated with the new, "hip economy". It is also the case that the political sponsors of these initiatives are not so naïve as to conflate cryptocurrencies with their underlying infrastructure; the challenge is to avoid throwing the blockchain baby out with the cryptocurrency bath water.

However, this political endorsement does throw up some curious anomalies as regulators, who have openly expressed their skepticism or active mistrust of these markets, find themselves co-opted into task forces created by their political masters to promote the latest iteration of the white heat of the technological revolution. Another oddity is that at the same time as politicians are advocating regulatory regimes with fewer barriers to innovation, the first movers in cryptocurrencies are giving way to participants calling for a more interventionist regulatory approach to their markets.

Of course, there still those who are philosophically opposed to the very concept of any state-generated involvement in their distributed ledger ecosystem. After all, its self-regulating anarchic character is its principal attraction for them. Nevertheless, there is an increasing number who consider that the time has come when some formal regulation would be beneficial. In part, this comes from a view that regulation gives a mantle of respectability. It also stems from recognition that criminal transactions do the market's image no favors. In this iteration of Thiers' law, regulation is a catalyst to convert bad money into good.

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Hollywood must take the initiative with vendor management

by Don Andrews

Hollywood's major studios are feeling pressure beyond that being applied by digital-streaming upstarts. The astute studios are beginning to understand that they have to create efficiencies in their own processes and avoid unforced errors in their everyday decision-making. Vendor management is an area where unforced errors are common, because the film industry requires the use of so many third-party vendors as a means of doing business.

The financial services industry has had a head start on vendor management because of the imposition of Dodd-Frank and the aftermath of the financial crisis. Regulators were in no mood to negotiate how banks felt about having to impose vendor management standards. Bank ratings are slashed, deals halted, and new business initiatives shelved if financial institutions do not have a handle on the third-party companies they are doing business with.

Hollywood doesn't have any regulators breathing down its neck the way the financial services sector has. And this is exactly why the industry needs to initiate vendor and risk management processes and protocols on its own, even more than the banks do. Regulators are interested and charged with the responsibility of preserving the assets of shareholders and keeping banks afloat. In the film production business, there is no guardian angel presiding to protect a Hollywood studio from failure at a micro-level (for example, a particular film or project) or the macro-level of the studio itself. If a studio wants to stay alive and competitive, the onus for doing so rests exclusively on its leadership. And without an intelligent approach to vendor risk and enterprise risk management altogether, there will continue to be painful lessons to be learned, and for some studios, the impact of these lessons could lead to catastrophic results.

In Hollywood, risk comes in all shapes and sizes. For example, in just one on-location shoot there are local employment, wage and hour regulations, insurance issues, Occupational Safety and Health Act (OSHA) issues, electrical and fire safety, weapons and stunt concerns, personnel headaches, location safety, and even the threat of kidnapping. Oversight of all of these facets of a production, combined with third parties that are often responsible for them, is something that takes preparation, diligence, and acumen on the level of any operational chief at a leading global bank. More importantly, it takes superlative support and skill from the legal team even before anyone sets foot on the set. Lawyers must not only understand actual operations when negotiating third party vendor contracts, but must also understand the ramifications of any vendor's failure to perform, and its impact on the production, as well as the effect of the very provisions that are included and/or omitted from a vendor agreement. They must ensure that the contracts negotiated are not standard, cut-and-paste contracts, which are anathema to this type of scenario. Lawyers simply cannot treat provisions in vendor agreements as "boilerplate." Instead, they must conduct an in-depth legal and practical analysis of each provision of these agreements. Review of vendor agreements must be detailed and thorough, and should be treated with the same level of importance as finalizing a budget for any material project. In other words, attorneys that do not work in sync with operations teams and directors and focus solely on financial considerations may be missing the point. The pace of change in the industry is indicating that lawyers who just want to practice law - either in the financial services world or in the entertainment business - are going to be of limited utility. The legal department at every studio (and their outside counsel) must be "wrapped" around overseeing all of the third-party providers and the agreements that govern the services they are (or are not) to provide.

Vendor issues are not unique to shoot locations or the back lot. Back at the office things are just as dicey. Data and cyber security are almost always the province of a third-party vendor, and diligence and oversight are critical. Simply negotiating standard contracts that do not allow anything more than "kicking the tires" in terms of oversight will not prevent the kind of cyber breaches that make headlines and result in significant liability. "Independent contractors" are everywhere at major studios, as well as interns, who conduct substantive duties and are largely unsupervised.

Vendor contracts are often negotiated in silos between separate legal teams that do not communicate as often as they should. Additionally, the applicable legal teams tend to lack centralized databases, or even an understanding of what the core obligations of each vendor agreement are, and a regular schedule of what responsibilities must be carried out. While technology exists to aid in this sort of function, it is not often utilized.

The basic issues of what vendors are actually doing, how are they doing it, who is watching them, and how their performance will be evaluated needs to be addressed with more efficiency and clarity. Moreover, legal teams need to be diligent about limiting what vendors “could be permitted to do” under their agreements, as this ambiguous scope of work often extends well beyond what is intended by the studio.

For entertainment firms and studios, there is no parochial administrator presiding over the industry ensuring that they are taking actions to create greater efficiencies, reduce costs, identify and address risks, and enhance revenue for their shareholders. There is no great governmental body that is debating or passing legislation to ensure there are tighter controls, or taking actions that guarantee the industry’s survival. They are on their own in a highly competitive, greatly transformed and challenging environment. Therefore, small actions that save millions or even billions in revenue, avoid expensive and embarrassing litigation, and preserve reputation and shareholder value are going to be what creates a competitive advantage for one studio vs. another. Decision-making that is rooted in data and science is ultimately going to be what produces winners in this highly competitive industry. There are many improvements that can be made in this area, and consequently many opportunities for Hollywood and the legal industry. However, taking advantage of those opportunities begins with a basic analysis of the contractual obligations between a studio and the vendors that it retains, and implementation of better, consistent risk-controlling practices around the very nature of contracting with third parties.

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The dawn of crypto-asset regulation

by Howard Womersley Smith

In September 2018, the House of Commons Treasury Committee issued a report on its inquiry into the regulation of crypto-assets. The inquiry examined, among other subjects, the role of digital currencies in the UK, the impact of distributed ledger (blockchain) technology, and how these should be regulated. The report recommends improvements to consumer and anti-money laundering protections (AML) when dealing in crypto-assets. The improvement will be achieved in part by extending the Financial Services and Markets Act (Regulated Activities) Order 2000 (RAO) to crypto-assets and associated activities.

"Crypto-assets", not "cryptocurrencies"

As a point of protocol, the report employs the term "crypto-assets" instead of the more commonly used "cryptocurrencies" on the basis that they do not demonstrate the functions of a conventional currency, such as a medium of exchange or store of value.

Crypto-asset concerns

The report also identifies a number of inherent problems with crypto-assets. It identifies the inherent risks to investments due to volatile crypto-asset markets, when compared to conventional fiat currencies. Related to this is the vulnerability of crypto-assets to market manipulation, given that the exchanges currently sit outside of market abuse regulations.

There is also increased scope for hacking, which would inevitably lead to the theft of the crypto-assets. The Committee suggests that such risks were exacerbated by the lack of a deposit insurance scheme (such as the UK Financial Services Compensation Scheme) to compensate investors in the event of a hack. Investors themselves have also caused losses, particularly where they have lost their passwords and have, therefore, been barred from accessing the exchange.

The Committee believes that investors and consumers are further let down by the irresponsible nature of promoters, whose advertisements are often misleading (and in some cases initial coin offerings (ICOs) have used celebrities to advertise the offering). The Financial Conduct Authority (FCA) is powerless to mitigate this, as crypto-assets, conveniently (!) fall outside of its remit.

Crypto-asset platforms were widely considered to provide opportunities for money laundering and other criminal enterprises because exchanges allow anonymous access and are not governed by the AML regulation.

Each of the above concerns is underpinned by the absence of a secure regulatory environment that affords investors and consumers sufficient safeguards.

Limitations of blockchain

The Committee discussed the use and benefits of blockchain technology as a means of storing data that crypto-assets use to record and verify transactions. The Bank of England and the FCA, together with industry experts, identified the efficiencies and features that blockchain will bring to transaction processing. The Chief Operating Officer of Everledger, Chris Taylor, in particular, spoke of the advantages that blockchain's immutable record-keeping bring to records of transfers, whether they concern the transfer of assets or of money.

That said, the Committee also heard about the limitations of crypto-assets and blockchain, including from the Bank of England, which argued that neither function well as a means of payment because of capacity constraints, citing the 30 million electronic payments per day that are made via its Bacs and Faster Payments systems compared to bitcoin's global peak of around 0.6 million transactions per day. Capacity constraints lead to higher costs as users must pay Uber-style surge fees to put their transactions at the front of a payments queue. These fees peaked in December 2017 at US $60 per bitcoin transaction.

From an environmental perspective, blockchain transactions also require a large amount of computer power and therefore energy, which itself will lead to higher transaction costs.

The report explains that during the inquiry the Committee heard evidence that blockchain technology is currently ill-suited to processing the transactions required for mass-market payment systems. Although it did recognize the utility of blockchain technology, especially in financial services and supply chain management, the Committee concluded that it had not been presented with any evidence that suggested blockchain was currently operationally reliable, and so would not promote it for blockchain's own sake.

The beginning of crypto-asset regulation?

The Committee has clearly recognized the need to regulate crypto-assets. Extending the RAO to cover crypto-assets and associated activities was considered to be the quickest method to achieve this, which would enable the FCA to protect consumers in respect of their dealings in crypto-assets. The EU's fifth Anti-Money Laundering Directive will bring crypto-assets under the umbrella of AML requirements when it is eventually implemented.

Comment

The rapidly developing tech industry will want to pay close attention to this space. However, with Brexit negotiations consuming the majority of the government's time, there is no clear timeline as to when it will consider the Committee's proposal to implement new legislation specifically regulating crypto-assets. However, the UK government's consultation period is expected to run to the end of 2019, delaying any concrete progress. It is therefore unlikely that we can expect the much-needed measures outlined in the report to come into effect anytime soon.

The inquiry has overlapped with the European Securities and Markets Association (ESMA) review into the risks ICOs and crypto-assets present to investors and to financial stability, while recognizing that ICOs and crypto-assets also provide innovation to the financial services sector. The review culminated in a report which recommends that ESMA writes to the EU Commission asking it to consider adding crypto-asset tokens to the Markets in Financial Instruments Directive (MIFID) II list of financial instruments and transferable securities.

If crypto-asset tokens are added to this list, secondary markets in tokens will qualify as MIFID, multilateral trading facilities (MTFs) or organized trading facilities (OTFs); any investment offering in tokens would be subject to the EU Prospectus Regulation and MIFID II; and those advising on them would also be subject to MIFID II.

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Crisis response: Practical issues for privilege and work product

by Gerard Stegmaier

Legal responsibilities in data security crises

As soon as a data breach happens, a primary consideration of in-house counsel - and the outside counsel they engage - should be the careful examination of what happened so that the attorneys can help the company respond effectively. Part of this duty arguably includes safeguarding the client's interests and property[1] and preserving the privilege of communications, work product, and reports involved in the investigative process. This article examines the bases of attorney-client privilege and attorney work product doctrine and seeks to provide practical tools that can help attorneys and incident response teams to be more effective.

A key part of effective incident response is a well-functioning and well-led interdisciplinary team. Outside advisors, lawyers, and other professionals increasingly are critical members of these teams. Third-party cybersecurity forensics firms have proven themselves invaluable partners to many companies that have experienced significant data incidents. By working with the company's information technology and security teams, these vendors can get to the root of the problem and help the company improve and move forward. Other third parties include crisis communications firms, breach notification and remediation support services, auditors, insurers, insurance brokers. A critical issue, however, is the extent to which the work of these experts and their findings are protected from discovery in future civil litigation and investigations brought by affected individuals, shareholders, banks, and others.

The case law around these specific scenarios is still developing, though guidelines are materializing. When preparing for the inevitable breach, it makes sense for counsel to have plans in place to address fast-moving questions, or to have outside counsel that can do so on hand.

Protecting privilege and client confidentiality in connection with internal investigations

Courts have long recognized the need, in certain circumstances, to protect from discovery the communications between a client and their attorney, as well as the work product prepared by an entity in anticipation of litigation. The extent to which those protections apply in breach scenarios, and in similar cases in which third-party vendors provide analysis and reports in response to incidents, is still being developed in the courts. However, there are helpful guideposts that can assist counsel in understanding these parameters.

The legal basis for the privilege

The attorney-client privilege concept arises from common law and the Federal Rules of Evidence (Rule 502)[2]. To invoke the privilege, a party to litigation must demonstrate that there was:

1. communication between client and counsel,
2. which was intended to be and was kept confidential, and
3. was made for the purpose of obtaining legal advice[3].

The purpose of the attorney-client privilege, as articulated in Upjohn v. United States and other foundational cases, "is to encourage full and frank communications between attorneys and their clients and thereby promote a broader public interest in the observance of the law and the administration of justice."[4]

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[1] *See, generally, In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 967-71 (Del. Ch. 1996) (a fiduciary duty exists to help safeguard the company's property and avoid waste); Model Rules of Professional Conduct.
[2] While the privilege has been developed in case law, Federal Rule of Evidence 502 articulates how waivers of the privilege may occur in federal court practice.
[3] *See*, e.g., *Upjohn v. United States*, 449 U.S. 383 (1981).
[4] Id. at 389.

The complementary attorney work product doctrine developed through case law and is codified in Federal Rule of Civil Procedure 26(b)(3) and in Federal Rule of Evidence 520.[5] Pursuant to the doctrine, a party ordinarily may not obtain discovery of documents prepared in anticipation of litigation by or for another party or its representative. This protection can be overcome if the party seeking discovery can demonstrate that it (a) has substantial need of the materials in the preparation of its case and (b) the party is unable, without undue hardship, to obtain the materials or their substantial equivalent by other means.[6]

Work product may be discoverable depending on the type of information it is.

In the Upjohn case, the U.S. Supreme Court affirmed that the attorney-client privilege applies to corporations as well, and protects communications between company attorneys and non-management employees, stating:

> in light of the vast and complicated array of regulatory legislation confronting the modern corporation, corporations, unlike most individuals, constantly go to lawyers to find out how to obey the law.[7]

In particular, the Court created the "Upjohn warning," the notice an attorney (in-house or outside counsel) provides a company employee to inform them that the attorney represents only the company and not the employee individually.

Courts outline the parameters for third-party vendor and breach scenarios

Of particular interest to companies is when and how reports created by forensic firms investigating data breaches at the direction of counsel are protected from discovery in civil class action lawsuits. As there is no statutory protection, defendants rely on the attorney-client privilege and the work-product doctrine.

It is well established that the work product doctrine protects from discovery documents and tangible things that are prepared in anticipation of litigation by a party's attorney, or for that party's attorney by another representative.[8] From an attorney-client privilege perspective, the Second Circuit case United States v. Kovel is widely cited for the proposition that the attorney-client privilege extends to communications made by a non-attorney individual with specialized knowledge retained by a law firm.[9] "What is vital to the privilege is that the communication be made in confidence for the purpose of obtaining legal advice from the lawyer," the court stated in reference to this case concerning a third-party accountant who provided guidance.[10]

Specifically in the data breach context, the 2014 Tennessee District Court case Genesco, Inc. v. Visa U.S.A., Inc. is cited for establishing many of the parameters for the privilege when working with outside forensics firms.[11] In that case, a report by the cybersecurity vendor Stroz Friedberg, who had been engaged by counsel, was prepared in contemplation of litigation. The court held that attorneys' factual investigations fall under the protection of the attorney-client privilege, which extended to Stroz Friedberg. In addition, the work-product doctrine did not allow discovery of mental impressions, conclusions, opinions, or legal theories.

As counsel navigates the crisis response, it is important to know how waiver of the privilege may occur. The Experian Data Breach Litigation case provides an example of when a plaintiff claimed that the defendant had waived the privilege both by having an outside forensics firm create a report on the incident and by sharing the report with a co-defendant pursuant to a joint defense agreement.[12] The Central District of California rejected those arguments, finding that the report by outside firm Mandiant was protected by the work-product doctrine. In particular, Mandiant had largely communicated with Experian's counsel and had not provided the full report to the company's internal incident response team. Additionally, plaintiffs could not argue that the report was their only method of obtaining the information since Mandiant never accessed Experian's live servers, using only images to create the report - theoretically, the plaintiffs could do the same. Finally, the court held that sharing the report with the co-defendant was not a waiver, either.

However, other defendants hiring outside consultants have not been so fortunate, or have overreached by using the supposedly privileged conclusions too aggressively. The recent case of Leibovic v. United Shore Financial Services shows the Sixth Circuit's skepticism about preservation of the privilege when conclusions of the vendor's analysis have

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[5] *See*, e.g., *Hickman v. Taylor*, 329 U.S. 495 (1947).
[6] *See* Fed. R. Civ. Proc. 26(b)(3)(A).
[7] *Id*. at 392.
[8] *See Hickman*, supra note 4.
[9] *United States v. Kovel*, 296 F.2d 918 (2d Cir. 1961):
[10] *Id*. at 922.
[11] *Genesco, Inc. v. Visa U.S.A*., Inc. 302 F.R.D. 168 (M.D. Tenn. 2014).
[12] *In re Experian Data Breach Litigation*, No. 15-cv-1592, *order issued* (C.D. Cal. May 18, 2017).

been partially disclosed.[13] Defendant United Shore described consultant Navigant's investigative conclusions in response to a discovery request. According to the court, this disclosure "went beyond providing factual information" and "exceeded the scope" of the interrogatory.[14]

While not in the data breach context, Doe v. Baylor Univ. in the Western District of Texas and Advanced Micro Devices, Inc. v. Intel in Delaware District Court also show how an outside consultant's reports may be discoverable if too much is publicly revealed. In Doe v. Baylor Univ., the defendant released a 13-page summary of a law firm's report, including "Findings of Fact" summarizing investigation and conclusions, along with a 10-page list of recommendations.[15] The court found that "substantial detail" was disclosed about what Baylor and its employees told the law firm and what advice Baylor received in return, thereby waiving the entire privilege protecting the report.[16] In the Advanced Micro Devices (AMD) case, the defendant similarly issued a press release with a detailed summary of "Key Study Findings."[17] By voluntarily disclosing the existence of the report, the name of the consultant who prepared it, its key findings, and its methodology, AMD had not fostered the policies underlying the work product doctrine and was not able to benefit from its protections, the court held.[18]

Best practices

When responding to data incidents and other situations where outside vendors may be needed to assist with the provision of legal advice or there may be pressure to share the information, the following questions may help companies to avoid losing protections shielding analysis and work product:

- Can you limit identification of the third party as the author of the report and attribute statements directly to the third party?
- Can you avoid "findings" or "conclusions" and instead limit to "facts" and limit detail?
- Can you avoid using the report offensively?
- Can you put together a non-privileged factual timeline that may be given to your adversary in place of a larger report?
- Are there other sources and ways for opponents to receive or access the information without relying on the professional judgment of your experts?
- Is there a common interest that may warrant a joint-defense agreement?[19]

As this nascent field, the parameters of privilege will become more clearly defined in the future. At this point, it is clear that care should be taken in communications to not reveal too much and to craft deliverables strategically with these concerns in mind.

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[13] *Leibovic v. United Shore Financial Services, LLC*, No. 17-2290 (6th Cir. Jan. 3, 2018).
[14] *Id.*
[15] *Doe v. Baylor Univ*., 240 F. Supp. 3d 646 (W.D. Tex. Mar. 7, 2017).
[16] *Id.*
[17] *Advanced Micro Devices, Inc. v. Intel Corp*., 2008 U.S. Dist. LEXIS 125410 (D. Del. Mar. 6, 2008).
[18] *See id.*
[19] *See, e.g., In re Bevill, Bresler & Schulman Asset Mgmt. Corp*., 805 F.2d 120, 126 (3d Cir. 1986) (requiring the party asserting the attorney-client privilege in a common interest arrangement to show that the communication was made in the court of a joint defense or common enterprise, was designed to further the shared interests, that it is otherwise privileged, and that the privilege has not been waived).

Staying in front of FINRA claims by seniors

by John O. Lukanski and David G. Murphy

The number of arbitrations filed annually with the Financial Industry Regulatory Authority (FINRA) by customers against their broker-dealers has, over the last decade, followed a downward trend. Numerous factors have contributed to this, the most significant of which is the appreciation and sustained performance of the stock market – there simply is not a lot to complain about when things are going well and portfolios are up in value. Despite this trend, firms cannot be complacent and instead should seek to identify and address prevailing risks. One such potential risk is the increasing population of seniors (those 65 years and older) and the corresponding increase in the number of senior-related claims asserted in FINRA arbitration. It has been reported that every day, a staggering 10,000 people turn 65 years old in the United States. And based upon statistics published by FINRA (that reflect data as of September 2018), claims broadly defined as "elder abuse" represent the category of claims with the largest annual percentage increase. Senior customers are vulnerable and, based upon our experience handling many internal reviews and FINRA and state regulatory matters, seniors are more likely than any group to be taken advantage by others.

When the stock market finally deflates on a sustained basis, resulting in real losses to investors, seniors will be a significant claimant population. Given their demographics, seniors will also likely suffer, on average, the largest losses. And in addition to their "elder abuse" claims, they will also be armed with claims based upon new initiatives aimed at enhancing the standard of care broker-dealers owe their customers, for example the SEC's Regulation Best Interest standard is already in the works and some states have sought to adopt a uniform fiduciary standard, mostly recently the State of New Jersey.

Given all this, firms must take steps to address this pending risk. We suggest at least the following:

Review supervision relating to senior accounts

Is your supervisory system focused on identifying the ways historically seniors have been abused by their registered representatives:

- Can you detect excessive trading and churning in commission-based accounts?
- Can you detect inactivity in fee-based accounts?
- Do managers call senior customers periodically to confirm regular contact with their registered representatives, including for trade authorizations, and to confirm that no inappropriate relationships with their registered representatives exist outside the brokerage relationship (loans, selling away, outside business interests or investments)?
- Can your systems detect common destinations for wire transfers made from senior accounts?
- Can your systems detect short-term trading in exchange traded funds (ETFs), unit investment trusts (UITs), and closed-end fund shares?

Review other processes, including complaint resolution

- Are your senior customers taking on too much investment risk in order to chase yield?
- Are your registered representatives experienced enough to handle a market downturn? Because of the sustained market appreciation there exists a good-sized registered representative population that has never experienced a sustained down market.
- What effort does your firm make to collect and maintain the names of trusted advisers for senior accounts consistent with FINRA Rule 4512?
- What steps does your firm take to freeze senior accounts under FINRA Rule 2165 when abuse is suspected?
- Are the personnel handling complaint resolution sensitive to (a) the generational preferences and habits of seniors, and (b) the various estate planning goals that seniors sometimes attempt to meet with their investment accounts?

Review your proposed defense team

Having a legal team that fits your matter is always important, but in the case of defending claims made by seniors, is your counsel sensitive to issues that may arise? For example, if annuities or debt securities are involved, does your counsel understand how they work? Also, does your team have experience with the field of gerontology and specifically how that field relates to investing and life planning?

Given the risks of FINRA-related claims by seniors, it would be prudent for firms to take proactive steps now to address the risks, such as the above listed items.

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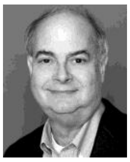

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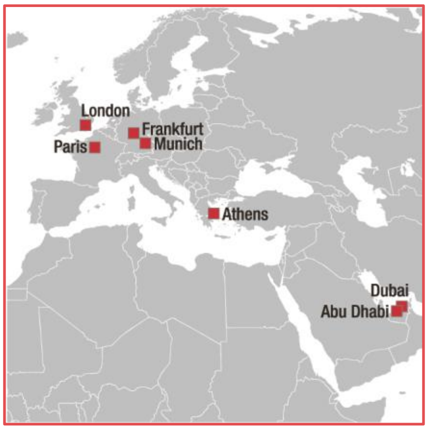

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