Diversity In The Legal Profession: The More Things Change, The More They Stay The Same – Until They Don't

The stated desire to address the diversity imbalance may give way to real change if peoples' wallets depend on it.

French writer Alphonse Karr famously wrote "plus ça change, plus c'est la même chose" – the more things change, the more they stay the same. This often seems true in the legal industry, especially when it comes to chronic challenges and the shared desire to bring about positive change.

David recently attended HBR Consulting's Legal Lab, an annual gathering of select industry leaders brought together by HBR (David serves on HBR's Advisory Board). This year's Legal Lab included individuals holding a diverse set of roles at law firms, law departments and technology companies, and addressed four key areas influencing the industry: law departments, large law firms, talent management and staffing, and technology. As expected, numerous challenges and opportunities were discussed, and the discourse was transparent and refreshing. Notably, one issue surfaced in every discussion, and throughout the event: diversity and inclusion. Nearly every participant discussed the industry's need to create more diverse and inclusive workplaces, at firms and companies, and the benefits that would accompany such a change. Those same leaders agreed that despite decades of effort, no firm or company had cracked the code toward moving the needle.

Many articles have discussed the disappointing statistics of legal industry diversity. For an overview, see the following, among many others:

- Americans Rank Law Firms Dead Last In Commitment To Diversity
- Minorities In The Legal Profession Have Barely Increased Since 2000

In summary, despite two decades of extensive efforts, gender and other diversity at the partner and GC level is essentially unchanged. Female equity partner ranks in Biglaw remains under 20%, and minority representation in the industry has grown by less than one percentage point since 2000. And women partners and GCs make demonstrably less than their male counterparts, among other troublesome diversity-related statistics. Why?

Venture capitalists often say that they'll invest only in products that are "painkillers, not vitamins." In other words, capital backs only ideas solving acute problems, and products that are must-haves, rather than nice-to-haves. That leads us to wonder — if lack of industry diversity, especially at senior levels, is widely recognized as an acute problem, why is no one developing a painkiller for it? Perhaps one answer is that the industry isn't feeling real pain — yet. Sure, having diversity would be better (a vitamin), but if large law firms and legal departments were really feeling pain, they'd demand products to alleviate that pain, entrepreneurs would build those products, and private capital, or clients themselves, would fund them.

Just after Legal Lab, we called our friend Caren Ulrich Stacy, founder and CEO of the Diversity Lab. A former Biglaw talent executive and now industry mover and shaker, Caren has dedicated her professional life to improving gender equality. We asked why funding wasn't more abundant, and why existing products (and myriad initiatives) weren't making an impact. Her answer surprised us. Many law firms, she said, view diversity initiatives much like professional development and training and less like core practice tools. They want them, but don't perceive them as important as practice tools or products that help grow revenue or profit — thus budgets and funding for diversity products and initiatives are relatively low compared to revenue-generating tools and initiatives, and often cut when expenses need to be reduced. For these firms, diversity is a vitamin, not a painkiller. Consequently, those trying to solve the diversity challenge find themselves competing against other nice-to-have products, fighting for limited and at-risk budget dollars. What's baffling is that this flies in the face of nearly universal recognition by firms and law departments that lack of diversity is a real pain point, and that increased diversity and inclusion leads to faster growth and larger profits – a view borne out by most research on the subject.

On closer reflection, the situation may be better than it appears. When we started Pangea3 in 2004, law firms and GCs alike told us that cost and commodity work were real issues, and they were seeking a solution. Like Kevin Costner's character, Ray, in *Field of Dreams*, we heard "If you build it, they will come." Simply put, outsourcing legal work seemed intuitive and in demand. We, along with others, built companies to serve that need, raising many millions of dollars in private capital. As it turned out, it took years before we or any other LPO gained real traction, despite building serious, high-quality operations. Only when the financial markets collapsed did the need for cost containment and reduction become severe enough to make legal outsourcing truly necessary. When that happened, there were enough companies with scale to satisfy the need, and legal outsourcing went mainstream. In short, the legal market insisted on outsourcing solutions that were fully scaled, and used them when the markets changed adversely. We believe the same could happen with diversity in the legal marketplace.

Using that experience, it's entirely possible that solving the diversity challenge will take the same effort – a combination of many companies building scaled solutions, combined with an event that dramatically increases demand for those solutions. And it's possible that we are about to see such demand.

The new Am Law 100 results just came out, and they're telling. Revenue per lawyer is up, but the seas are choppy, according to ALM, publisher of the rankings.

First, revenue stratification between the 50 highest grossing firms and the next 50 firms is real and continues to grow. According to Big Law Business, "Law firms in the top half of the Am

Law 100 experienced a 3.6 percent increase in revenue per lawyer, but the bottom half lost ground, and revenue per lawyer actually declined by 1.3 percent." Second 50 firms are experiencing revenue declines, making it even harder for those firms to continue increase their profit per partner (PPP), which is how partners take home more this year than last.

Second, revenue volatility is increasing. According to the American Lawyer, "In 2016, 44 percent of firms who report financial data to the bank [Citi] had a reversal in their rate of PPP growth from the year prior. Some 25 percent saw PPP rise in 2015 and fall in 2016; 19 percent saw the opposite occur. In pre-recession times, only about 25 percent of firms on average saw a change in direction in their PPP from year-to-year." Eventually, it will become impossible for those firms to increase PPP and manage that volatility without some change, and they may — at long last — invest seriously in diversity — as a tool to grow revenue and profit. Note how companies like Facebook, HP, and MetLife are now demanding diversity from their outside counsel.

Put simply, the stated desire to address the diversity imbalance may give way to real change if peoples' wallets depend on it. If that happens, there is a real opportunity for companies focused on diversity (software, programming, coaching, etc.) to service those law firms, provided those companies attain the scale and credibility that law firms and their clients will demand.

We are not in the habit of making predictions, so all this is speculative. But if we're right, companies investing in diversity solutions now, and building for scale, will be positioned for rapid growth when those solutions become a pain-killer, and not merely a vitamin. Here's hoping that happens, and that the markets create the long-sought-after changes everyone seems to want.

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Companies Use Diversity Data to Hold Law Firms Accountable

April 3, 2017

Corporate diversity programs have come a long way since 1999, when Charles Morgan, then-GC of BellSouth Corp., led a group of his peers to sign a statement promising to consider law firm diversity when hiring their outside counsel. Today, legal departments aren't just asking firms to field diverse groups of attorneys — they're asking those firms to put attorneys in leadership positions, and they're asking for data to back it up.

On Saturday, Facebook began requiring outside counsel to field teams with at least 33 percent women and ethnic minorities and show they are actively creating "clear and measurable leadership opportunities for women and minorities" in the company's legal matters, the New York Times **reported**.

The changes have coincided with corporate demands on in-house legal teams to track their spending with greater precision, indicating that the use of data to hold law firms accountable for diversity initiatives will only increase.

Until recently, corporate legal departments have been hesitant to put specific metrics around diversity expectations, despite the fact that they're already using metrics to track the business aspects of law firm performance, according to HP Chief Legal Officer and General Counsel Kim Rivera. "The concept is not alien," she said. The only thing changing is that diversity and inclusion are now being measured alongside project budgets, open litigation matters, and staff productivity.

Facebook's new policy comes on the heels of HP's **announcement in February** that it would start withholding fees from law firms that don't meet diversity requirements. As part of its new policy, the technology giant will withhold up to 10 percent of invoiced amounts from law firms that don't field at least one "diverse relationship partner" or at least one woman and one "racially/ethnically diverse" attorney each performing at least 10 percent of the billable hours on HP matters. Rivera said she has been contacted by in-house counsel from several other Fortune 500 companies who are interested in implementing similar programs.

The 'Front-End' of Diversity

According to Robert Grey, president of the Leadership Council on Legal Diversity, programs like HP's are the "front-end of what is becoming a much more analytical, data-driven approach to understanding how to develop a more diverse talent pool." Corporations now have far more data analytics tools at their disposal to track the work and leadership opportunities given to otherwise under-represented outside counsel.

Alan Bryan, senior associate general counsel at Walmart, says his work in legal operations — a role designated to managing the company's legal matters — has transferred seamlessly to the work of holding the company's outside counsel accountable to diversity targets.

"Legal Ops is created to address spend, and you do that with the data you have in your system," said Bryan. "But you can also address diversity at the same time and make it just as imperative as the spend, with the same tools."

Instead of relying solely on law firms for their reporting of diversity statistics, in-house law departments can now see which attorneys are doing what kind of work. For example, a GC can easily check if a young woman of color is staffed for short amounts of time on document review, or if she's taking on a leadership role and logging significant hours on more complicated work. Walmart monitors diversity data within its legal matter management system, which can track race, gender, and ethnicity or hours worked per attorney, according to Bryan.

Measuring the Data

Though a representative for Walmart was unable to provide any data on firms that have adjusted their ranks based on the company's program, Kim Koopersmith said she wouldn't have become chair of Akin Gump without the retail giant's intense focus on recruiting women and people of color relationship partners. Koopersmith was the company's relationship partner from 2009 to 2012, at which point she was elected chair. "There is a gravitas that comes from having significant client relationships," she told Big Law Business.

Kim Koopersmith speaks about diversity and inclusion at the 2015 Big Law Business D&I Summit.

Indeed, one of the most powerful tools corporations have in the effort to increase law firm diversity is their ability to demand who gets leadership roles on their legal matters.

Microsoft, which has had a law firm diversity program since 2008, announced in 2015 that it would pay an annual bonus of up to 2 percent to firms that meet specific diversity targets in their leadership ranks. Last year, Microsoft deputy general counsel David Howard said the company's law firms had increased "diverse representation" in their management committees from 31.2 percent to 34.4 percent. In particular, he singled out the progress made by K&L Gates, Orrick and Perkins Coie. "Each firm shared with us that the newly refocused [diversity program] provided a real push to expand and refine their efforts," he **wrote in a blog post**.

The approximately 50 firms on AT&T’s so-called Preferred Counsel Program, which receive the bulk of the company’s work, are held to high diversity standards as tracked by an annual law firm survey, according to David McAtee, the company’s senior executive vice president and general counsel. “We do hold back some compensation for our outside firms, and the survey — including the diversity element of the survey — is a factor in whether the firms ultimately receive those funds,” he said. McAtee declined to elaborate specifically on the holdback policy.

At NBCUniversal, GC Kimberley Harris takes a similar approach. She said her team generates diversity statistics on pending matters on a quarterly basis, not only to hold law firms accountable but to hold her senior in-house lawyers accountable as well. Harris said NBCUniversal hasn’t talked about withholding fees or providing bonuses based on that data, but she hasn’t ruled it out.

A representative for NBC declined to provide any concrete statistics about the company’s outside counsel diversity, but Harris said she plans to use the data to prevent young women and attorneys of color from leaving law firms before they ever have a chance to move up the ranks. “Law firms usually do a good job of bringing in diverse classes,” she said. “But when you get to mid-level and people who could be considered for partner, there are very few people left.” Harris plans to work with law firms to identify fourth, fifth and sixth year associates, put them on NBC matters, and develop the kinds of relationships that will put them in a strong position to become partner.

MetLife, similarly, **is requesting** law firms develop promotion and retention plans to foster diversity, but isn’t requiring specific data or benchmarks.

Skepticism Among Legal Scholars

While there is some indication this new generation of corporate diversity programs might have a greater impact than past pledges, law professors who have studied the history of corporate diversity initiatives remain skeptical.

Stacy Hawkins, who teaches diversity courses at Rutgers Law School, said many such in-house programs have existed over the past ten to fifteen years, and yet law firms have only achieved marginal gains in expanding their rosters and leadership positions beyond white men. “I’m not sure how much these efforts standing alone have generated the kinds of results we want to see more broadly in the legal profession,” Hawkins said.

Deborah Rhode, a law professor at Stanford University, said one problem in-house programs have historically encountered is a lack of enforcement. In a 2015 survey of diversity initiatives at Fortune 100 companies, Rhode found one managing partner out of 23 who reported losing business over a failure to meet a client’s diversity demands. Walmart cut a few firms loose when it began its diversity program in 2005, but hasn’t since then.

Paul Weiss partner Claudine Meredith-Goujon told Big Law Business that only a minority of the firm’s clients audit its diversity statistics after it is engaged. Just a few clients, including HP, have truly robust auditing programs. Corporate diversity programs are "most effective when they demand specific accountability," including clear benchmarking and regular feedback, she said.

Risks of Tokenism

Without a commitment to developing junior talent, firms also run the risk of tokenism, according to Vernā Myers, a diversity and inclusion consultant who studies unconscious bias. "You can't just put people in places because they have a certain demographic identity," said Myers. "You have to do all the stuff that is required to make those people ready for those opportunities." Hawkins said she has heard from Big Law lawyers whose firms staffed them on projects just to satisfy client diversity demands.

The general counsel who spoke with Big Law Business said they are aware of the risk of tokenism and take it seriously. These days, large companies are aware that younger attorneys are only benefiting from diversity programs if they are given real opportunities for advancement, they said.

Kim Rivera said she plans to weed out tokenism in HP's new initiative.

"If you have a tokenistic approach, you will have that problem but you won't have it with us, because we'll throw you off the project," she said. "If you don't have diverse teams that are up to the task and engaged and excited about doing the work, we're going to know that."

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The regulatory landscape for insurance companies has undergone significant change since the global financial crisis of 2007–2008. In the US, the individual states have begun implementing various regulatory and legislative changes that will continue to fundamentally affect the operations of large international insurance groups. At the US federal level, the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010 (Dodd-Frank Act) introduced a new era of federal regulation of certain areas of insurance in the US, although the future of many aspects of the Dodd-Frank Act remains uncertain under the new Trump administration and the Republican-controlled Congress. The prudential regulation of insurance and reinsurance companies across the EU is undergoing significant change under the Solvency II Directive, which came into effect on 1 January 2016 and affects both European and non-European insurance groups with operations in the EU. It remains to be seen how the UK's exit from the European Union (Brexit) will affect the UK's insurance industry and regulatory environment. In addition, standards and policy measures under development internationally by the Financial Stability Board (FSB) and the International Association of Insurance Supervisors (IAIS), once finalised and implemented, are expected to have significant implications on the regulatory framework applied to international insurance groups. As the legal environment is likely to continue to be in a state of flux for several years to come, it will be critical for practitioners who provide corporate and transactional advice to stay abreast of the latest developments with respect to the US and international insurance regulatory schemes.

Significant developments at the US state level

Historically, the insurance industry in the US has been regulated almost exclusively by the individual states. Every state has a comprehensive body of statutes, regulations, accounting principles and actuarial guidelines that govern virtually every aspect of an insurance company's operations, including licensing, capital and reserve adequacy, permitted investments, transactions with affiliated companies and reinsurance. At its core, the insurance regulatory framework in the US is designed to protect insurers and their policyholders from risk in other parts of the insurer's holding company group by subjecting individual insurers to stand-alone capital requirements based on statutory accounting principles, and imposing significant capital and asset mobility constraints and other regulatory protections. These laws are generally aimed at insulating state-regulated insurers from contagion by affiliates, whether they are domiciled in the US or in foreign jurisdictions.

Beginning in 2008, US insurance regulators, through the National Association of Insurance Commissioners (NAIC), began reviewing lessons learned from the financial crisis and, specifically, studied the case of American International Group (AIG) and the potential impact of non-insurance operations on insurance companies in the same group. At the heart of the lessons learned from the 2007–2008 global financial crisis was the need for insurance regulators to be able to assess the enterprise risk within a holding company system, both nationally and internationally, and its potential impact on insurers within that group.

US states have made significant progress in the past few years in adopting the latest revisions to the NAIC model insurance holding company act, which provides state insurance regulators with new group-wide supervisory tools, including a new enterprise risk report that insurance holding companies will be required to submit at least annually. The enterprise risk report, to be filed with the lead state commissioner of the holding company system, must identify the material risks within the holding company system that could pose enterprise risk. Another new group solvency initiative being implemented at the individual US state level is the own risk and solvency assessment (ORSA), which requires large and medium-sized US insurance groups to conduct at least annually an internal assessment of the material and relevant risks associated with the insurer's or insurance group's current business plan, and the sufficiency of capital resources to support those risks. In addition, many states have adopted legislation authorising the establishment of supervisory colleges. A supervisory college is a convention comprising the principal insurance regulators of a specific insurance group that meets periodically to facilitate cooperation and exchange of information on a group-wide basis among regulators, as a complement to the supervision of individual entities within a group. Requirements to prepare and submit an ORSA and establish supervisory colleges have also been developed under Solvency II and the standards proposed by the IAIS.

The NAIC is also in the process of developing a group capital calculation for US insurance groups. The approach the NAIC has recommended and plans to develop would be an aggregation methodology that utilises existing state-based capital calculations (ie, risk-based capital or 'RBC') for US-domiciled insurance companies; the standards to be used for calculating capital for entities without existing capital requirements remain a topic of debate. In any event, the NAIC has made clear that its intention is to develop a group capital assessment as opposed to any group-level capital requirement.

Notwithstanding the significant state-based developments in the area of group-wide supervision, the NAIC and state regulators are unlikely to completely jettison the solo entity ring-fencing principle, which has been a cornerstone of policyholder protection in the view of the NAIC and state regulators. Rather, the NAIC has advocated for a 'windows and walls' approach, whereby new group-wide supervisory powers will enable state insurance regulators to collect information on activities throughout the holding company system, thereby providing both 'windows' to assess group activity and risks, and the ability to 'wall' off insurance capital from any non-insurance activities of the group that are deemed to be risky. The Solvency II Directive and group-supervision proposals published by the IAIS, however, are premised on mechanisms for direct, consolidated group-level supervision. Debate as to the right approach to group-wide supervision of insurers is likely to continue, creating uncertainty for marketplace participants as to the regulatory landscape that will apply to insurance companies operating in multiple jurisdictions.

The NAIC and US state and federal regulators have continued to focus on the use of captive reinsurance vehicles by insurance companies. In recent decades, US insurers have been using captive reinsurance vehicles and various financing structures with counterparties in order to ease the capital burdens associated with statutory reserve requirements for certain types of life and annuity contracts. In December 2012, the NAIC approved a new valuation manual containing a principle-based approach to life insurance company reserves. Principle-based reserving (PBR) is designed to tailor the reserving process to specific products in an effort to create a principle-based modelling approach to reserving rather than the factor-based approach historically employed.

PBR became effective on 1 January 2017. The adoption of PBR, along with other changes to actuarial guidelines and credit for reinsurance regulations adopted by the NAIC, are intended to eventually eliminate, or at least diminish, the need for insurers to employ captive reinsurance vehicles and other reserve financing structures.

Finally, the states and the NAIC are beginning to address regulatory approaches relating to cybersecurity (an area in which the US federal government is also increasingly involved), and the burgeoning field of so-called Insure-Tech (a subset of FinTech encompassing a variety of emerging technological and other innovations that have begun to disrupt the traditional methods of insurance marketing, underwriting and claims servicing).

Significant developments at the US federal level

At the US federal level, the Dodd-Frank Act established the Federal Insurance Office (FIO) to monitor the insurance industry and identify gaps in regulation that could contribute to a systemic crisis, and granted the Board of Governors of the Federal Reserve System (Federal Reserve) significant regulatory powers over systemically important insurers and other insurers that are affiliated with an insured depository institution. As a result of the Dodd-Frank Act, the insurance holding companies for which the Federal Reserve is the consolidated supervisor hold approximately one-third of US insurance industry assets, according to Congressional testimony by the Federal Reserve. Other provisions of the Dodd-Frank Act have affected, or may affect, the management and operations of insurance groups, including new regulations on swaps, securities laws reforms, and the establishment of a new orderly liquidation authority (which, though generally not available to resolve insurance companies, may be applied to resolve insurance holding companies or their non-insurance subsidiaries). In addition, the promulgation by the Department of Labor (DOL) of new fiduciary investment advice rules in April 2016 would lead to significant changes in the way financial services providers sell financial products (including fixed and variable annuities) and provide investment advice to retirement plans and IRAs. The DOL's fiduciary rule remains controversial and the current US administration has delayed its effective date; the current rule may be replaced or possibly repealed.

Federal Reserve supervision of certain insurance groups

Until the enactment of the Dodd-Frank Act, the Federal Reserve and other federal banking agencies generally only had regulatory authority over insurance groups to the extent an insurance group owned a bank or a savings and loan company, with the parent company qualifying as a bank holding company (BHC) or savings and loan holding company (SLHC) (several insurance groups currently qualify as SLHCs, although there are currently no insurance-based BHCs). The Financial Stability Oversight Council (FSOC), established pursuant to the Dodd-Frank Act and composed of federal financial regulators, state regulators, and an independent insurance expert appointed by the President, has the authority to designate an insurance group as a systemically important financial institution (SIFI) to be subject to enhanced prudential standards and supervision by the Federal Reserve. The FSOC designated two US insurers – AIG and Prudential Financial – as SIFIs in 2013, and designated a third insurer, MetLife, in 2014. As permitted by the Dodd-Frank Act, MetLife challenged its SIFI designation in federal district court. On 30 March 2016, the district court agreed (in part) with MetLife's grounds and rescinded the designation. The FSOC has appealed that decision and the appeal is pending. SIFI designations are subject to an annual re-evaluation process conducted by the FSOC.

Accordingly, insurance-based SIFIs and SLHCs are now subject to supervision and examination by the Federal Reserve, with insurance-based SIFIs being subject to additional 'enhanced prudential standards' for which the Federal Reserve is required to establish regulations pursuant to Title I of the Dodd-Frank Act. The enhanced prudential standards include, or will include, requirements and limitations relating to risk-based capital, leverage, liquidity, stress testing, risk management, resolution planning, early remediation, management interlocks and credit concentration, and may also include additional standards regarding capital, public disclosure, short-term debt limits and other related subjects at the discretion of the Federal Reserve and the FSOC. Many of the enhanced prudential standards would apply to already-existing state insurance statutes that govern the activities of insurance holding companies. For example, acquisitions of insurance companies will require not only the approval of domiciliary state regulators, but, depending on the nature of the transaction, may also require approval by the Federal Reserve and the satisfaction of conditions set forth in the Bank Holding Company Act. Likewise, the investments permitted by insurers under state laws may also need to comply with additional (yet-to-be-promulgated) requirements respecting credit concentration limits.

The Dodd-Frank Act authorises the Federal Reserve to tailor its application of enhanced prudential standards to different companies on an individual basis or by category, and the Federal Reserve has stated that it intends to take into account the differences between bank holding companies and non-bank SIFIs, including insurance companies, when applying the enhanced prudential standards required by the Dodd-Frank Act. How the Federal Reserve might ultimately apply the prudential standards to federally supervised insurance-based groups is unclear. Many in the US insurance industry were initially concerned that the Federal Reserve might apply a 'bank-centric' model with respect to capital and leverage requirements. In response to this concern, in December 2014 Congress enacted the 'Insurance Capital Standards Clarification Act of 2014', which provides that, in establishing the consolidated minimum leverage and risk-based capital requirements mandated under the Dodd-Frank Act, the federal banking agencies shall not be required to include (including for purposes of consolidation) entities regulated by a state or foreign insurance regulator to the extent such entities are acting in their capacity as regulated insurance entities. This act was an important step in clarifying the Federal Reserve's ability to deviate from a bank-centric capital framework with respect to consolidated risk-based capital and leverage requirements for insurance groups subject to its supervision.

The majority of the enhanced prudential standards have yet to be finalised for insurance-based SIFIs. In June 2016, the Federal Reserve issued proposed rules applicable to insurance-based SIFIs relating to enhanced prudential standards for risk management, corporate governance and liquidity risk management, and issued a conceptual proposal outlining two potential approaches to capital standards: a 'building-block approach' that would be applicable to insurance-based SLHCs and be largely based on existing state and foreign capital rules, and a potentially more onerous 'consolidated approach' that would be applicable to insurance-based SIFIs.

Based on early indications from the Trump administration and Republican proposals in Congress, the current insurance-based SIFIs may be de-designated under the new administration. Moreover, the designation and supervisory powers of the FSOC and Federal Reserve over non-bank financial institutions under the Dodd-Frank Act could be circumscribed and perhaps even repealed. Until such changes occur, and depending on future rule-making by the Federal Reserve and the extent to which the Dodd-Frank Act is replaced or modified, the regulatory landscape applicable to an insurance-based SIFI or SLHC will continue to be significantly different from that applicable to other US insurers, and any transaction that involves such entities will need to be assessed in light of the federal supervisory framework applicable to them.

FIO and the Covered Agreement

While the FIO has no general supervisory or regulatory authority over the business of insurance, it is authorised to coordinate and develop federal policy on prudential aspects of international insurance matters. In particular, the FIO has taken a primary role in representing the US government within the IAIS. In December 2013, the FIO released its 'modernisation' report, which includes 27 recommendations for modernising insurance regulation in the US, most of which relate to 'near-term' state-based reforms respecting capital adequacy and solvency, reserving requirements and captive reinsurers, as well as marketplace regulation. The FIO modernisation report suggests there may be a basis for federal involvement if the states fail to accomplish reforms in the near term. State insurance departments, through the NAIC, will likely continue to support the creation and implementation of more uniform laws across the states in order to prevent such federal intervention and maintain the current state-based system.

The FIO is authorised under the Dodd-Frank Act to assist the Secretary of the Treasury (Treasury) in negotiating 'covered agreements' with foreign governments and regulators. A 'covered agreement' is a written bilateral or multilateral agreement regarding prudential measures with respect to the business of insurance or reinsurance that (i) is entered into by the US and one or more non-US governments and (ii) relates to the recognition of insurance prudential measures that achieves a level of protection for insurance consumers that is substantially equivalent to the level of protection achieved under state insurance regulation. In November 2015, the FIO began working with the US Trade Representative and Treasury to negotiate a 'covered agreement' with the EU intended to address group supervision and reinsurance regulation in connection with achieving 'equivalence' between the US insurance regulatory regime and Solvency II. On 13 January 2017, the US and EU announced they had successfully concluded negotiations on a covered agreement and the agreed text was submitted to the appropriate committees of Congress, starting a 90-day review period required by the Dodd-Frank Act. The 90-day period has expired and it is not clear yet what position the new US administration will take on the agreement, and whether it will take the steps necessary to have the agreement enter into force from the US perspective. Some industry participants and the NAIC are opposed to the agreement in its current form, while other industry participants favour the current agreement.

Subject to certain exceptions and qualifications, the agreement provides that US-based insurance groups will be supervised at the worldwide group level only by their relevant US insurance supervisors, and that such insurance groups will not have to satisfy EU group capital, reporting and governance requirements for the worldwide group. Under the covered agreement, the EU must apply these group supervision terms provisionally until the date of entry into full force of the agreement. The agreement also seeks to impose equal treatment of US and EU-based reinsurers that meet certain financial strength and market conduct conditions. In the US, once fully implemented, the agreement requires US states to lift reinsurance collateral requirements on qualifying EU-based reinsurers and provide them equal treatment with US reinsurers or be subject to federal pre-emption. In the EU, the agreement requires national authorities in the EU to lift local presence requirements that have been recently applied to US-based reinsurers doing business in certain EU member states. The reinsurance provisions of the agreement are subject to various implementation and application timetables in the US and EU.

International insurance regulatory developments

Developments in the US relating to group supervision and regulatory capital requirements for insurance companies are occurring in parallel with the development by the FSB and IAIS of new global standards applicable to such institutions. The standards and policy measures proposed by the IAIS discussed below would, once finalised and to the extent implemented into local law, significantly impact the regulatory framework applicable to international insurance groups. At the present time, however, the manner and timing of implementing the IAIS's insurance regulatory reforms in the US remain uncertain, as does the extent to which the IAIS's capital and other regulatory standards and rules will complement, supplement or otherwise conflict with those developed pursuant to the Dodd-Frank Act and the NAIC's solvency modernisation initiatives. A number of practical issues will also need to be resolved, including how measures applicable to 'global systemically important insurers' (G-SIIs) would apply to an entity supervised by a body that is not a member of the FSB (such as a state insurance regulator, rather than the Federal Reserve), which may become an issue to the extent that insurers or reinsurers that may not be designated as SIFIs under the Dodd-Frank Act are designated as G-SIIs.

Many of the IAIS's proposals for the insurance sector remain controversial among the US insurance industry, members of Congress, state regulators and the NAIC, particularly with respect to proposed regulatory capital standards, which are viewed by some as favouring a European, 'going-concern' approach to solvency issues over the 'gone-concern' approach used by US state regulators. A perceived lack of transparency in the decision-making processes of the IAIS and FSB has also been a source of criticism by members of Congress, the NAIC and industry.

The FSB and IAIS

The FSB consists of representatives of national financial authorities of the G20 nations, various international standard-setting bodies (including the IAIS), as well as the International Monetary Fund (IMF) and the World Bank. The US members of the FSB include the Federal Reserve, the Securities and Exchange Commission and the Treasury Department. The G20, the FSB and related governmental bodies have developed proposals to address issues such as financial group supervision, capital and solvency standards, systemic economic risk, corporate governance, effective resolution regimes, and related issues associated with responses to the financial crisis. FSB member nations agree to undergo periodic peer reviews assessing the soundness and stability of members' financial systems and their implementation of proposed financial regulatory reforms, which are generally conducted by means of the Financial Sector Assessment Program (FSAP) reports prepared by the IMF or World Bank.

The IAIS is a voluntary membership organisation of insurance supervisors and regulators from more than 200 jurisdictions in nearly 140 countries. US members of the IAIS include the FIO, the NAIC, state insurance regulators and the Federal Reserve. While the policy measures and financial reforms promulgated by the IAIS and the FSB have no legal force unless enacted at the national level, the relevant national financial authorities of members' jurisdictions are expected to implement and enact the policy measures and financial reforms agreed by the FSB and IAIS.

IAIS three tiers of supervision

The IAIS has developed three tiers of supervisory requirements and actions applicable to the insurance industry:

- Insurance Core Principles (ICPs): initially published in 2011 and periodically revised since then, the ICPs apply to the supervision of all insurers and insurance groups, regardless of size or systemic importance;
- The Common Framework (ComFrame): the latest full draft of ComFrame was issued in September 2014 and applies to the cross-border supervision of 'internationally active insurance groups' (IAIGs); and
- G-SII Policy Measures: published in July 2013, these policy measures only apply to insurance groups designated as G-SIIs.

ICPs

ICPs are structured to allow a wide range of regulatory approaches and supervisory processes to suit different markets, and cover a broad range of topics, encompassing, among many other topics, supervisor responsibilities, confidentiality, licensing, change in control, risk management, enforcement, resolution and capital adequacy. The IMF issued an FSAP report in March 2015 assessing the observance by US regulators of the ICPs, which found a 'reasonable level of observance' of the ICPs in the United States, but criticised a lack of compliance with certain ICPs and recommended more federal government involvement in US insurance regulation.

ComFrame

At the direction of the FSB, the IAIS is developing ComFrame as a model framework for the supervision of IAIGs that contemplates 'group-wide supervision' across national boundaries. The IAIS is seeking to promote the financial stability of IAIGs by endorsing:

- uniform standards for insurer corporate governance and enterprise risk management;
- a framework for group capital adequacy assessment that accounts for group-wide risks;
- additional regulatory and disclosure requirements for insurance groups;
- requirements to conduct group-wide risk and solvency assessments (ORSA); and
- the establishment of ongoing supervisory colleges.

ComFrame is scheduled to be finalised and adopted in 2019, and will be subject to revision through prior field testing and confidential reporting. ComFrame is concerned primarily with the ongoing supervision of IAIGs, and is not focused on whether an insurance group is systemically important or on how to reduce the systemic risk of insurers (which is the focus of the G-SII Policy Measures and related assessment methodologies). An IAIG is defined as a large, internationally active group that includes at least one sizeable insurance entity. The IAIS does not intend to develop a definitive list of IAIGs, but has proposed quantitative criteria for national supervisors to assess on a regular basis whether they should apply ComFrame to an insurance group.

It is estimated that approximately 50 to 60 firms from around the world would qualify as IAIGs under the current proposed criteria, including all designated G-SIIs.

In connection with ComFrame, the IAIS is in the process of developing a risk-based global insurance capital standard (ICS) applicable to all IAIGs. The first public consultation draft for the ICS was published by the IAIS in December 2014. As with ComFrame, the ICS is scheduled to be finalised and adopted by the IAIS in late 2019, although there are indications that the ICS may not be fully developed and implemented by that time.

G-SIIs

G-SIIs are defined by the FSB and the IAIS as insurers whose distress or disorderly failure, because of their size, complexity and interconnectedness, would cause significant disruption to the global financial system and economic activity. The FSB, in consultation with the IAIS and national authorities, designates G-SIIs on an annual basis each November. The most recent set of G-SII designations (in November 2016) includes nine life and composite insurers (three of which are US-based: AIG, Prudential Financial and MetLife). The FSB and the IAIS have yet to designate any reinsurers as G-SIIs, and the FSB has indicated that such designations will be delayed for the near future pending further assessment.

G-SII designations are based on an assessment methodology developed by the IAIS, which is subject to review and revision every three years. The IAIS issued an updated G-SII assessment methodology in June 2016. Drivers of systemic importance under the IAIS's most recent assessment methodology include size, global activity and substitutability (each receiving 5 per cent risk weightings), with 'asset liquidation' (roughly 36 per cent) and interconnectedness (roughly 49 per cent) representing the remaining and primary assessment drivers (each of which contain sub-elements focused on potentially systemic insurance product features, which the IAIS formerly analysed and referred to under the now-abandoned concept of 'non-traditional/non-insurance' (NTNI) activities). In February 2017, the IAIS announced the adoption of a three-year systemic risk assessment and policy workplan due to be finalised by year-end 2019, which will focus on developing a macroprudential activities-based approach to regulating systemic risk.

The G-SII Policy Measures promulgated by the IAIS and endorsed by the FSB include:

- enhanced group-wide supervision, with group-wide supervisors to have direct powers over holding companies and the power to impose restrictions and prohibitions on certain activities (eg, to limit or eliminate systemically important activities or limit the use of affiliate reinsurance for NTNI lines of business);
- enhanced capital standards, including basic capital requirements (BCR) and higher loss absorption capacity requirements (HLA), which apply to all group activities, including those of non-insurance subsidiaries; the BCR is intended to serve as the initial foundation for the application of HLA requirements; the various capital standards and requirements are currently expected to be implemented in late 2019, and the IAIS envisages that the ICS will eventually replace the BCR as the foundation for HLA;
- systemic risk management plans: group-wide supervisors are to oversee the development by G-SIIs of plans for managing, mitigating and possibly reducing systemic risk;
- enhanced liquidity planning and management: group-wide supervisors are to require a regular gap analysis of liquidity risks and adequacy of available liquidity resources under normal and stressed conditions; and
- effective resolution regimes: the FSB has developed a document entitled the 'Key Attributes of Effective Resolution for Financial Institutions', which sets forth the key features of resolution regimes that should be applied across jurisdictions to systemically significant financial institutions; the IAIS has developed an annex to this document that outlines the key attributes that are intended to apply to the resolution of G-SIIs.

Under the insurance-sector specific elements of the Key Attributes, G-SIIs will be expected to develop and prepare recovery and resolution plans to be submitted to their group-wide supervisors on an annual basis. In addition, 'crisis management groups' are expected to be established that will include the relevant supervisory authorities, central banks, resolution authorities, finance ministries and guarantee fund authorities of each G-SII, as a forum for relevant regulators to discuss enhancing preparedness for the potential failure of the G-SII. Moreover, resolvability assessments are to be conducted by the home authority and crisis management group of each G-SII to assess the feasibility of the G-SII's resolution strategies. Finally, institution-specific cross-border cooperation agreements are to be developed and entered into among the G-SII's relevant resolution authorities.

Solvency II

Solvency II is a European Union directive (enacted in 2009) that is intended to codify and harmonise EU insurance regulation. Solvency II became effective, and its full implementation began, in January 2016. Solvency II is based on three pillars of enhanced regulation:

- Pillar 1 addresses quantitative measures to ensure insurance firms are adequately capitalised with risk-based capital, including requirements relating to technical provisions (ie, reserves) and solvency capital and minimum capital requirements;
- Pillar 2 addresses qualitative measures, governance, risk management and supervisory interaction, including a requirement that firms conduct an ORSA; and
- Pillar 3 covers enhanced supervisory reporting and public disclosure requirements.

Solvency II also contains provisions designed to strengthen the supervision of insurance groups, including establishment of colleges of supervisors and the imposition of group-based capital requirements in addition to capital requirements for individual insurers. As group supervision may include groups headquartered in non-EU jurisdictions, or include subsidiaries of a EU-based group located in non-EU jurisdictions, Solvency II permits group solvency and capital calculations to take account of local capital standards and requirements in relevant non-EU countries where members of the group are domiciled, provided the supervisory regime of the non-EU jurisdiction involved has been assessed as 'equivalent' by the European Commission, or (absent an equivalence assessment by the European Commission) the relevant EU group supervisor has undertaken its own equivalence assessment or has applied 'other methods' to ensure appropriate supervision. In the absence of equivalence, the relevant non-EU insurer will be consolidated with the group's EU operations for purposes of applying the Solvency II minimum capital and solvency requirements. Solvency II also permits equivalence decisions regarding the regulation of reinsurance, ie requirements applicable to non-EU reinsurers reinsuring risks in the EU. Although to date the US supervisory regime has not been assessed as fully equivalent, the European Commission's third country equivalence decisions adopted in June 2015 granted the US insurance regulatory regime, as well as the regimes in certain other countries, provisional equivalency for a period of 10 years with respect to the 'solvency calculation' area of Solvency II (but not the 'group supervision' or 'reinsurance' areas). This provisional equivalence will allow EU insurers with subsidiaries in the US to use local rules, rather than Solvency II rules, to carry out their EU prudential reporting for these subsidiaries. The insurance regulatory regimes of Switzerland and Bermuda have been granted full equivalence in all three equivalence areas. As discussed above, the recently negotiated 'covered agreement' is intended to functionally result in equivalent treatment for the US insurance regulatory regime for both reinsurance and group-supervision purposes. It remains to be seen whether the UK will continue to implement Solvency II in the same manner as it currently does following the finalisation of its exit from the EU, and whether, after its exit, the UK will need to seek an equivalence decision from the EU, and the US equivalent treatment from the UK.

* *Samuel R Woodall and Roderick M Gilman provided valuable assistance in the preparation of this Introduction.*

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The Directors Roundtable

WORLD RECOGNITION OF DISTINGUISHED GENERAL COUNSEL: HONORING RICARDO ANZALDUA & THE LAW DEPARTMENT OF METLIFE

Tuesday, July 18, 2017

CONTINUING LEGAL EDUCATION MATERIALS REGARDING METLIFE, INC. v. FINANCIAL STABILITY OVERSIGHT COUNCIL

[1] Ryan Tracy and Erik Holm, *MetLife Wins Bid to Shed 'Systemically Important' Label; Ruling gives insurance company a reprieve from more onerous capital requirements and oversight*, Wall St. J., March 30, 2016

[2] Sara Randazzo, *MetLife Ruling the Latest Win for a Son of Justice Scalia; Eugene Scalia has been a successful advocate for companies challenging government regulation*, Wall St. J., March 30, 2016

[3] Excerpts from Brief for Plaintiff-Appellee in *Metlife, Inc. v. Financial Stability Oversight Council*, No. 16-5086, 2016 WL 4363339 (D.C. Cir. Filed Aug. 15, 2016)

[4] Presidential Memorandum for the Secretary of the Treasury, 2017 WL 1421320 (Apr. 21, 2017)

http://www.wsj.com/articles/federal-judge-rescinds-federal-government-determination-that-metlife-is-systemically-important-1459349828

MARKETS MAIN

MetLife Wins Bid to Shed 'Systemically Important' Label

Ruling gives insurance company a reprieve from more onerous capital requirements and oversight

MetLife, the largest U.S. life insurer by assets, contends that regulators erred when they declared the firm to be a so-called systemically important financial institution. PHOTO: MARK LENNIHAN/ASSOCIATED PRESS

By Ryan Tracy and Erik Holm

Updated March 30, 2016 7:47 p.m. ET

WASHINGTON—MetLife Inc. won a legal battle over federal regulators seeking to brand the insurer a threat to the financial system and to ramp up government oversight of the company and its operations.

The federal judge's ruling Wednesday deals a blow to the expansive post-financial-crisis safety net. It could embolden other institutions to file similar challenges as well as political critics seeking to curb the broad discretion given to regulators five years ago.

The Obama administration criticized the ruling and could still appeal. But for now, the decision means MetLife, the largest U.S. life insurer by assets, has shaken off potential higher capital requirements and other restrictions that came with its December 2014 designation as a "systemically important financial institution," or SIFI. Regulators apply the label to financial giants whose failure they believe would threaten the economy, and it submits them to much tougher rules on capital and use of borrowed money to reduce their risks.

Investors cheered the news, pushing MetLife shares up 5.4% Wednesday. Shares also rose about 2% for the insurer's two main rivals, Prudential Financial Inc. and American International Group Inc., which have also been designated systemically important and are expected to consider challenges to that designation following MetLife's successful legal challenge, said people familiar with the matter.

Defenders of the 2010 Dodd-Frank Act that gave regulators the powers to expand their oversight of MetLife warned of the ruling's dangers. Jeffrey Gordon, a Columbia Law School professor who helped write a brief in the case supporting the government, said the decision could be "damaging to long-term financial stability of the United States..."

U.S. District Judge Rosemary Collyer's two-page order said she sided with MetLife on two counts of its legal complaint and partially sided with the firm on a third. Those counts included arguments that regulators made an arbitrary and capricious decision based on a faulty process, raising the prospect that Judge Collyer's ruling could have broader implications for other firms that underwent a similar process.

Still, the exact scope of the decision remains unclear because she issued her opinion under seal. A public version may be released later, possibly with redactions. It is possible Judge Collyer's decision is worded narrowly enough that the government could redo its homework on MetLife and reaffirm its decision on a basis that would stand up in court.

READ MORE

- MetLife Seen Proceeding With Breakup Plans
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- MetLife Seen Proceeding With Breakup Plans
- A 'Systemically Important' Judge
- Ruling Could Delay Rules For Asset Managers
- Read the Judge's Order
- MetLife Case Challenging SIFI Designation Nears Hearing (Feb. 9)
- Unlike Rival MetLife, AIG Not Shunning SIFI Tag (Jan. 26)
- MetLife to Shed Big Chunk of Life Unit (Jan. 12)
- MetLife Contests 'Systemically Important' Label (Oct. 3, 2014)

The applicability of the decision for other firms "may be limited given the scope of the decision," Isaac Boltansky, an analyst with Compass Point Research & Trading LLC, said in a note to clients Wednesday.

But the decision is a major rebuke of the Obama administration and the Dodd-Frank law it implemented as its main response to the financial crisis. The law sought to prevent a repeat of the 2008 bailouts in part by creating a new Financial Stability Oversight Council, or FSOC, made up of regulators and empowering it to bring large financial firms that don't have a federal regulator under tighter oversight. Those provisions were a direct response to the taxpayer support of AIG, which didn't previously have a federal regulator watching over all of its operations.

The ruling Wednesday suggests the government may have overreached. Judge Collyer had appeared sympathetic during a hearing in February to arguments that FSOC created a foregone conclusion by starting with a hypothetical assumption that MetLife was failing. She also questioned the propriety of the process, in which the same council members made the decision about MetLife and heard the company's appeal. The council includes the Treasury secretary and heads of regulatory agencies such as the Federal Reserve and Securities and Exchange Commission.

"We strongly disagree with the court's decision," said a spokesman for Treasury Secretary Jacob Lew, who heads the oversight council. The statement didn't explicitly commit to a legal appeal but said "we are confident that FSOC's determination was lawful and will continue to defend the Council's designations process vigorously."

MetLife Chief Executive Steve Kandarian was in his office Wednesday when people entered waving papers showing the firm had won. He called the ruling "a win for MetLife's customers, employees and shareholders."

"From the beginning, MetLife has said that its business model does not pose a threat to the financial stability of the United States," Mr. Kandarian said.

The ruling could also energize congressional critics of Dodd-Frank who have been working to make several changes to the law, including making it harder for the oversight council to designate firms as SIFIs without first giving the firms a chance to address problems that regulators identify.

"It is simply unacceptable for there to be unanswered questions about the FSOC's designation process, which is why I have advocated for increased congressional oversight and accountability," Senate Banking Committee Chairman Richard Shelby (R., Ala.) said in a statement.

While the ruling will encourage critics in the financial industry who feel the government's regulatory apparatus has grown so large that it is stifling business, it is in some ways too late. Just the prospect of the rules has already left a changed industry.

Despite appealing the designation, MetLife said in January that it was seeking to divest itself of a large piece of its U.S. life-insurance unit as part of its plan to ease some of the capital burden under the regulations. Mr. Kandarian said Wednesday’s decision doesn’t change those plans, as the company had elected to pursue a split because of other factors, too. He has previously said the stand-alone U.S. life insurer that MetLife envisions “will be more nimble and competitive.”

Other firms branded “systemically important” are facing similar pressures. General Electric Co. has sold off the bulk of the finance unit that once accounted for more than half its profit as new regulations hurt its returns. AIG has resisted calls for a breakup from activist investors but has unveiled steps to shrink the conglomerate in coming years.

The council could get a new test in the coming days: GE Capital is expected to soon ask the council to rescind its SIFI label in light of the major changes it has made.

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Appeared in the March 31, 2016, print edition as 'Judge Curbs Oversight of MetLife.'

http://www.wsj.com/articles/metlife-ruling-the-latest-win-for-a-son-of-justice-scalia-1459364864

FINANCIAL REGULATION

MetLife Ruling the Latest Win for a Son of Justice Scalia

Eugene Scalia has been a successful advocate for companies challenging government regulation

Eugene Scalia at his offices in Washington in 2012. PHOTO: STEPHEN VOSS FOR THE WALL STREET JOURNAL

By Sara Randazzo

March 30, 2016

A federal judge's decision to revoke MetLife Inc.'s MET 0.36% ▲ "too big to fail" designation is the latest in a string of wins for the insurer's lawyer, Eugene Scalia, who has emerged as a go-to advocate in recent years for companies looking to challenge government regulation.

Mr. Scalia, the 52-year-old son of late U.S. Supreme Court Justice Antonin Scalia, has taken an ax to the Dodd-Frank Act since its 2010 implementation.

His challenges, on behalf of industry groups and corporations in the financial-services industry, have often relied on a separate 1990s-era federal law requiring financial regulators to do a cost-benefit analysis of new rules.

MORE ON THE METLIFE DECISION

- MetLife Wins Bid to Shed 'Systemically Important' Label
- MetLife and the Dodd-Frank Backlash
- The Short Answer: What You Need to Know About SIFIs

Mr. Scalia has successfully argued that regulators have sometimes failed to meet that burden when implementing the Dodd-Frank law. On those grounds or others, Mr. Scalia has secured wins against the U.S. Securities and Exchange Commission and Commodity Futures Trading Commission.

In 2012, a court sided with Mr. Scalia's trade-group client in overturning limits on commodity-markets trading. In another win, an appellate court halted an SEC rule that would have given shareholders more say in replacing corporate directors.

In one loss, a federal appellate court in 2013 ruled against the Investment Company Institute and U.S. Chamber of Commerce, represented by Mr. Scalia, in an attempt to block a regulation requiring mutual funds and others that invest in certain commodities to register with the CFTC.

While declining to comment on MetLife specifically, Mr. Scalia said Wednesday that "Dodd-Frank is an important statute, but often when the government believes it's handling a particularly important issue, there can be a tendency to overreach."

Mr. Scalia said he's drawn to legal cases concerning administrative agencies because a win can "literally change the law." He added that his interest in it also "undoubtedly comes from the fact it was an area my father taught when he was a law professor, and an area of great interest to him as a judge and justice."

Mr. Scalia could soon be poised to insert himself into another controversy. Legal challenges are expected to follow a forthcoming rule from the Labor Department holding retirement investment advisers to stricter standards. While Mr. Scalia wouldn't say Wednesday whether he'll back such a case, he has advised brokerage firm Primerica in earlier challenges to the proposed rules.

Last year, Mr. Scalia testified at a congressional hearing over the role in the U.S. of the Financial Stability Board, an international body that monitors the global financial system.

Such an organization has its place, Mr. Scalia said, "but concerns arise if U.S. legal rights and processes take a back seat to decisions that were forged in private meetings with regulators overseas." He questioned whether the international group, which designated MetLife and other U.S. companies as "global systemically important insurers" were "a silent force" behind MetLife receiving the comparable designation in the U.S.

Mr. Scalia, a partner at Gibson, Dunn & Crutcher LLP in Washington, D.C., also has a successful record as a lawyer on labor and employment matters. He spent a year as the top lawyer for the U.S. Labor Department under President George W. Bush and has since defended companies against wage-and-hour, discrimination and labor suits.

Mr. Scalia has defended Boeing Co. in a challenge by the National Labor Relations Board over the aerospace company's decision to move a factory to a nonunion state, and SeaWorld Entertainment Inc. in a case against the Occupational Safety and Health Administration following the death of a trainer by a killer whale.

In the 1990s, he helped overturn a Labor Department compliance program on workplace safety standards, arguing that ergonomics rules aimed at curbing repetitive-motion injuries were based on "thoroughly unreliable science."

Write to Sara Randazzo at sara.randazzo@wsj.com

Corrections & Amplifications:
Eugene Scalia's legal challenges have often relied on a 1990s-era federal law requiring financial regulators to do a cost-benefit analysis of new rules; on these grounds or others, he has secured wins against the U.S. Securities and Exchange Commission and the Commodity Futures Trading Commission. An earlier version of this article incorrectly implied that reliance on the cost-benefit law underpinned all of his legal victories against the CFTC. (April 4, 2016)

2016 WL 4363339 (C.A.D.C.) (Appellate Brief)
United States Court of Appeals,
District of Columbia Circuit.

METLIFE, INC., Plaintiff-Appellee,

v.

FINANCIAL STABILITY OVERSIGHT COUNCIL, Defendant-Appellant.

No. 16-5086.
August 15, 2016.

On Appeal From The United States District Court For The District Of Columbia
Not Yet Scheduled For Oral Argument

Brief For Appellee

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***vii** TABLE OF AUTHORITIES

Cases

* Authorities upon which MetLife chiefly relies are marked with an asterisk.

***1** INTRODUCTION

When Congress created the Financial Stability Oversight Council ("FSOC"), it did not grant FSOC a roving mandate to designate every large financial company for enhanced federal regulatory oversight. Instead, Congress carefully prescribed eleven statutory factors that the agency must consider when determining whether a company warrants designation as a nonbank systemically important financial institution. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank Act"). Because the consequences of designation are far-reaching - including the imposition of heightened capital and liquidity requirements, oversight of a company's structure and decision-making processes, and regulatory fees and costs - Congress also expressly authorized companies to challenge their designations as "arbitrary and capricious." 12 U.S.C. § 5323(h). In so doing, Congress made clear that FSOC is bound by the same principles of reasoned decision-making as all other regulatory agencies. FSOC therefore must adhere to both the Dodd-Frank Act and its own regulations, rely on concrete evidence and logical inferences rather than unwarranted speculation and unsubstantiated guesswork, and consider the consequences of its decisions, including whether designation will actually protect the U.S. economy from financial instability.

***2** FSOC violated both the Dodd-Frank Act and fundamental principles of administrative law when it designated MetLife. Having decided to target MetLife for designation, FSOC selectively applied the statutory criteria established by Congress, repeatedly departed from its own regulations in order to overcome MetLife's evidence and analysis, consistently embraced unreasonable assumptions and counter-factual conjecture in the face of contrary historical examples, and disregarded representations by MetLife's state insurance regulators and the views of the two independent Council members with insurance expertise.

Notwithstanding these errors, FSOC accuses the district court of imposing on the agency an unrealistic "requirement to identify with precision the impact that distress would have on the broader [economy]" and of "second-guessing the expert judgment of the nation's federal financial regulators." FSOC Br. 22, 49. Those characterizations are demonstrably false. Far from demanding clairvoyance or overriding FSOC's substantive conclusion about MetLife's alleged systemic importance, the district court simply required that FSOC adhere to its own regulatory standards and the basic precepts of reasoned agency decision-making. Two of FSOC's errors - its failures to consider MetLife's vulnerability to material financial distress and to assess whether the effects of that distress would be " 'sufficiently severe to inflict significant damage on the broader economy,' " JA802 - were deviations from standards adopted *by FSOC itself* in its regulations implementing ***3** the Dodd-Frank Act. *See* 77 Fed. Reg. 21,637 (Apr. 11, 2012) (codified at 12 C.F.R. pt. 1310, App. A) ("Final Rule and Interpretive Guidance"). And the third ground on which the district court rescinded MetLife's designation - FSOC's failure to consider whether the designation would have effects that would actually undermine the agency's regulatory objectives - reflects a basic tenet of administrative law that every agency must satisfy when taking regulatory action.

The district court did not reach several other flaws in FSOC's designation decision, including its unfounded, counterintuitive assumption that state insurance regulators would *exacerbate* the effects of material financial distress at MetLife, FSOC's disregard for settled risk analysis methodologies applied by other federal agencies, its failure to consider reasonable alternatives to designating MetLife, and FSOC's persistent refusal to provide MetLife with access to the administrative record or its prior designation decisions. Agency "expertise" is not a justification for indulging ahistorical assumptions, spurning well-established risk analysis principles, disregarding viable regulatory alternatives, or withholding record evidence and the agency's most relevant precedents. In each of these respects - as well as those identified by the district court - the Final Designation was arbitrary and capricious and was appropriately rescinded.

***4** STATEMENT OF ISSUES

1. Whether FSOC improperly departed from its Final Rule and Interpretive Guidance and the Dodd-Frank Act by failing to evaluate MetLife's vulnerability to material financial distress.

2. Whether FSOC violated its Final Rule and Interpretive Guidance, the Dodd-Frank Act, and principles of reasoned decision-making when assessing whether material financial distress at MetLife could pose a threat to U.S. financial stability.

3. Whether FSOC acted arbitrarily and capriciously in refusing to consider the effects of designation on MetLife.

4. Whether FSOC acted arbitrarily and capriciously by declining to consider reasonable alternatives to designating MetLife.

5. Whether FSOC's designation procedures violate due process and the separation of powers.

STATUTES AND REGULATIONS

Pertinent statutes and regulations are reproduced in the Addendum to this brief.

***5** STATEMENT OF THE CASE

I. The Statutory and Regulatory Framework for FSOC Designations

The Dodd-Frank Act authorizes FSOC to designate nonbank financial companies as systemically important financial institutions subject to supervision by the Board of Governors of the Federal Reserve System ("Board") where one of two standards is satisfied: (1) "material financial distress at the" company "could pose a threat to the financial stability of the United States" or (2) "the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities" of the company "could pose" such a threat. 12 U.S.C. § 5323(a)(1).

In determining whether one of these designation standards is met, the DoddFrank Act directs FSOC to consider eleven statutory factors, including (1) the company's leverage, off-balance sheet exposures, financial assets, and liabilities; (2) its relationships with other significant financial companies; (3) the degree to which the company is already subject to regulation; and (4) "any other risk-related factors [FSOC] deems appropriate." 12 U.S.C. § 5323(a)(2).

FSOC implemented these statutory standards through a Final Rule governing the designation process, which is accompanied by Interpretive Guidance that "describes the manner in which [FSOC] intends to apply the statutory standards and considerations in making determinations" to designate a nonbank financial company. 12 C.F.R. pt. 1310, App. A, § I. The Final Rule and Interpretive Guidance ***6** translates Congress's statutory framework into six designation categories: size, interconnectedness, substitutability, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny. *See Id.* at § II(d)(1). In adopting this framework, FSOC explained that the six categories address two distinct inquiries: The first three categories are intended to assess "the potential impact of a nonbank financial company's financial distress on the broader economy," while the remaining categories "seek to assess the vulnerability of a nonbank financial company to financial distress." *Id.*

JA661. He further took issue with FSOC for assuming, as the Final Designation's "central foundation," a "sudden and unforeseen insolvency of unprecedented scale, of unexplained causation, and without effective regulatory responses or safeguards." JA663.

***16** Adam Hamm, FSOC's non-voting State Insurance Commissioner Representative, dissented because FSOC failed "to appropriately consider the efficacy of the state insurance regulatory system." JA666. Hamm also criticized FSOC's asset liquidation and exposure analyses because FSOC made "hypothetical and highly implausible claims of significant policyholder surrenders," JA669-70, and ignored insurance regulators' "authority to impose stays or apply similar powers to manage heightened policyholder surrender activity," JA668.

III. District Court Proceedings

As authorized by Dodd-Frank, 12 U.S.C. § 5323(h), MetLife filed suit challenging the Final Designation as arbitrary and capricious.

On March 30, 2016, the district court rescinded the Final Designation. JA779-813. Although the court determined that MetLife is a nonbank financial company eligible for designation, JA796, it held that, in designating MetLife, FSOC had arbitrarily and capriciously departed from its own Final Rule and Interpretive Guidance in two material respects. First, FSOC failed "to evaluate MetLife's vulnerability to material financial distress" despite its commitment to do so in its Final Rule and Interpretive Guidance, "steadfastly refused ... to acknowledge that it changed positions," and "never explained why it abandoned the Guidance." JA799, 802. Second, FSOC disregarded its commitment in the Final Rule and Interpretive Guidance to determine whether material financial distress ***17** at a company could pose a threat to U.S. financial stability by evaluating whether " 'there would be an impairment of financial intermediation or financial market functioning that would be sufficiently severe to inflict significant damage on the broader economy.' " JA802 (quoting 12 C.F.R. pt. 1310, App. A, § II(a)). In fact, "the Final Determination hardly adhered to any standard when it came to assessing MetLife's threat to U.S. financial stability," as illustrated by FSOC's exposure analysis, which "merely summed gross potential market exposure" without assessing the plausible potential losses from those exposures. JA803. A "summary of exposures and assets," the court emphasized, "is not a prediction." JA804.

In addition, the district court held that FSOC arbitrarily and capriciously refused to consider the effects of designation on MetLife, which are " 'an important aspect of the problem when deciding whether regulation is appropriate.' " JA808 (quoting *Michigan v. EPA,* 135 S. Ct. 2699, 2707 (2015)). " '[N]o regulation is appropriate,' ' the court concluded, ' 'if it does significantly more harm than good.' ' *Id.* (quoting *Michigan,* 135 S. Ct. at 2707).

Because these deficiencies in the Final Designation each required rescission, JA811, the court did not reach MetLife's other arguments, including that FSOC arbitrarily and capriciously assumed the inefficacy of state regulation, ignored settled risk analysis methodologies, failed to consider reasonable alternatives to designation, and violated MetLife's due process rights and separation of powers principles.

*18 SUMMARY OF ARGUMENT

FSOC's designation of MetLife suffers from numerous fatal deficiencies. In addition to repeatedly redefining the ground rules governing the designation process - by selectively disregarding statutory criteria and abandoning its own regulations without acknowledgment or explanation - FSOC consistently disregarded record evidence that undermined its conclusions, ignored long-standing principles of risk analysis and the views of experts on state insurance regulation, relied on unfounded and ever-more-dire speculation about the distress MetLife could experience and the potential effects of that distress, and declared itself indifferent to the consequences of its designation decision. Confronted with the task of defending that manifestly flawed analysis, FSOC repeatedly departs from the reasoning of the Final Designation in favor of arguments that appear nowhere in the decision itself. The district court correctly cast aside FSOC's *post hoc* rationalizations, *see SEC v. Chenery Corp.,* 318 U.S. 80, 93-94 (1943), and identified three serious errors in FSOC's decision to designate MetLife. The Final Designation should be rescinded on each of those independent grounds, as well as on several additional grounds that the district court did not reach.

I. FSOC departed from its Final Rule and Interpretive Guidance when it refused to evaluate MetLife's vulnerability to material financial distress. FSOC unequivocally committed in its Final Rule and Interpretive Guidance "to assess the ***19** vulnerability of a nonbank financial company to financial distress," 12 C.F.R. pt. 1310, App. A, § II(d)(1), by considering a company's leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny. In the Final Designation, however, FSOC simply *assumed* that MetLife would experience material financial distress. FSOC's unacknowledged and unexplained departure from its own regulations was arbitrary and capricious, and also violated the Dodd-Frank Act, which independently requires an assessment of vulnerability as part of the designation inquiry. FSOC then compounded its error by assuming extreme degrees of distress at MetLife that are far more severe than the "imminent danger of insolvency" standard it committed to apply in its Final Rule and Interpretive Guidance.

II. FSOC further stacked the deck in favor of designation by abandoning the standard it adopted in the Final Rule and Interpretive Guidance for determining whether a company's material financial distress could destabilize the U.S. economy. In lieu of that standard - which required establishing that the effects of distress "would be sufficiently severe to inflict significant damage on the broader economy," 12 C.F.R. pt. 1310, App. A, § II(a) - FSOC conducted an amorphous, *ad hoc* inquiry that "hardly adhered to any standard" at all. JA803. Rather than attempt to determine whether MetLife's material financial distress could cause financial harm to other market participants that would rise to the level of threatening U.S. financial stability, FSOC simply tallied other financial institutions' raw exposures ***20** to MetLife - without estimating potential losses from these exposures, evaluating the materiality of those estimated losses, or considering collateral and other risk mitigants. As the district court explained, this *sub silentio* departure from the standard FSOC committed to apply in the Final Rule and Interpretive Guidance undermines both its exposure and asset liquidation analyses.

In addition, FSOC ignored accepted principles of risk analysis and reasoned decision-making by refusing to specify plausible, objectively defined scenarios under which to evaluate the risks posed by MetLife, and unreasonably assumed the total inefficacy of the state insurance regulatory system, hypothesizing that intervention by state regulators would actually *aggravate,* rather than quell, economic turmoil - a counterintuitive assumption for which FSOC provided absolutely no support. These flaws provide further grounds for rescinding the Final Designation.

III. Underscoring its single-minded focus on designating MetLife, FSOC refused to consider whether designation might undermine its regulatory objectives by increasing the possibility that MetLife could experience financial distress that might destabilize the U.S. economy. According to FSOC, it had no obligation to consider the consequences of its designation decision and was free to ignore MetLife's representations that designation could actually weaken the company and lead to its break-up. FSOC's utter disregard for the consequences of its designation ***21** decision is incompatible with principles of reasoned decision-making and the Dodd-Frank Act.

IV. FSOC also refused to consider reasonable alternatives to designating MetLife, including the activities-based approach proposed by MetLife, under which FSOC would identify any systemically risky activities undertaken by insurers and recommend to the relevant primary regulator that those activities be regulated on an industry-wide, rather than a company-specific, basis. Although FSOC is currently evaluating an activities-based approach for asset managers, FSOC steadfastly maintained that it need not even consider that approach for MetLife because it had already decided to evaluate MetLife for designation on a company-specific basis and the Dodd-Frank Act does not mandate activities-based regulation.

V. Finally, FSOC violated due process and the separation of powers by denying MetLife access to the administrative record and FSOC's prior designation decisions during the designation proceedings, and subjecting MetLife to an administrative apparatus in which the same principals and staff wrote the rules, built the case against MetLife, considered MetLife's challenge to the Proposed Designation, and made the final decision to designate MetLife. By blending the legislative, investigative, prosecutorial, and adjudicative roles in the same principals and staff - who decided to designate MetLife based on a record and agency precedent that the ***22** company had never seen - FSOC denied MetLife the opportunity to mount a meaningful defense to designation.

For all of these reasons, the Final Designation is impossible to reconcile with fundamental tenets of administrative law, the Dodd-Frank Act, or basic principles of fairness. And because FSOC made clear that "[n]o single consideration [was] dispositive" in its decision to designate MetLife, JA394, each of these errors requires rescission of the Final Designation in its entirety, *see Nat'l Fuel Gas Supply Corp. v. FERC,* 468 F.3d 831, 839 (D.C. Cir. 2006).

STANDARD OF REVIEW

This Court reviews a grant of summary judgment "applying the same standards as those that govern the district court's determination." *Alpharma, Inc. v. Leavitt,* 460 F.3d 1, 6 (D.C. Cir. 2006) (internal quotation marks omitted). As the prevailing party, MetLife "may, of course, defend [the] judgment on any ground properly raised below whether or not that ground was relied upon, rejected, or even considered by the District Court." *Granfinanciera, S.A. v. Nordberg,* 492 U.S. 33, 38-39 (1989) (internal quotation marks omitted).

FSOC's designation decisions are subject to arbitrary and capricious review, 12 U.S.C. § 5323(h), which requires FSOC to comply with basic precepts of reasoned decision-making under the Administrative Procedure Act ("APA"), 5 U.S.C. § 706. Agency action is arbitrary and capricious when the agency "entirely ***23** failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise." *Motor Vehicle Mfrs. Ass'n of the U.S., Inc. v. State Farm Mut. Auto. Ins. Co.,* 463 U.S. 29, 43 (1983).

ARGUMENT

I. The Final Designation Contravened FSOC's Final Rule And Interpretive Guidance And The Dodd-Frank Act By Failing To Consider MetLife's Vulnerability To Material Financial Distress.

The Dodd-Frank Act authorizes FSOC to designate a nonbank financial company if it determines that "material financial distress" at the company could pose a "threat to the financial stability of the United States." 12 U.S.C. § 5323(a)(1). In its Final Rule and Interpretive Guidance, FSOC stated that it will evaluate three categories of criteria "to assess the vulnerability of a nonbank financial company to financial distress." 12 C.F.R. pt. 1310, App. A, § II(d)(1). FSOC's failure to undertake that vulnerability assessment in the Final Designation of MetLife - and its persistent refusal to acknowledge its shift in position - were arbitrary and capricious.

*24 A. The District Court Correctly Concluded That FSOC Violated Its Interpretive Guidance By Refusing To Assess MetLife's Vulnerability To Material Financial Distress.

In its Final Rule and Interpretive Guidance, FSOC distilled Dodd-Frank's statutory designation criteria into six categories that are dedicated to two distinct inquiries. Specifically, "[t]hree of the six categories - size, substitutability, and interconnectedness - seek to assess the potential impact of the nonbank financial company's financial distress on the broader economy." 12 C.F.R. pt. 1310, App. A, § II(d)(1). "The remaining three categories - leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny of the nonbank financial company - seek to assess *the vulnerability*

2017 WL 1421320 (White House)

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PRESIDENTIAL MEMORANDUM FOR THE SECRETARY OF THE TREASURY
SUBJECT: FINANCIAL STABILITY OVERSIGHT COUNCIL

April 21, 2017

***1** The White House

Office of the Press Secretary

For Immediate Release

MEMORANDUM FOR THE SECRETARY OF THE TREASURY

The Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203 (the “Dodd-Frank Act”), authorizes the Financial Stability Oversight Council (FSOC) to determine that a nonbank financial company's material financial distress or the nature, scope, size, scale, concentration, interconnectedness, or mix of its activities could pose a threat to the financial stability of the United States. If the FSOC makes such a determination, the affected nonbank financial company shall be subject to supervision by the Board of Governors of the Federal Reserve System (Federal Reserve Board) and certain prudential standards. The Dodd-Frank Act similarly authorizes the FSOC to designate certain financial market utilities and financial activities as “systemically important,” and thus subject to certain risk management standards, among other things. These determinations and designations have serious implications for affected entities, the industries in which they operate, and the economy at large. Therefore, it is important to ensure that these processes for making determinations and designations promote market discipline and reduce systemic risk. It is equally important to ensure that, once notified by FSOC that it is under review, any entity under consideration for a determination or designation decision is afforded due, fair, and appropriately transparent process.

Accordingly, by the authority vested in me as President by the Constitution and the laws of the United States of America, and to promote certainty in the financial markets, I hereby direct the Secretary of the Treasury (Secretary) to take the following actions:

Section 1. Report on FSOC Processes. The Secretary shall conduct a thorough review of the FSOC determination and designation processes under section 113 (12 U.S.C. 5323) and section 804 (12 U.S.C. 5463) of the Dodd-Frank Act and provide a written report to the President within 180 days of the date of this memorandum. As part of this review, and along with any other considerations that the Secretary deems appropriate, the Secretary shall consider the following:

(a) whether these processes are sufficiently transparent;

(b) whether these processes provide entities with adequate due process;

(c) whether these processes give market participants the expectation that the Federal Government will shield supervised or designated entities from bankruptcy;

(d) whether evaluation of a nonbank financial company's vulnerability to material financial distress, under 12 CFR 1310 App. A.II.d.1, should assess the likelihood of such distress;

***2** (e) whether any determination as to whether a nonbank financial company's material financial distress could threaten the financial stability of the United States, under 12 CFR 1310 App. A.II.a, should include specific, quantifiable projections of the damage that could be caused to the United States economy, including a specific quantification of estimated losses that would be likely if the company is not subjected to supervision under section 113;

(f) whether these processes adequately consider the costs of any determination or designation on the regulated entity;

(g) whether entities subject to an FSOC determination under section 113 or designation under section 804 are provided a meaningful opportunity to have their determinations or designations reevaluated in a timely and appropriately transparent manner; and

(h) whether, prior to being subject to an FSOC determination under section 113 or designation under section 804, the entity should be provided with information on how to reduce perceived risk, so as to avoid being subject to such determination or designation.

As part of this review, the Secretary shall include in the required report: the Secretary's conclusions regarding the issues enumerated above; recommendations, as appropriate, on how the FSOC processes for determinations under section 113 and designations under section 804 could be improved; and recommendations for any legislative changes necessary to improve these processes.

Sec. 2. Evaluation and Review of the FSOC. The Secretary shall also evaluate and report to the President on whether the activities of the FSOC related to the determination and designation processes under section 113 and section 804, respectively, are consistent with Executive Order 13772 of February 3, 2017 (Core Principles for Regulating the United States Financial System). In the report, the Secretary should provide, if appropriate, recommendations for legislation or regulations that would ensure that the FSOC and its activities are consistent with the principles set forth in Executive Order 13772.

Sec. 3. Temporary Pause of Determinations and Designations. Pending the completion of this review and submission of the Secretary's recommendations, the Secretary shall, to the extent consistent with law, not vote for any non emergency proposed determinations under 12 CFR 1310.10(b) or any non-emergency proposed designations under 12 CFR 1320.13(c).

Sec. 4. General Provisions. (a) Nothing in this memorandum shall be construed to impair or otherwise affect:

(i) the authority granted by law to an executive department or agency, or the head thereof; or

(ii) the functions of the Director of the Office of Management and Budget relating to budgetary, administrative, or legislative proposals.

***3** (b) This memorandum shall be implemented consistent with applicable law and subject to the availability of appropriations.

(c) This memorandum is not intended to, and does not, create any right or benefit, substantive or procedural, enforceable at law or in equity by any party against the United States, its departments, agencies, or entities, its officers, employees, or agents, or any other person.

DONALD J. TRUMP

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WORLD RECOGNITION OF DISTINGUISHED GENERAL COUNSEL: HONORING RICARDO ANZALDUA & THE LAW DEPARTMENT OF METLIFE

Keith Willner
Partner
KWillner@mayerbrown.com

Tuesday, July 18, 2017

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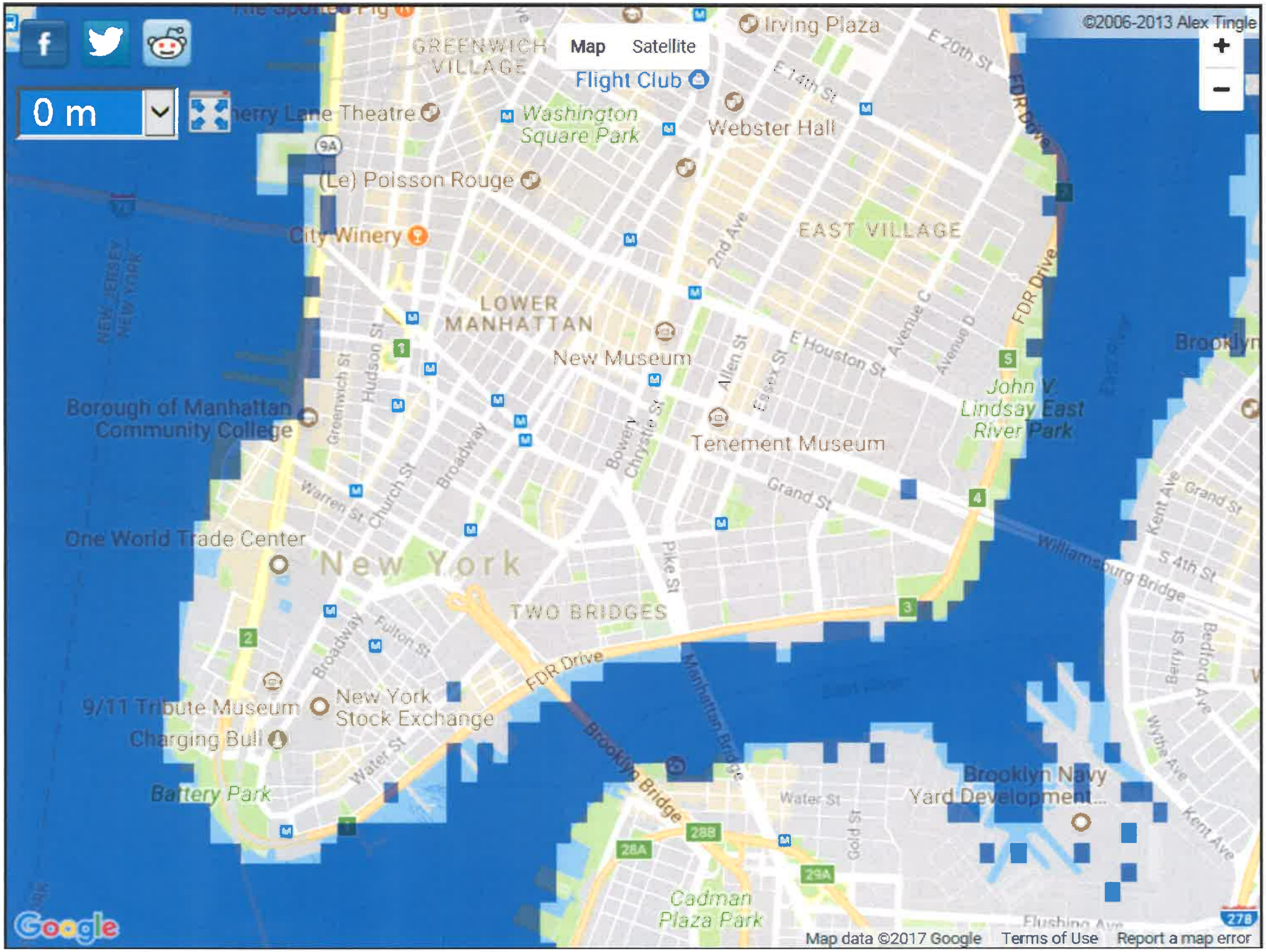

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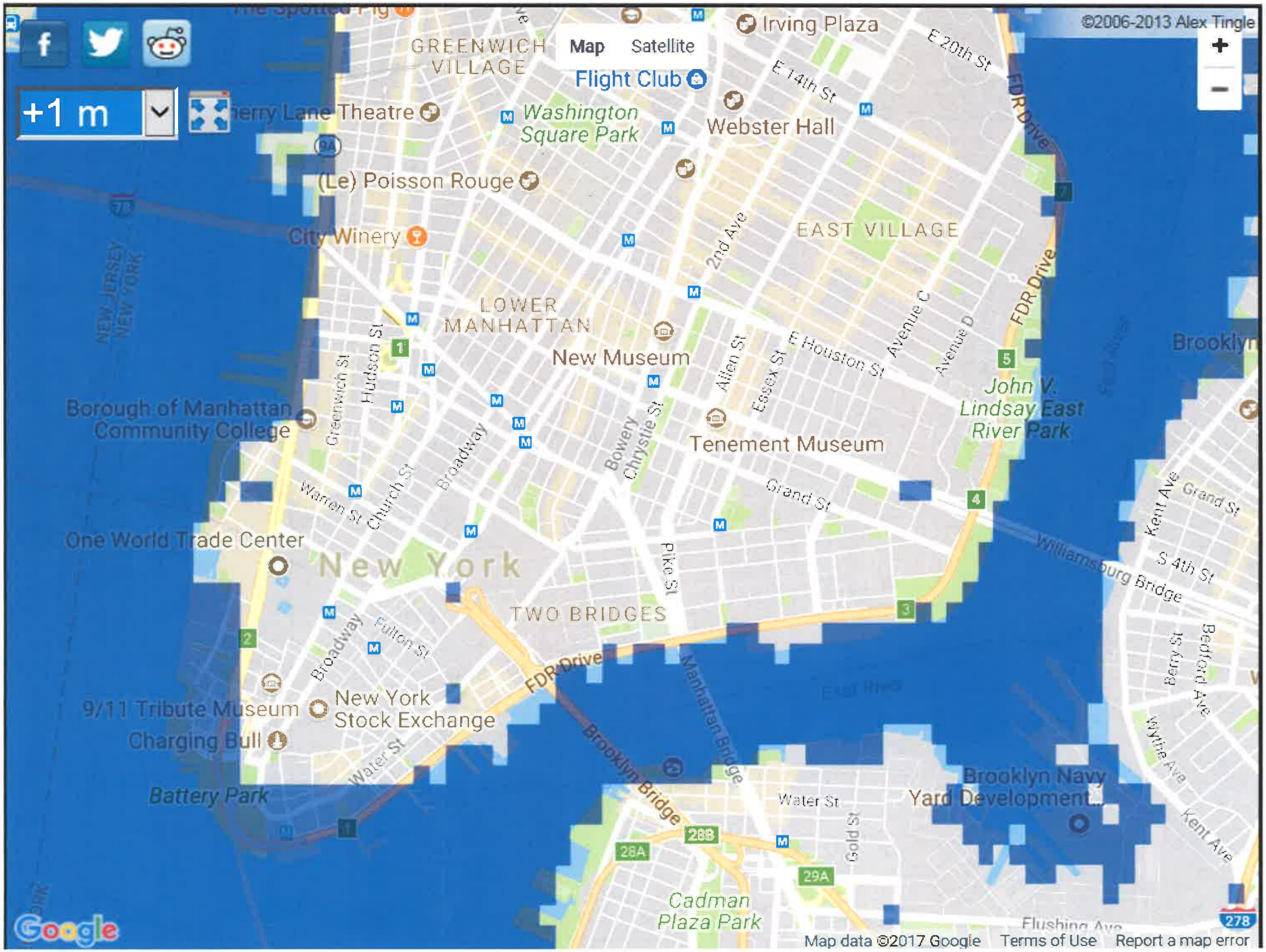

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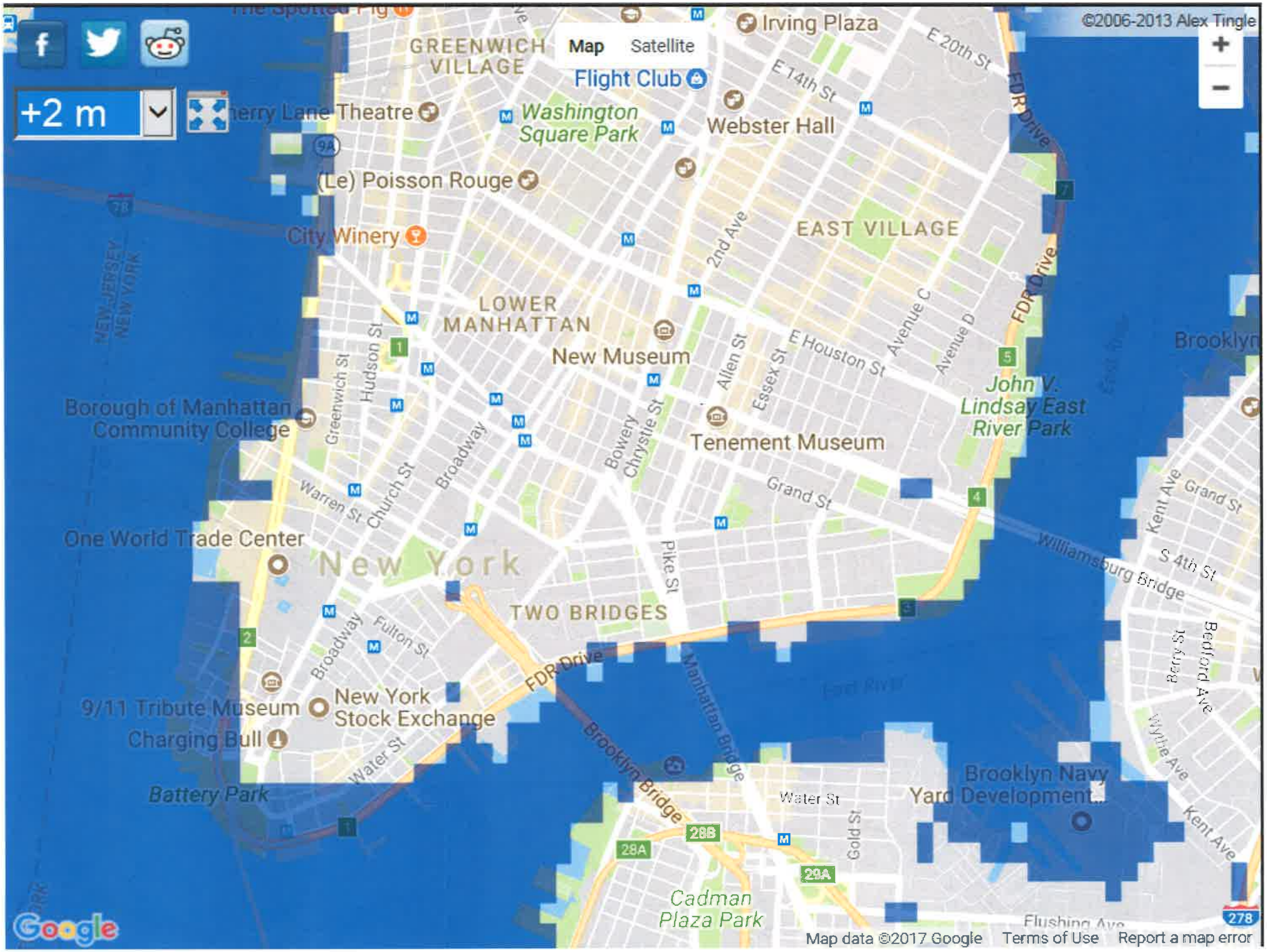
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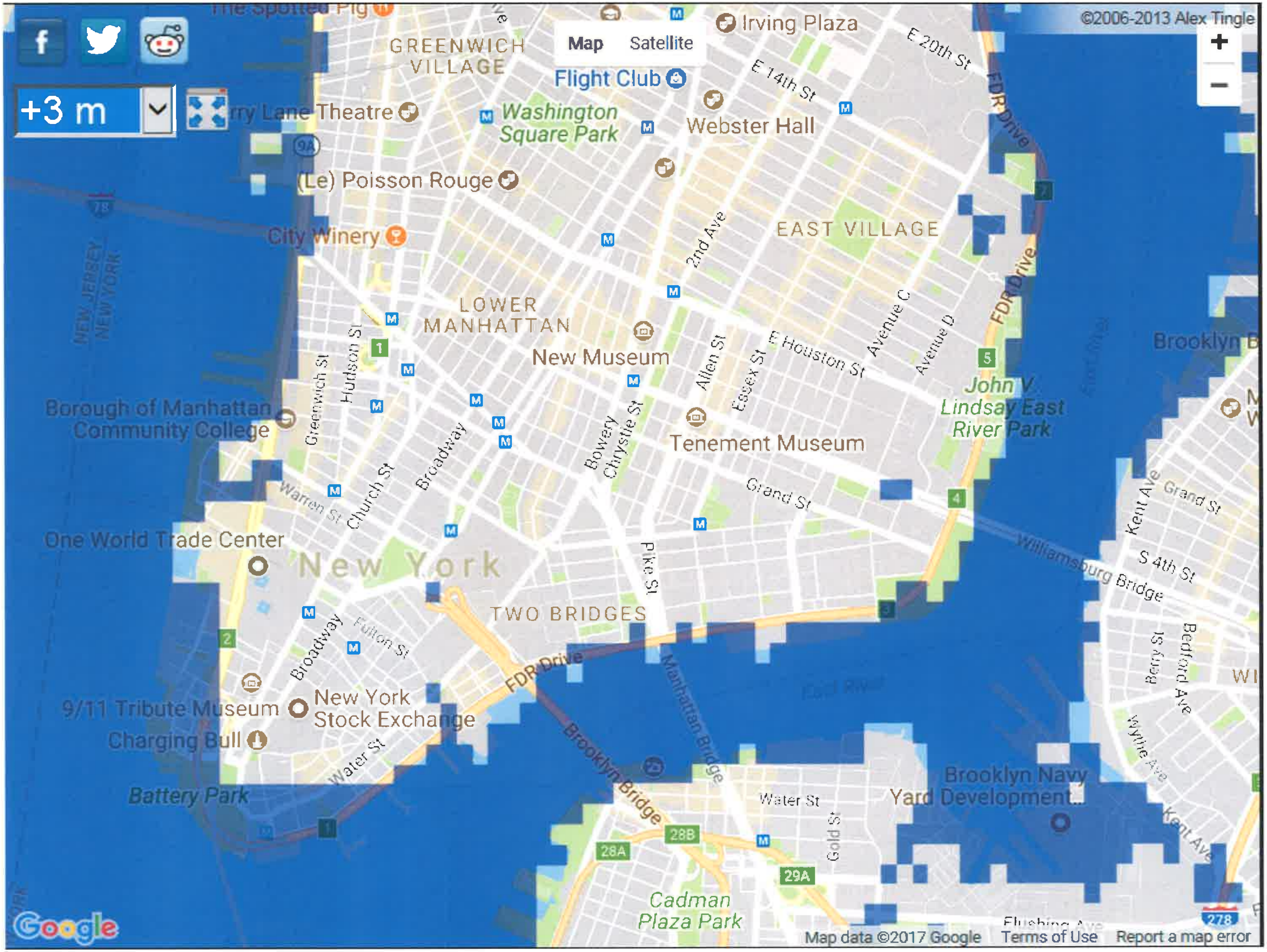

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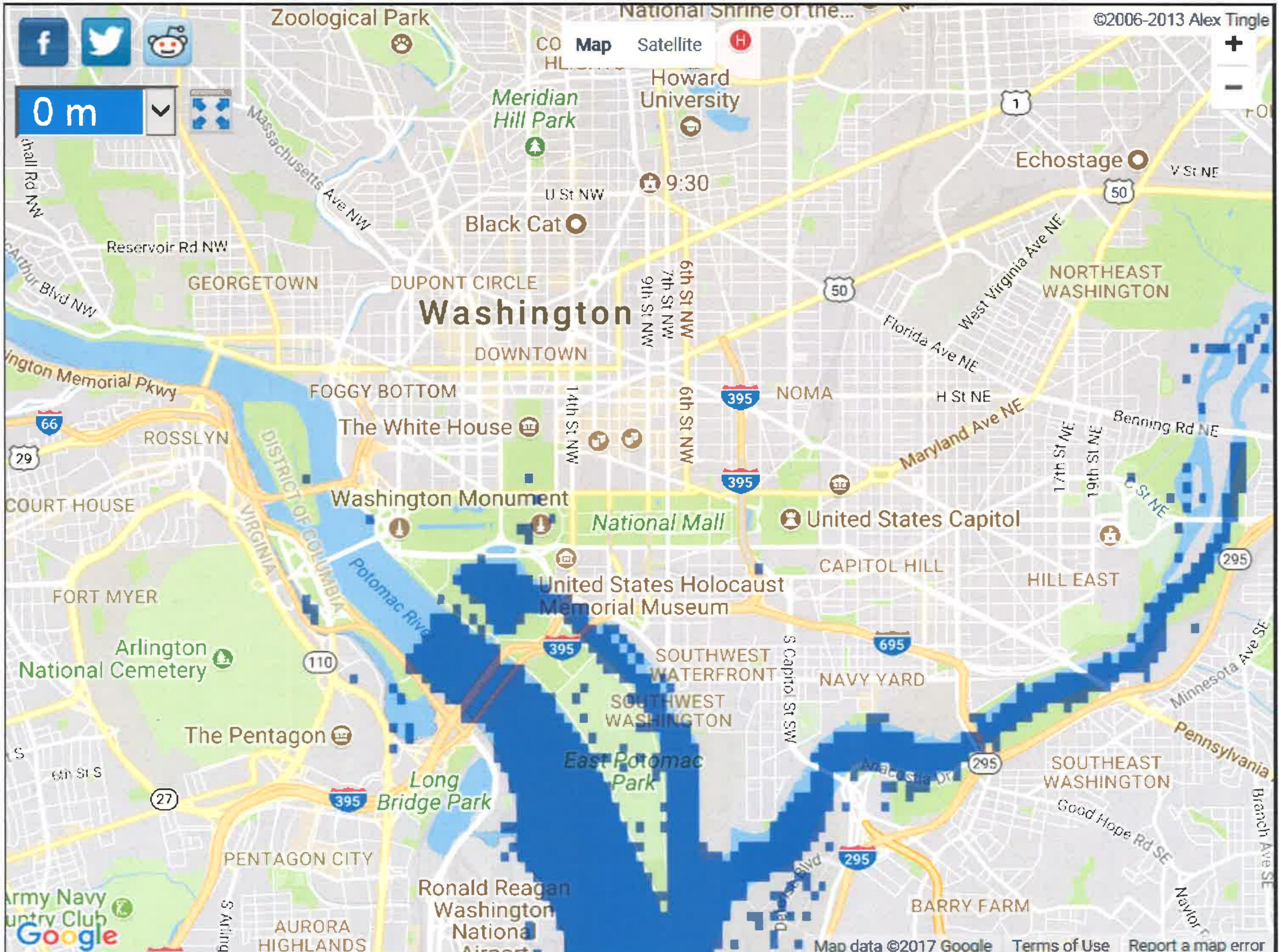

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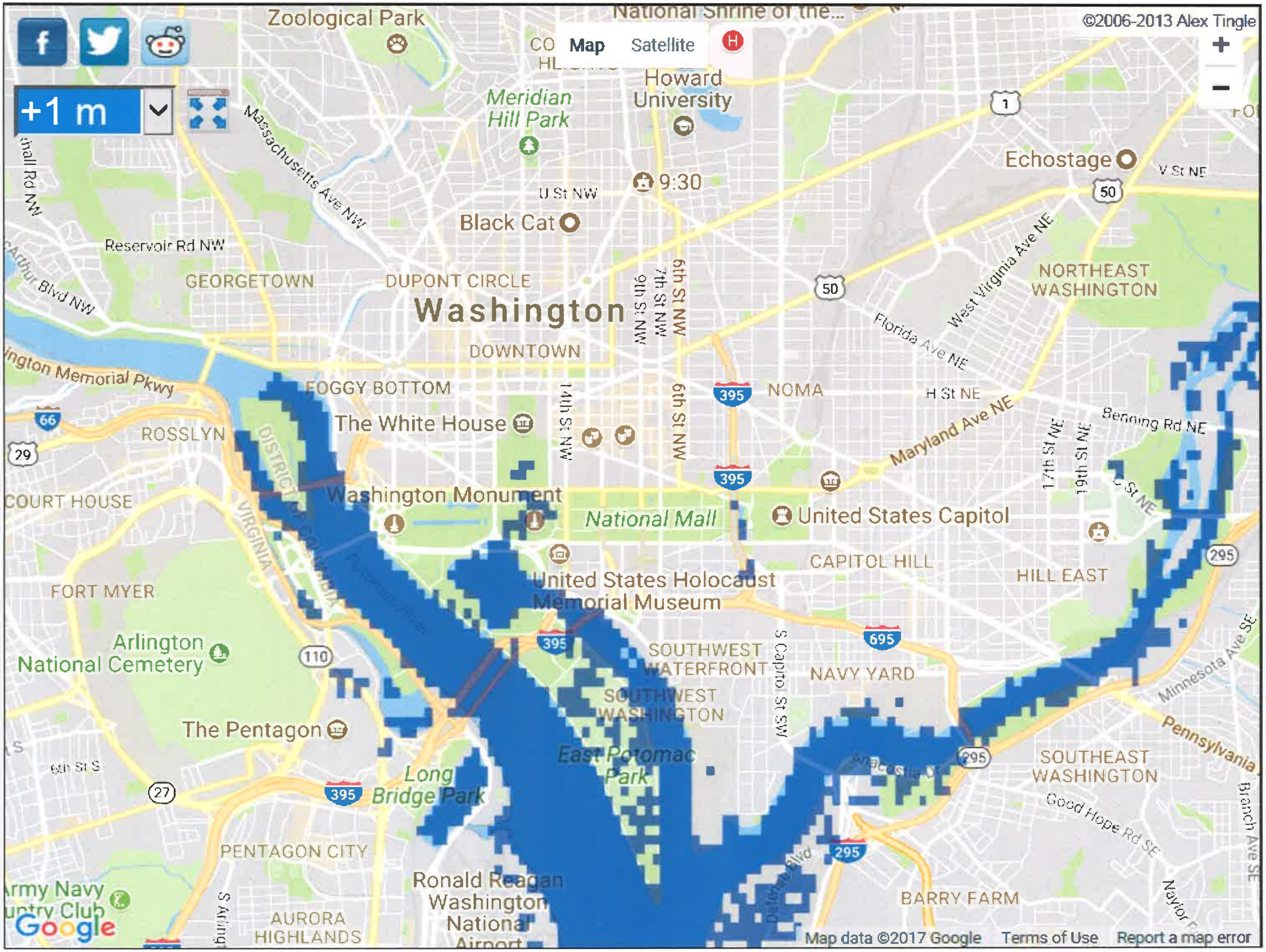

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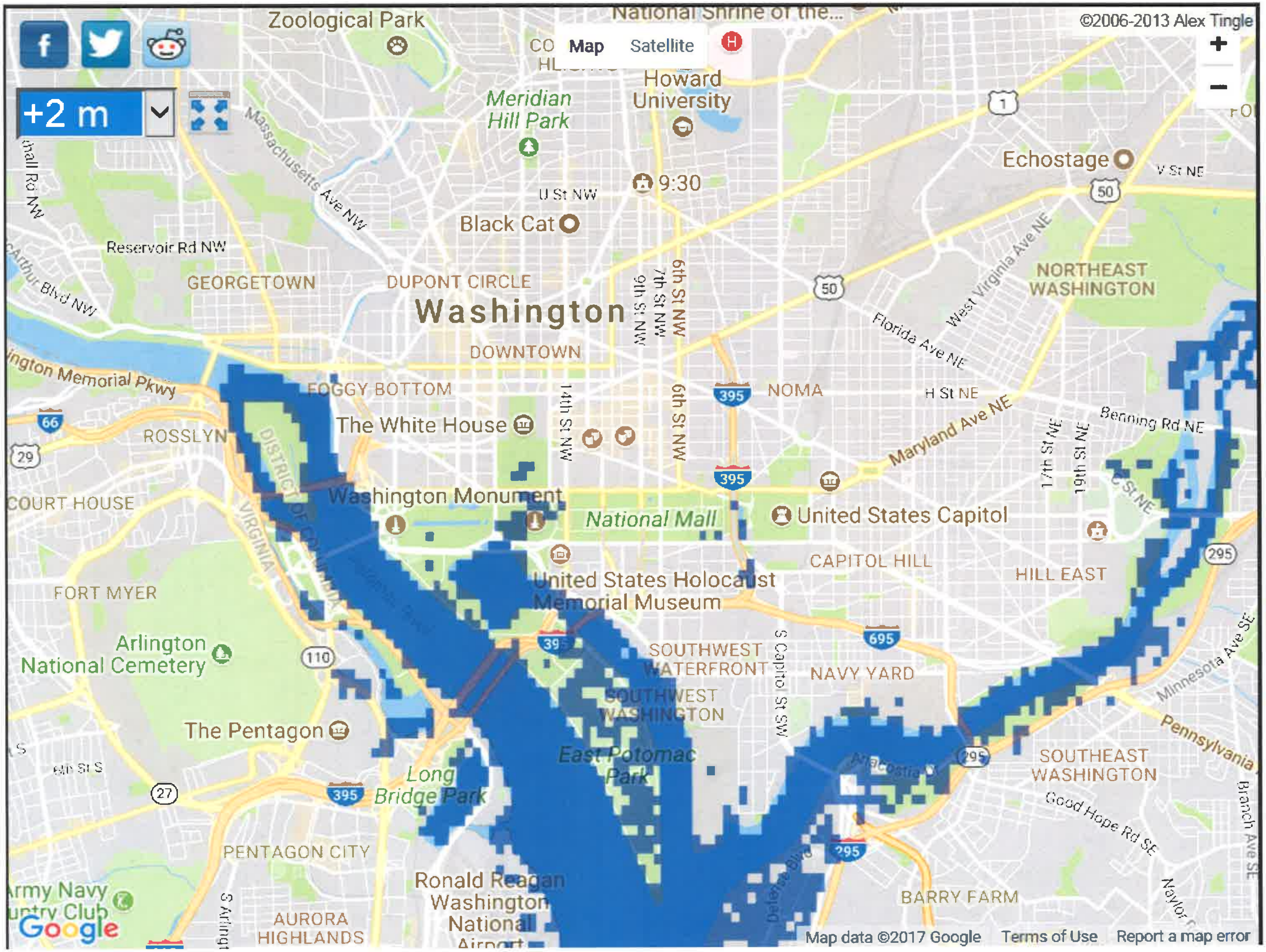

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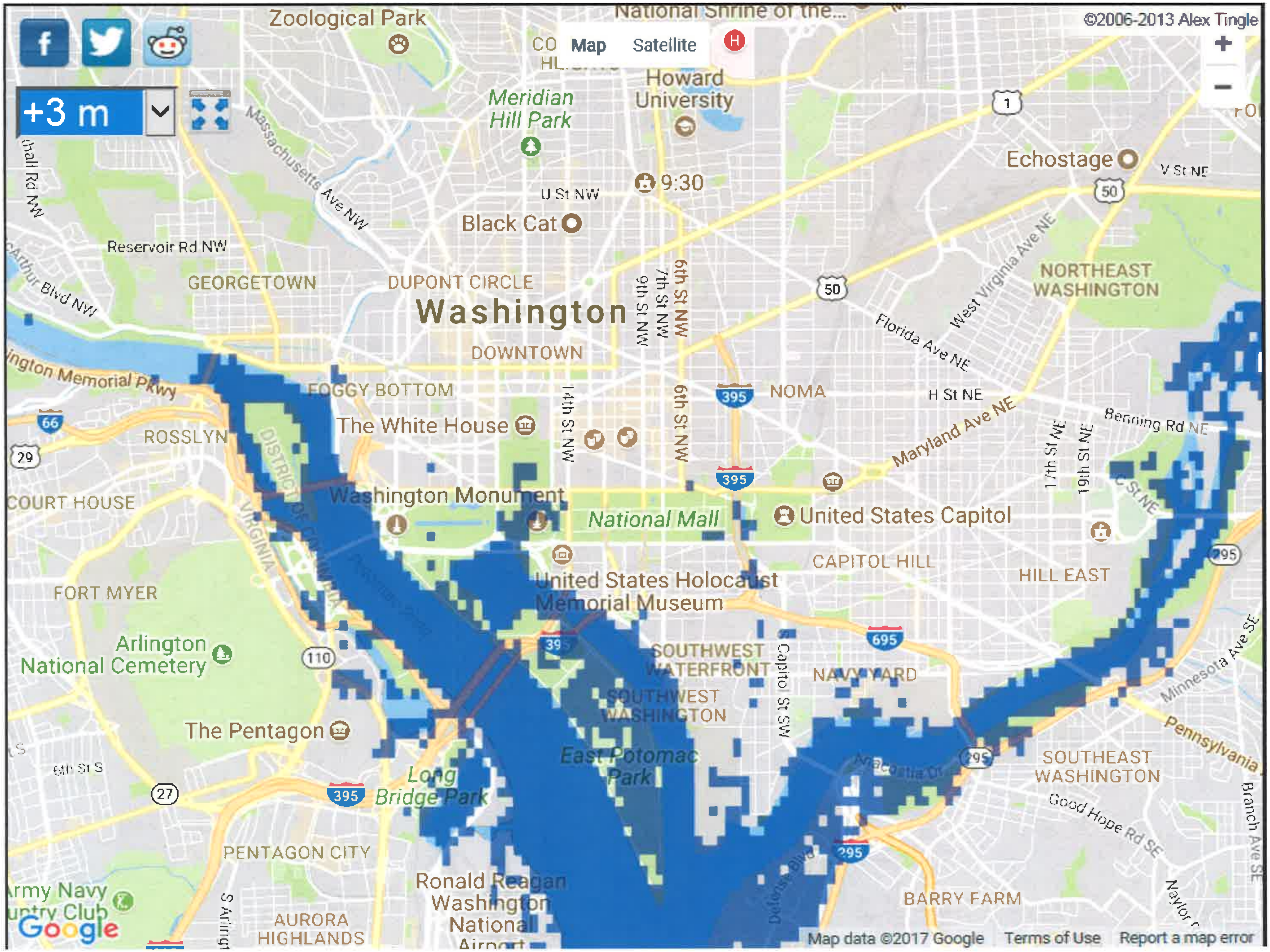

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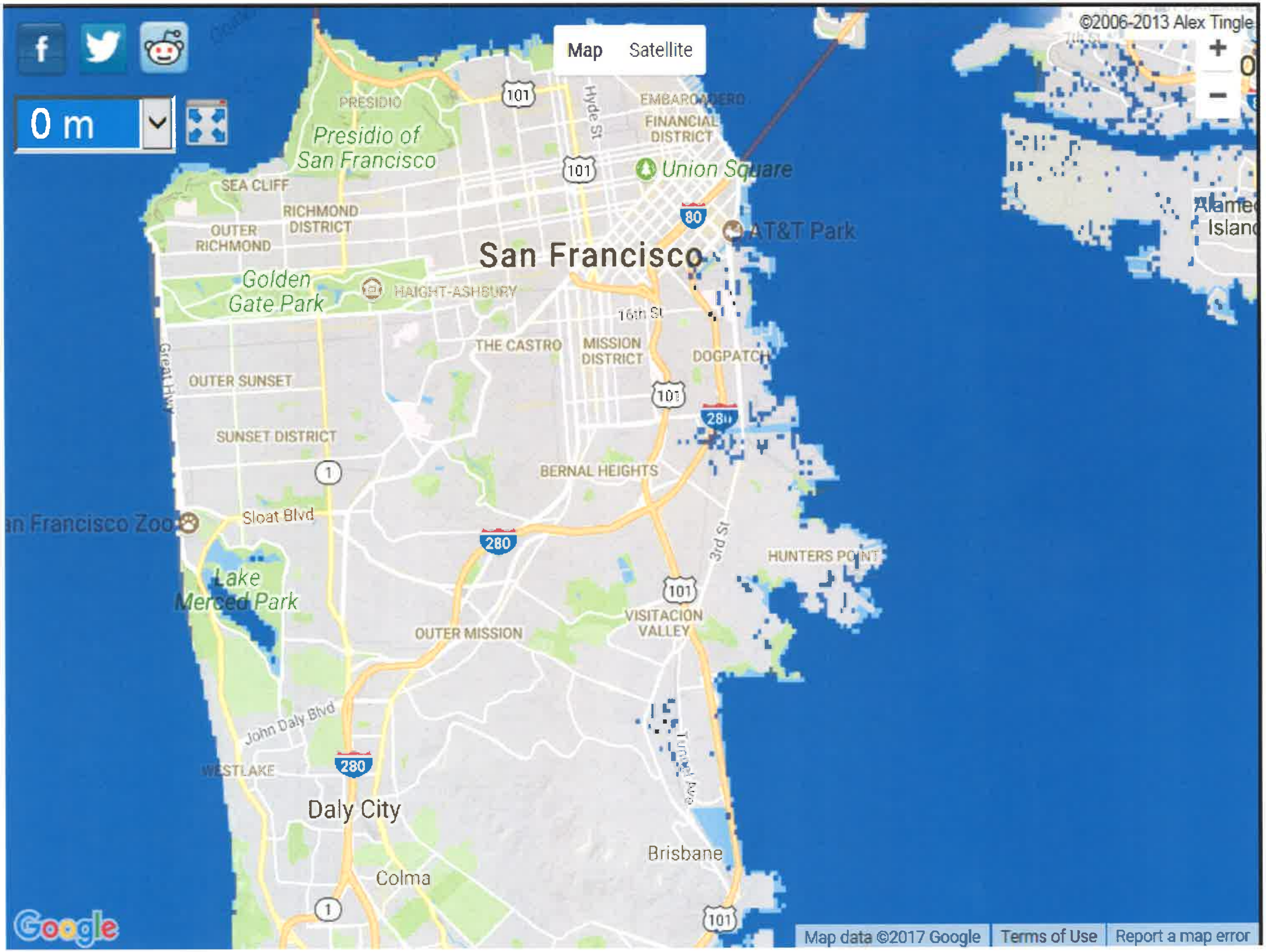

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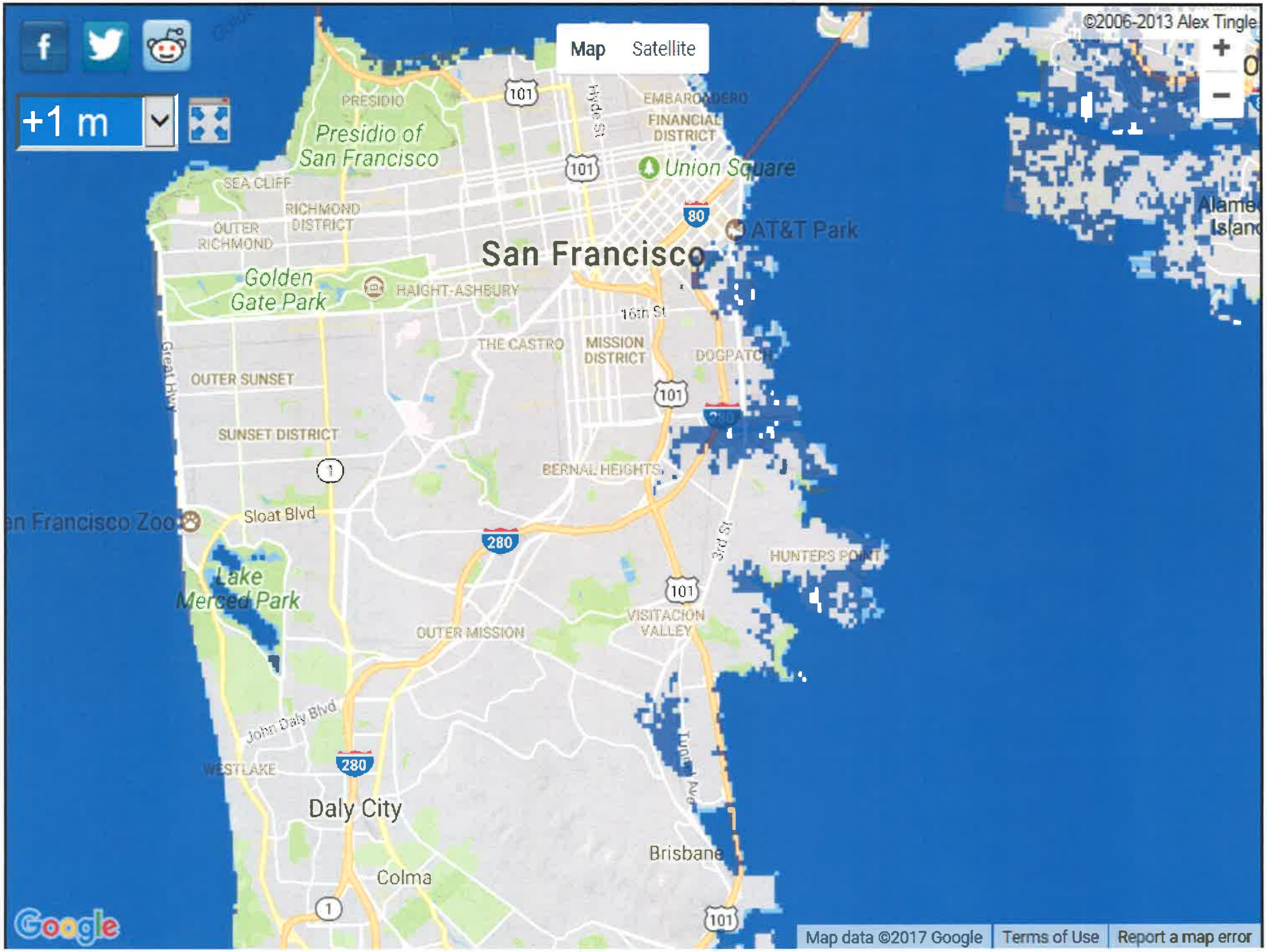

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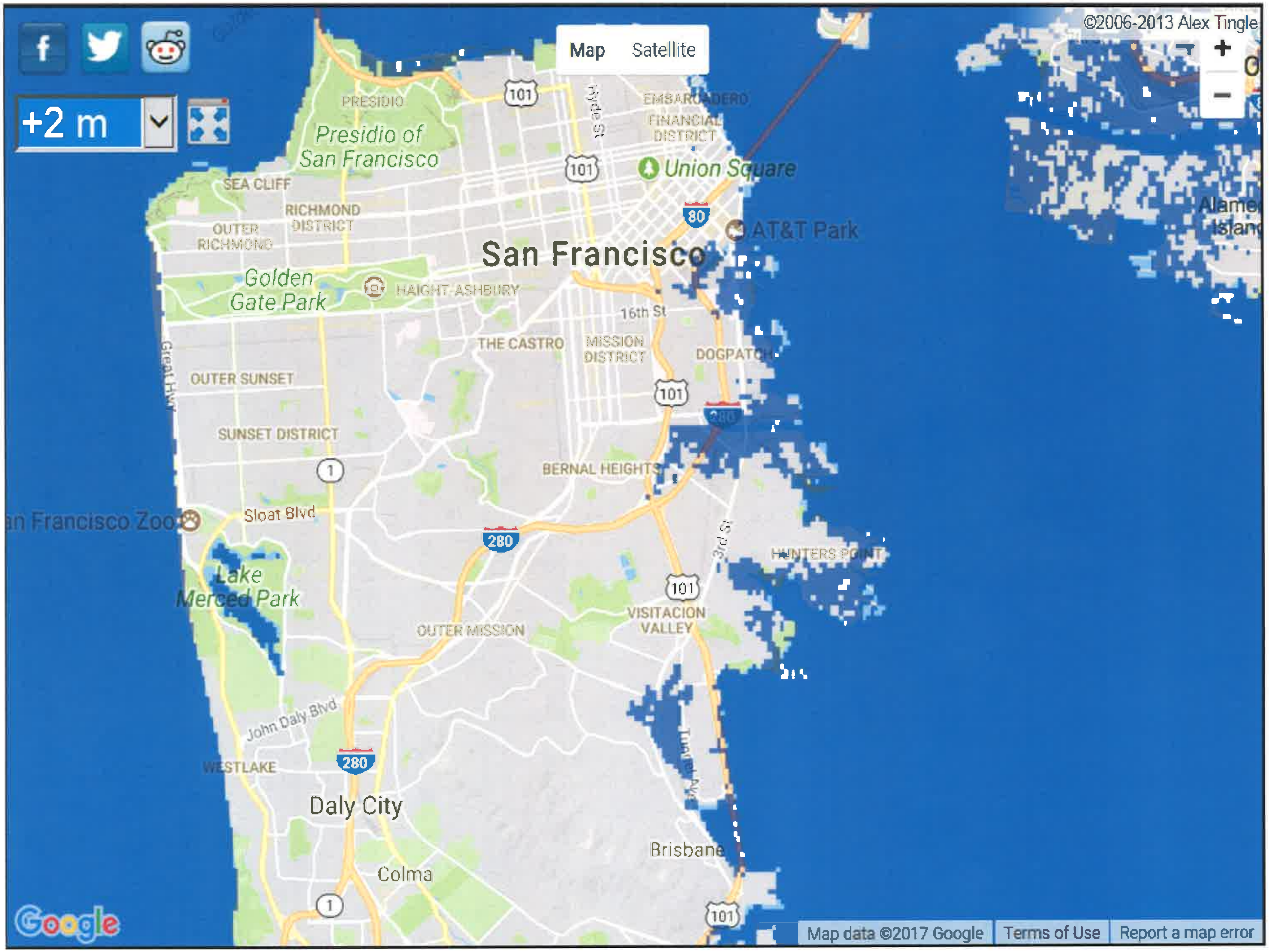

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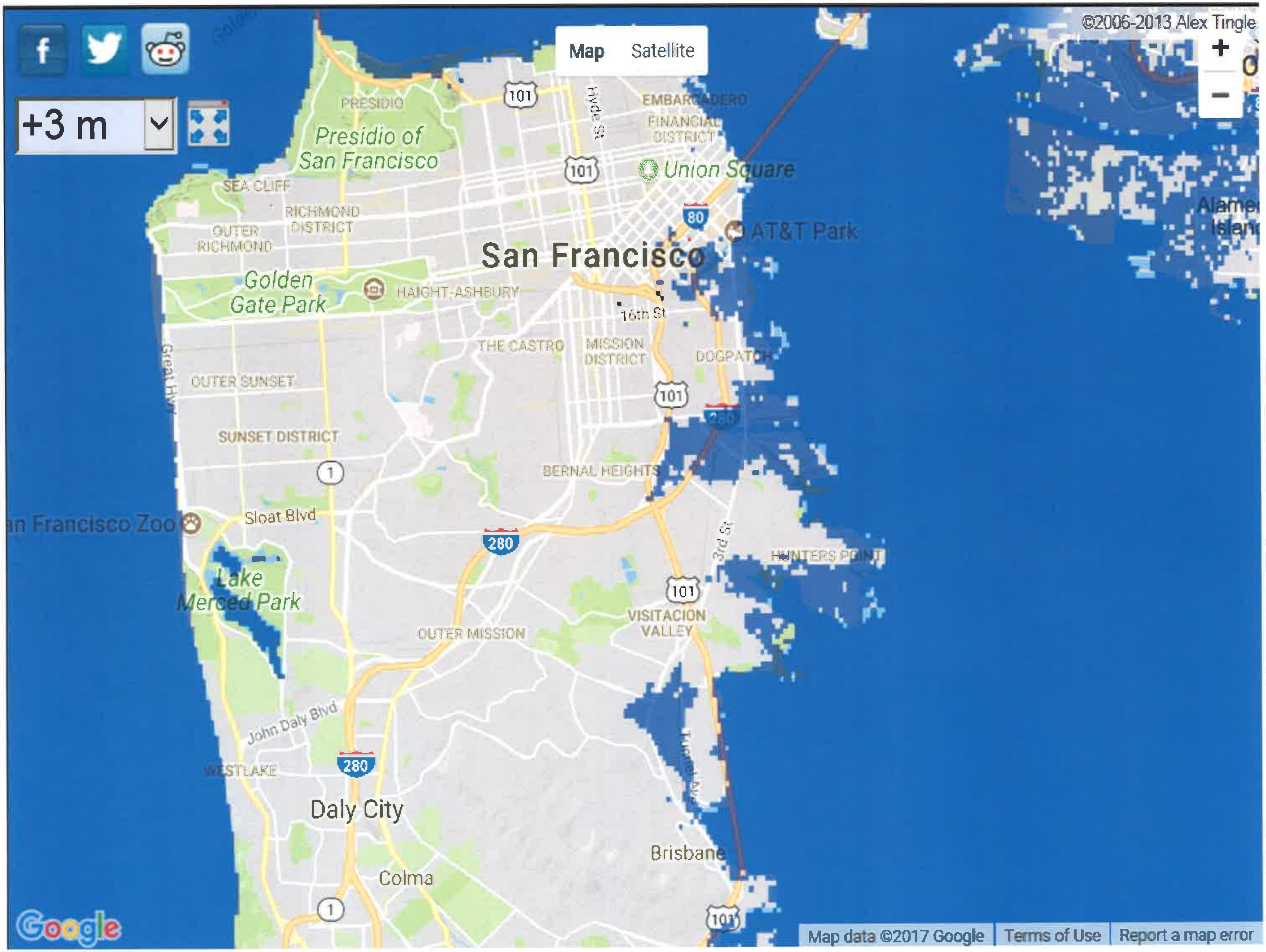

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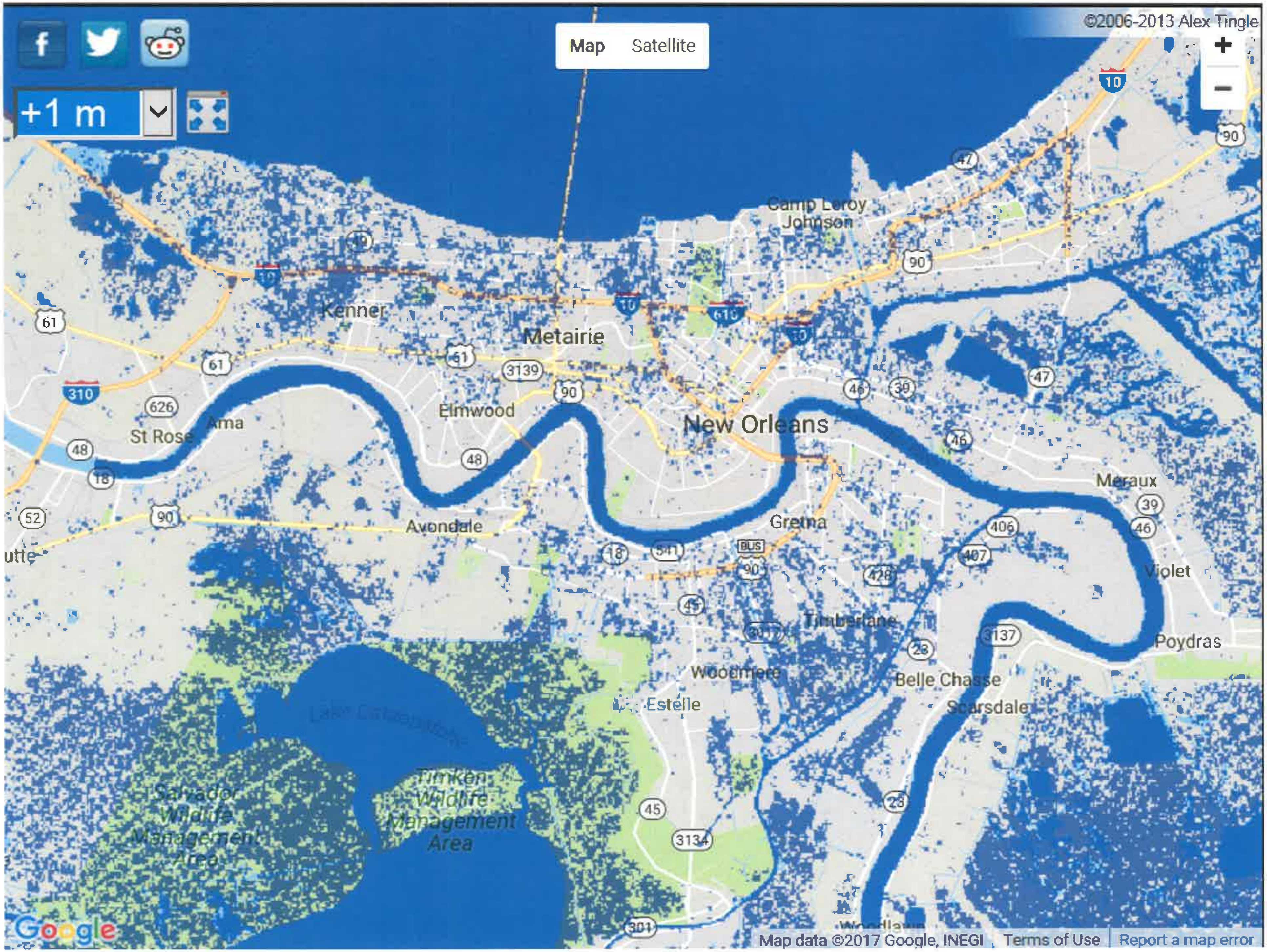

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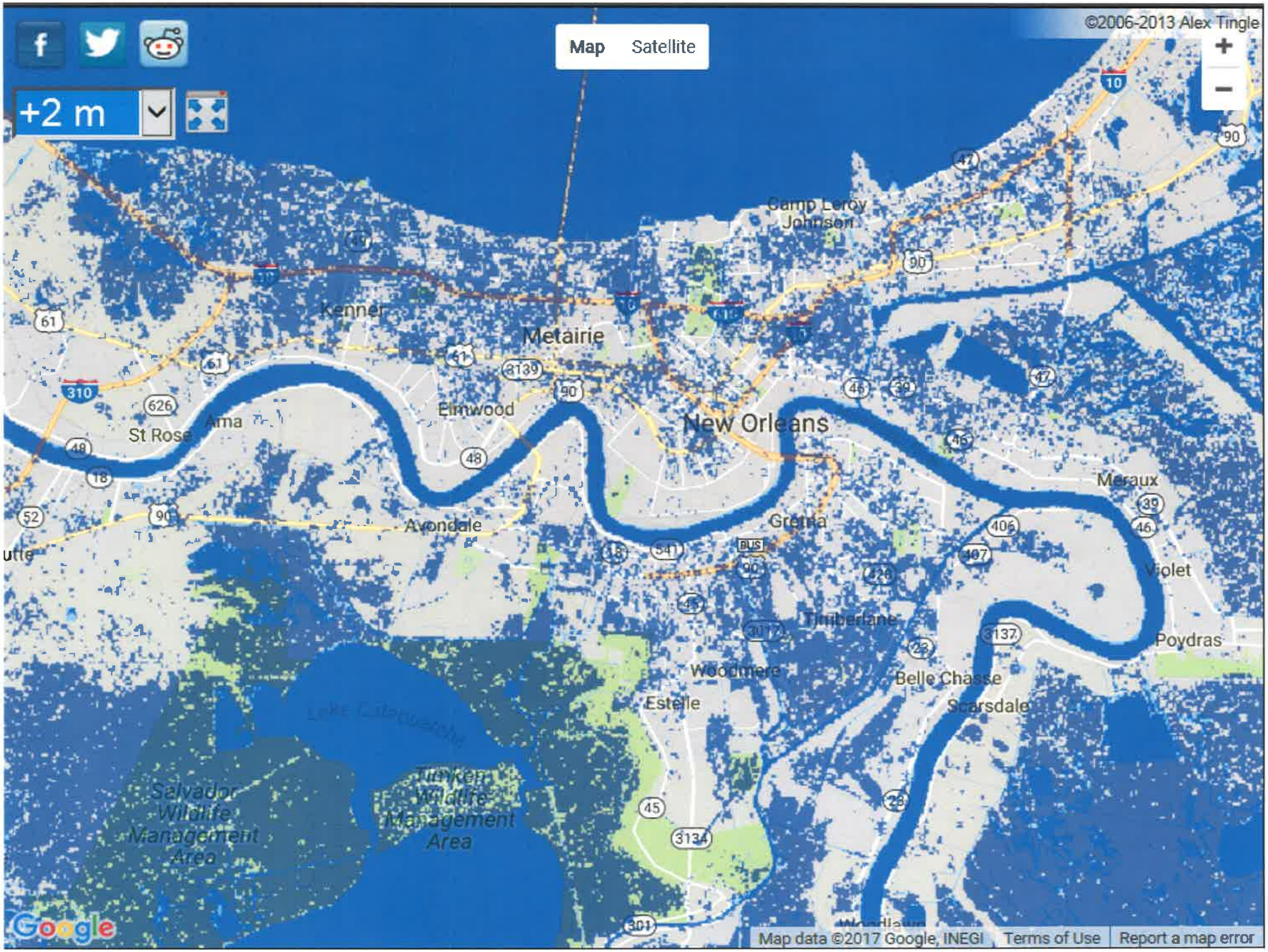
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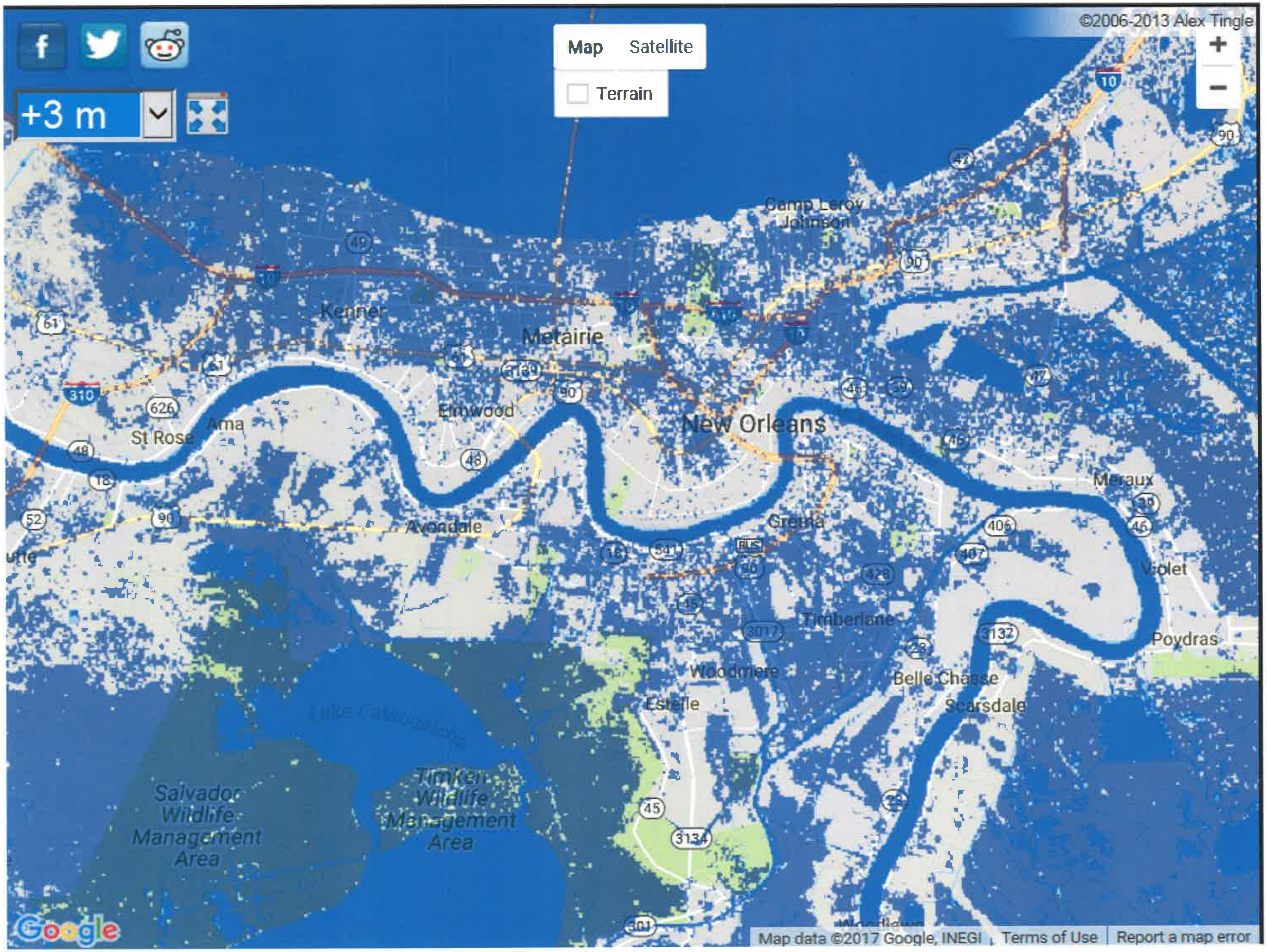

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Greenhouse Gas Emission Mitigation Scenarios and Implications

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Box 2.5. IPCC SRES Scenario Terminology (Source: Nakicenovic *et al.*, 2000)

Model: a formal representation of a system that allows quantification of relevant system variables.
Storyline: a narrative description of a scenario (or a family of scenarios) highlighting the main scenario characteristics, relationships between key driving forces, and the dynamics of the scenarios.
Scenario: a description of a potential future, based on a clear logic and a quantified storyline.
Family: scenarios that have a similar demographic, societal, economic, and technical-change storyline. Four scenario families comprise the SRES: A1, A2, B1, and B2.
Group: scenarios within a family that reflect a variation of the storyline. The A1 scenario family includes three groups designated by A1T, A1FI, and A1B that explore alternative structures of future energy systems. The other three scenario families consist of one group each.
Category: scenarios are grouped into four categories of cumulative CO_2 emissions between 1990 and 2100: low, medium–low, medium–high, and high emissions. Each category contains scenarios with a range of different driving forces yet similar cumulative emissions.
Marker: a scenario that was originally posted on the SRES website to represent a given scenario family. A marker is not necessarily the median or mean scenario.
Illustrative: a scenario that is illustrative for each of the six scenario groups reflected in the Summary for Policymakers of this report. They include four revised "scenario markers" for the scenario groups A1B, A2, B1, and B2, and two additional illustrative scenarios for the A1FI and AIT groups. See also "(Scenario) Groups" and "(Scenario) Markers".
Harmonized: harmonized scenarios within a family share common assumptions for global population and GDP while fully harmonized scenarios are within 5% of the population projections specified for the respective marker scenario, within 10% of the GDP and within 10% of the marker scenario's final energy consumption.
Standardized: emissions for 1990 and 2000 are indexed to have the same values.
Other scenarios: scenarios that are not harmonized.

which should be considered equally sound, were chosen to illustrate the whole set of scenarios. They span a wide range of uncertainty, as required by the SRES Terms of Reference. These encompass four combinations of demographic change, social and economic development, and broad technological developments, corresponding to the four families (A1, A2, B1, B2), each with an illustrative "marker" scenario. Two of the scenario groups of the A1 family (A1FI, A1T) explicitly explore energy technology developments, alternative to the "balanced" A1B group, holding the other driving forces constant, each with an illustrative scenario. Rapid growth leads to high capital turnover rates, which means that early small differences among scenarios can lead to a large divergence by 2100. Therefore, the A1 family, which has the highest rates of technological change and economic development, was selected to show this effect.

To provide a scientific foundation for the scenarios, the writing team extensively reviewed and evaluated over 400 published scenarios. Results of the review were published in the scientific literature (Alcamo and Nakicenovic, 1998), and made available to the scientific community in the form of an Internet scenario database. The background research by the six modelling teams for developing the 40 scenarios was also published in the scientific literature (Nakicenovic, 2000).

2.5.1.3 A Short Description of the SRES Scenarios

Since there is no agreement on how the future will unfold, the SRES tried to sharpen the view of alternatives by assuming that individual scenarios have diverging tendencies — one emphasizes stronger economic values, the other stronger environmental values; one assumes increasing globalization, the other increasing regionalization. Combining these choices yielded four different scenario families (*Figure 2.11*). This two-dimensional representation of the main SRES scenario characteristics is an oversimplification. It is shown just as an illustration. In fact, to be accurate, the space would need to be multi-dimensional, listing other scenario developments in many different social, economic, technological, environmental, and policy dimensions.

The titles of the four scenario storylines and families have been kept simple: A1, A2, B1, and B2. There is no particular order among the storylines; they are listed in alphabetical and numerical order:

- The A1 storyline and scenario family describes a future world of very rapid economic growth, global population that peaks in mid-century and declines thereafter, and the rapid introduction of new and more efficient technologies. Major underlying themes are convergence among regions, capacity building, and increased cultural and social interactions, with a substantial reduction in regional differences in per capita income. The A1 scenario family develops into three groups that describe alternative directions of technological change in the energy system. The three A1 groups are distinguished by their technological emphasis: fossil intensive (A1FI), non-fossil energy sources (A1T), or a balance across all sources (A1B).[12]
- The A2 storyline and scenario family describes a very heterogeneous world. The underlying theme is self-

[12] Balanced is defined as not relying too heavily on one particular energy source, on the assumption that similar improvement rates apply to all energy supply and end-use technologies.

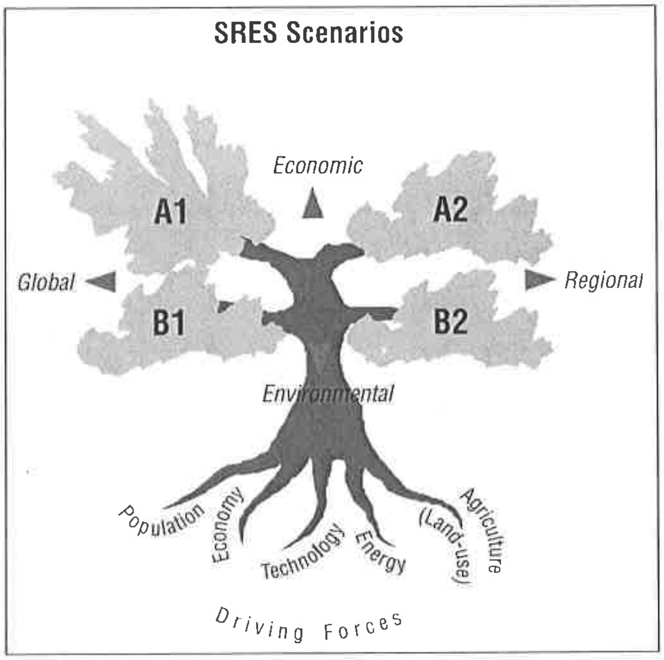

***Figure 2.11.** Schematic illustration of SRES scenarios. The four scenario "families" are shown, very simplistically, for illustrative purposes, as branches of a two-dimensional tree. The two dimensions shown indicate global and regional scenario orientation, and development and environmental orientation, respectively. In reality, the four scenarios share a space of a much higher dimensionality given the numerous driving forces and other assumptions needed to define any given scenario in a particular modelling approach. The schematic diagram illustrates that the scenarios build on the main driving forces of GHG emissions. Each scenario family is based on a common specification of some of the main driving forces.*

reliance and preservation of local identities. Fertility patterns across regions converge very slowly, which results in continuously increasing global population. Economic development is primarily regionally oriented and per capita economic growth and technological change are more fragmented and slower than in other storylines.

- The B1 storyline and scenario family describes a convergent world with the same global population that peaks in mid-century and declines thereafter, as in the A1 storyline, but with rapid changes in economic structures towards a service and information economy, with reductions in material intensity, and the introduction of clean and resource-efficient technologies. The emphasis is on global solutions to economic, social, and environmental sustainability, including improved equity, but without additional climate initiatives.
- The B2 storyline and scenario family describes a world in which the emphasis is on local solutions to economic, social, and environmental sustainability. It is a world with a continuously increasing global population at a rate lower than in A2, intermediate levels of economic development, and less rapid and more diverse technological change than in the B1 and A1 storylines. While the scenario is also oriented towards environmental protection and social equity, it focuses on local and regional levels.

In all, six models were used to generate the 40 scenarios that comprise the four scenario families. They are listed in *Table 2.5*. These six models are representative of emissions scenario modelling approaches and different integrated assessment frameworks in the literature, and include so-called top-down and bottom-up models.

***Table 2.5:** Models used to generate the SRES scenarios*

Model	Source	Reference
Asian Pacific Integrated Model (AIM)	National Institute of Environmental Studies in Japan	Morita *et al.*, 1994 Kainuma *et al.*, 1998, 1999a, 1999b
Atmospheric Stabilization Framework Model (ASF)	ICF Consulting in the USA	EPA 1990; Pepper *et al.*, 1992
Integrated Model to Assess the Greenhouse Effect (IMAGE), used in connection with the WorldScan model	IMAGE: RIVM and WorldScan: CPB (Central Planning Bureau), The Netherlands	IMAGE: Alcamo 1994; Alcamo *et al.*,1998; de Vries *et al.*, 1999 WorldScan: CPB Netherlands, 1999
Multiregional Approach for Resource and Industry Allocation (MARIA)	Science University of Tokyo in Japan	Mori and Takahashi, 1998
Model for Energy Supply Strategy Alternatives and their General Environmental Impact (MESSAGE)	IIASA in Austria	Messner *et al.*, 1996; Riahi and Roehrl, 2000
The Mini Climate Assessment Model (MiniCAM)	PNNL in the USA	Edmonds *et al.*, 1996

2.5.1.4 Emissions and Other Results of the SRES Scenarios

Figure 2.12 illustrates the range of global energy-related and industrial CO_2 emissions for the 40 SRES scenarios against the background of all the 400 emissions scenarios from the literature documented in the SRES scenario database. The six scenario groups are represented by the six illustrative scenarios. *Figure 2.12* also shows a range of emissions of the six scenario groups next to each of the six illustrative scenarios.

Figure 2.12 shows that the four marker and two illustrative scenarios by themselves cover a large portion of the overall scenario distribution. This is one of the reasons that the SRES Writing Team recommended the use of all four marker and two illustrative scenarios in future assessments. Together, they cover most of the uncertainty of future emissions, both with respect to the scenarios in the literature and the full SRES scenario set. *Figure 2.12* also shows that they are not necessarily close to the median of the scenario family because of the nature of the selection process. For example, A2 and B1 are at the upper and lower bounds of their scenario families, respectively. The range of global energy-related and industrial CO_2 emissions for the six illustrative SRES scenarios is generally somewhat lower than the range of the IPCC IS92 scenarios (Leggett *et al.*, 1992; Pepper *et al.*, 1992). Adding the other 36 SRES scenarios increases the covered emissions range. Jointly, the SRES scenarios cover the relevant range of global emissions, from the 95th percentile at the high end of the distribution all the way down to very low emissions just above the 5th percentile of the distribution. Thus, they only exclude the most extreme emissions scenarios found in the literature – those situated out in the tails of the distribution. What is perhaps more important is that each of the four scenario families covers a sizable part of this distribution, implying that a similar quantification of driving forces can lead to a wide range of future emissions. More specifically, a given combination of the main driving forces is not sufficient to uniquely determine a future emission path. There are too many uncertainties. The fact that each of the scenario families covers a substantial part of the literature range also leads to an overlap in the emissions ranges of the four families. This implies that a given level of future emissions can arise from very different combinations of dri-

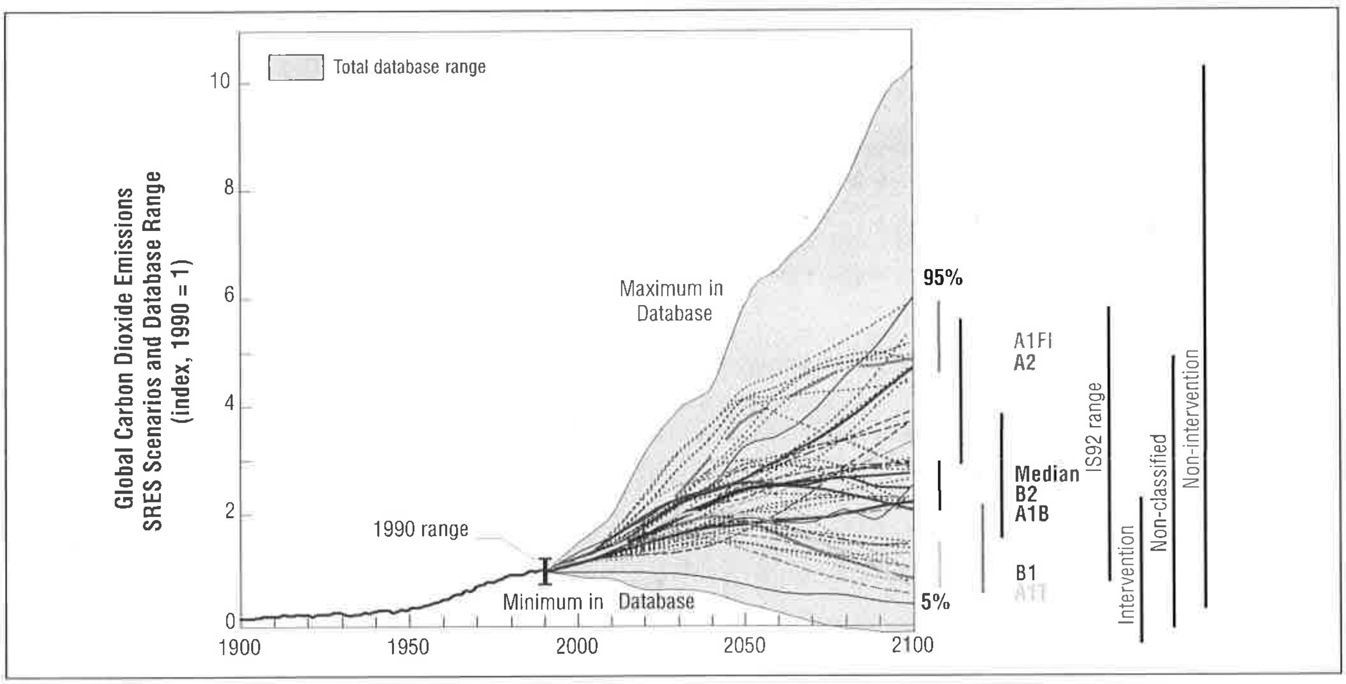

***Figure 2.12:** Global CO_2 emissions from energy and industry, historical development from 1900 to 1990 and in 40 SRES scenarios from 1990 to 2100, shown as an index (1990 = 1). The range is large in the base year 1990, as indicated by an "error" bar, but is excluded from the indexed future emissions paths. The dashed time-paths depict individual SRES scenarios and the blue shaded area the range of scenarios from the literature (as documented in the SRES database). The median (50th), 5th, and 95th percentiles of the frequency distribution are shown. The statistics associated with the distribution of scenarios do not imply probability of occurrence (e.g., the frequency distribution of the scenarios in the literature may be influenced by the use of IS92a as a reference for many subsequent studies). The 40 SRES scenarios are classified into six groups. Jointly the scenarios span most of the range of the scenarios in the literature. The emissions profiles are dynamic, ranging from continuous increases to those that curve through a maximum and then decline. The coloured vertical bars indicate the range of the four SRES scenario families in 2100. Also shown as vertical bars on the right are the ranges of emissions in 2100 of IS92 scenarios, and of scenarios from the literature that apparently include additional climate initiatives (designated as "intervention" scenarios emissions range), those that do not ("non-intervention"), and those that cannot be assigned to either of these two categories ("non-classified").*

ving forces. This result is of fundamental importance for assessments of climate change impacts and possible mitigation and adaptation strategies.

An important feature of the SRES scenarios obtained using the SAR methodology is that their overall radiative forcing is higher than the IS92 range despite comparatively lower GHG emissions (Wigley and Raper, 1992; Wigley *et al.*, 1994; Houghton *et al.*, 1996; Wigley, 1999; Smith *et al.*, 2000; IPCC, 2001). This results from the loss of sulphur-induced cooling during the second half of the 21st century. On one hand, the reduction in global sulphur emissions reduces the role of sulphate aerosols in determining future climate, and therefore reduces one aspect of uncertainty about future climate change (because the precise forcing effect of sulphate aerosols is highly uncertain). On the other hand, uncertainty increases because of the diversity in spatial patterns of SO_2 emissions in the scenarios. Future assessments of possible climate change need to account for these different spatial and temporal dynamics of GHG and sulphur emissions, and they need to cover the whole range of radiative forcing associated with the scenarios.

In summary, the SRES scenarios lead to the following findings:

- Alternative combinations of driving-force variables can lead to similar levels and structure of energy use and land-use patterns, as illustrated by the various scenario groups and scenarios. Hence, even for a given scenario outcome, for example, in terms of GHG emissions, there are alternative combinations and alternative pathways that could lead to that outcome. For instance, significant global changes could result from a scenario of high population growth, even if per capita incomes would rise only modestly, as well as from a scenario in which a rapid demographic transition (low population levels) coincides with high rates of income growth and affluence.
- Important possibilities for further bifurcations in future development trends exist within one scenario family, even when adopting certain values for important scenario driving force variables to illustrate a particular possible development path.
- Emissions profiles are dynamic across the range of SRES scenarios. They portray trend reversals and indicate possible emissions crossover among different scenarios. They do not represent mere extensions of a continuous increase of GHGs and sulphur emissions into the future. This more complex pattern of future emissions across the range of SRES scenarios reflects the recent scenario literature.
- Describing potential future developments involves inherent ambiguities and uncertainties. One and only one possible development path (as alluded to for instance in concepts such as "business-as-usual scenario") simply does not exist. And even for each alternative development path described by any given scenario, there are numerous combinations of driving forces and numerical values that can be consistent with a particular scenario description. This particularly applies to the A2 and B2 scenarios that imply a variety of regional development patterns that are wider than in the A1 and B1 scenarios. The numerical precision of any model result should not distract from the basic fact that uncertainty abounds. However, in the opinion of the SRES writing team, the multi-model approach increases the value of the SRES scenario set, since uncertainties in the choice of model input assumptions can be more explicitly separated from the specific model behaviour and related modelling uncertainties.
- Any scenario has subjective elements and is open to various interpretations. While the SRES writing team as a whole has no preference for any of the scenarios, and has no judgement about the probability or desirability of the scenarios, the open process and reactions to SRES scenarios have shown that individuals and interest groups do have such judgements. This will stimulate an open discussion in the political arena about potential futures and choices that can be made in the context of climate change response. For the scientific community, the SRES scenario exercise has led to the identification of a number of recommendations for future research that can further increase understanding about potential development of socio-economic driving forces and their interactions, and associated GHG emissions.

2.5.2 *Review of Post-SRES Mitigation Scenarios*

2.5.2.1 Background and Outline of Post-SRES Analysis

The review of general mitigation scenarios shows that mitigation scenarios and policies are strongly related to their baselines, and that there has been no systematic comparison of the relationship between baseline and mitigation scenarios. Modellers participating in the SRES process recognized the need to analyze and compare mitigation scenarios using as their baselines the new IPCC scenarios, which quantify a wide range of future worlds. Consequently, they participated (on a voluntary basis) in a special comparison programme to quantify SRES-based mitigation scenarios (Morita *et al.*, 2000a; 2000b). These SRES-based scenarios are called "Post-SRES Mitigation Scenarios".

The process of the post-SRES analysis was started by a public invitation to modellers. A "Call for Scenarios" was sent to more than one hundred researchers in March 1999 by the Coordinating Lead Authors of this chapter and the SRES to facilitate an assessment of the potential implications of mitigation scenarios based on the SRES cases, which report was developed in support of the Third Assessment Report. Modellers from around the world were invited to prepare quantified stabilization scenarios for two or more concentrations of atmospheric CO_2, based on one or more of the six SRES scenarios. Concentration ceilings include 450, 550 (minimum require-

Time to Update Risk Factors

Updating risk factors is an important part of the process of preparing a company's annual report on Form 10-K or Form 20-F pursuant to the rules of the US Securities and Exchange Commission. Item 503(c) of Regulation S-K requires a plain English explanation of how risks impact the company and its securities. This presentation must specifically identify significant factors that add risk to an investment.

The complete set of risk factors must appear in the annual report on Form 10-K or Form 20-F. Therefore, now is the right time for calendar-year public companies to review the entirety of their risk factor disclosures to determine if there are any new risks that should be discussed and if there are any existing risk factors that should be modified.

The risk factors should not be a generic discussion of risks that could impact any company or any securities but must be tailored for the specific issues affecting the company as the operating environment changes—and 2016 was a year of change. Some key risk factor topics to consider at this time, either as stand-alone risk factors or intertwined as part of other risk factor discussions, include the following:

Cybersecurity. Awareness of the significance of cybersecurity from both an economic and a security perspective has grown dramatically over the past few years. There is a greater recognition that cybersecurity is an issue that impacts companies of all types and that cybersecurity risks are increasing. Accordingly, companies should assess whether they need to expand or revise their cybersecurity disclosures to avoid potentially incomplete or misleading disclosure, especially in light of any events that may have occurred over the past year, whether or not such events were particular to them.[1]

Climate Change and Sustainability. Sustainability and climate change have garnered increasing attention, including in the context of risk factor disclosure. Climate change risk factor disclosure may discuss the impact of existing or pending legislation, regulation or international accords, as well as the physical impact of climate change or the impact of public awareness of sustainability issues on a company's business. To the extent deemed relevant, a risk factor could also discuss uncertainties with respect to potential changes in climate change regulation and treaties under the new US administration. Because climate change is an evolving area, the necessity for and scope of a climate change and sustainability risk factor is something that a company should carefully consider when preparing its upcoming annual report on Form 10-K or Form 20-F, as well as future annual reports.

Changes in US Administration. As the Trump presidency and new Congress get under way, it is too early to predict the changes in law and regulation that may result from the change in administration. However, there are a number of areas that have been publicly targeted for change that could impact the risk profile of certain companies. For example, companies in the health care or insurance industries may face risks relating to the Affordable Care Act and possible replacements. Some companies may be facing increased risks with respect to potential withdrawal or modification of international trade agreements. Others may be concerned about changes in tax policy, such as the elimination of renewable energy tax credits or significant changes to the current system. Some companies have already begun to include risk factor disclosure relating to the change in the US administration. As the disclosure season progresses, issuers are encouraged to monitor developments regarding legislation and regulatory shifts, even if only proposed.

Brexit. Following the United Kingdom referendum last summer in favor of leaving the European Union, some companies began including Brexit risk factors in their periodic reports to address political, social and economic uncertainty, as well as stock market volatility and currency exchange rate fluctuations. For example, Brexit has been mentioned in the context of risk factors on topics such as currency exchange rates, global economic conditions and international operations, as well as having been discussed as a separate risk factor. Brexit is an ongoing process that will take some time to fully negotiate and implement. The BBC reports that Prime Minister Theresa May intends to trigger the process to initiate the negotiations for the terms of the UK's separation from the European Union by the end of March 2017, meaning the United Kingdom will be expected to leave the European Union by the summer of 2019.[2] As Brexit progresses, impacted companies should continually evaluate whether Brexit poses a risk to them and what level of Brexit-related disclosure is appropriate under the circumstances. This disclosure may need to continue to evolve over the next couple of years.

Energy Sector. The energy sector continues to reel from the decline in oil prices that at their lowest point in 2016 fell more than 70 percent from their June 2014 levels. Given the general economic conditions and the competition inherent in the industry, energy companies are looking at an unpredictable future. In addition to those topics set forth above, the primary risks that should be considered by energy companies, where applicable, are fluctuations in the price and volatility of oil, gas or energy commodities; supply risks; political, regulatory or legislative developments; operational and exploration and production risks; limited access to capital or indebtedness; inaccurate reserve estimates; hydraulic fracturing regulation; changes in and level of demand; shortage of rigs and equipment or personnel; and exposure to and use of hedging and derivative instruments.

Practical Considerations. Each company should consider its specific risk profile when determining if its risk factor presentation is sufficiently comprehensive and current. If a topic is not relevant for a company, the company should not include it as a risk factor, even if many other companies do. Likewise, if a company has a unique risk, that risk should be discussed even if other companies do not disclose a comparable risk factor. Foreign private issuers should consider specific jurisdictional or regional risks unique to their particular geography.

The topics highlighted above are not the only areas to consider as part of an annual review of risk factor disclosure. The past year had many developments that may have impacted companies' risk profiles. Companies may be facing increased risk due to terrorism and related security costs. Fluctuations in currency rates and commodity prices also may have significant impact. Political turmoil and changes in various parts of the world might affect business. There may be industry-specific developments that present risks for certain companies. Companies should assess whether their existing risk factors are adequate to cover recent developments.

Companies should review risk factors of similarly situated companies to identify topics to consider for disclosure in their own risk factors, including updates that have been presented in quarterly reports over the past year.

In addition to deciding what revisions are needed from a factual point of view, each company should review its risk factor discussion to be sure it is clearly presented in relation to the company and does not merely contain a boilerplate discussion of general risks.

If a risk factor update could materially impact a company's financial results, it may also be appropriate for that company to discuss that aspect in the management's discussion and analysis, or comparable section, of its annual report on Form 10-K or Form 20-F.

For more information about the topics raised in this Legal Update, please contact the author of this Legal Update, Laura D. Richman, at +1 312 701 7304, any of the following lawyers or any other member of our Corporate & Securities practice.

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Endnotes

1. For further information about the SEC's views on cybersecurity disclosure, see CF Disclosure Guidance: Topic 2 at https://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm.
2. http://www.bbc.com/news/uk-politics-32810887.

DuaneMorris

The Directors Roundtable Presents

Managing Risks for Public Company's in Today's Regulatory Environment

Presenter: Mauro M. Wolfe

5 Major Risk Areas

- Disclosure is “at the heart of the SEC’s regulatory approach” SEC Chairman Jay Clayton speech, 7.12.17
- SEC Statute of Limitations – 5 years
- Accountability of Individuals – The Yates Memo
- Managing Investigation Costs – Advent of A.I.
- Cross Border Cases - Risks

SEC Priorities

- Disclosure is “at the heart of the SEC’s regulatory approach” SEC Chairman Jay Clayton speech, 7.12.17
- Cost of Compliance a factor to consider in rule making
- SEC must evolve as business evolves

Enforcement Priorities

- Target of market professionals
- Cyber security

SEC Statute of Limitations – 5 years

- Gabelli v. SEC, Supreme Court ruled civil penalties subject to 5 year statute of limitations
- SEC v. Kokesh, Supreme Court ruled that 5 years equally applicable to equitable remedies including disgorgement
- SEC response is to seek 1 year tolling agreements from individuals and companies

Accountability of Individuals

- DOJ - Yates Memo
- SEC – Cooperation Program

Managing Investigation Costs

- On shore and off shore rates below $50/hour
- Advent of Artificial Intelligence

Cross Border Cases

Critical Mistakes to Avoid

- Violating local laws which may constitute criminal conduct
- Get local counsel involved as early as possible
- Foreign privacy law – can employee emails be reviewed without consent? Can the emails be transferred to the U.S.?
- Understand attorney-client privilege in the local jurisdiction
- Employment law – can you interview employees?
- Encrypted data

Credits

Mauro Wolfe

Mauro Wolfe is a litigation partner at Duane Morris LLP. His practice focuses on white-collar criminal defense, FINRA and SEC securities enforcement, and internal corporate investigations. Among his clients have been U.S. and foreign corporations, corporate executives, and government officials. He is a member of the New York Council of Defense Lawyers, and is listed in the 2013 and 2012 editions of New York Super Lawyers – Metro in the area of Criminal Defense: White Collar. Mr. Wolfe is AV Preeminent Peer Review Rated by Martindale-Hubbell in the areas of Criminal Law, White Collar Crime, and Litigation. He was recently appointed as a National Subcommittee Co-chair on White Collar & Corporate Investigations for the American Bar Association Securities Litigation Committee and as an Officer for the International Bar Association Criminal Committee.

Earlier in his career Mr. Wolfe worked as a federal prosecutor and as a senior enforcement attorney at the SEC. Throughout his career in the public and private sectors, Mr. Wolfe has been involved in high profile matters. He has been sourced and quoted by *The New York Times, The National Law Journal, Bloomberg, Associated Press, Barron's, Philadelphia Daily News, The Star-Ledger, The New York Post, The San Francisco Chronicle, The Wall Street Journal Blog,* and many others.

Reining in the SEC: The Supreme Court Limits Disgorgement to a Five-Year Statute of Limitations

June 6, 2017 General disgorgement, jovy dedaj, sec, wolfe Jovalin Dedaj

By Mauro M. Wolfe and Jovalin Dedaj

In yet another setback for the SEC, the Supreme Court unanimously decided that disgorgement actions, a cornerstone of SEC enforcement, are subject to a five-year statute of limitations. Previously, in *Gabelli v. SEC*, a unanimous Supreme Court had already decided that civil penalties were subject to a five-year bar. This time, the question before the Court was whether disgorgement in particular was a penalty for purposes of the five-year statute of limitations. Justice Sotomayor, writing for the unanimous court, concluded that disgorgement was a penalty and not, as the SEC contended, simply a measure of restitution.

Two months ago, we discussed the circuit split that had set the stage for yesterday's decision. In *SEC v. Kokesh*, which was the decision reviewed by the Supreme Court, the Tenth Circuit reasoned that because disgorgement only deprived the wrongdoer of the illicit gains, it did not inflict punishment and, thus, could not be considered a penalty per se. The Eleventh Circuit, in *SEC v. Graham*, thought otherwise, explaining that because disgorgement was a subset of forfeiture, it was subject to a five-year statute of limitations.

In a brief opinion, Justice Sotomayor emphasized the punitive nature of disgorgement actions. Deterrence is not merely an incidental effect of disgorgement, Justice Sotomayor wrote. Rather, courts have consistently held that the primary purpose of disgorgement orders is to deter violations of the securities laws. In addressing the SEC's remedial-versus-punitive arguments, Justice Sotomayor noted that disgorgement did not "return the defendant to the place he would have occupied had he not broken the law." Indeed, disgorgement sometimes exceeds the profits of the wrongdoing and, in this context, disgorgement is clearly a punitive, rather than a remedial, sanction.

The Court's decision is a significant limitation on the SEC's enforcement powers. Now, given the smaller window for disgorgement actions, as we opined weeks ago, the SEC will likely respond by seeking more tolling agreements or proceed more expeditiously in its enforcement actions, which could be difficult in the more sophisticated and complex cases.

In the wake of the Great Recession, we have seen a marked uptick in the SEC's policing and enforcement efforts. However, yesterday's decision would suggest that the Supreme Court is not as willing to grant the SEC a blank check when it comes to enforcement powers as one might expect. Indeed, given yesterday's decision, the decision in *Gabelli* in 2013, and the recent rumblings over the appointment of the SEC's administrative law judges, it would appear that SEC enforcement has had a poor track record with the courts recently.

Ultimately, we should expect to see more requests by the SEC for tolling agreements in the future. The question for companies and individuals is whether to summarily agree to toll the statute of limitations or challenge the SEC. The choices are fraught with risk and reward.

Generally, there is very little for an individual "target" to gain from cooperating with the SEC as it relates to tolling agreements. In other words, if you represent the main actor in the case, the SEC generally will not offer you a material benefit for agreeing to sign the tolling agreement. Therefore, as a general matter, it may be the case that individuals continue to decline signing tolling agreements, but that remains to be seen. We are assuming that there is no "cooperation" benefit to exchange with the SEC.

The more complex issue is related to companies. The SEC will no doubt argue that a failure to sign a tolling agreement will be viewed as a lack of cooperation, possibly resulting in greater fines and penalties, although there is no specific available data showing the benefits of signing such an agreement. The anecdotal wisdom is that by not signing the agreement the SEC will punish companies more. Perhaps, it is time to revisit this question going forward in light of the Supreme Court's ruling.

About Jovalin Dedaj

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Remarks at the Economic Club of New York

SEC Chairman Jay Clayton

New York, N.Y.

July 12, 2017

Thank you, Terry [Lundgren], for that kind introduction. I am delighted to speak to you here at the Economic Club of New York. The Club has established itself as an esteemed, non-partisan forum for economic discourse. It is an ideal place to discuss policy of the U.S. Securities and Exchange Commission ("SEC" or "the Commission" or "the agency") and its effects on the U.S. economy and the American people. I intend to do just that in this, my first public speech as Chairman of the SEC.[1]

Nearly six months ago, my predecessor Mary Jo White gave her last public address as SEC Chair in this same forum. In her remarks, she stated "I am confident in reporting that the agency is today a stronger protector of investors than ever before and much better equipped to meet the challenges of the fast-paced, complex, and interconnected securities markets of 2017."[2] I am pleased — and thankful — to say that I agree with Chair White. When I arrived at the Commission, I made it a priority to meet with staff across the agency. With each meeting, I became more impressed by the breadth of issues my 4,600 colleagues cover, and even more, by their dedication.

The Dodd-Frank Act of 2010[3] required the SEC to complete an unprecedented array of congressionally mandated rulemakings — all on top of the agency's usual work. Under Chair White's leadership, the Commission made great strides, adopting a number of the rules with which it was charged. Admittedly, there are still Dodd-Frank mandates to be completed. But I have inherited an agency with considerably more discretion over its agenda.

Today, I will share my perspective on the Commission and the principles that should guide where we go from here. I will then talk about some of the specific areas where I believe the agency should take action in the near-term to further its mission.

I. Guiding Principles

I believe in a model of leadership that is rooted in principles. I want to outline eight principles that will guide my SEC Chairmanship.[4]

A. Principle #1: The SEC's mission is our touchstone.

The SEC has a three-part mission: (1) to protect investors, (2) to maintain fair, orderly, and efficient markets, and (3) to facilitate capital formation. Each tenet of that mission is critical. If we stray from our mission, or emphasize one of the canons without being mindful of the others, investors, companies (large and small), the U.S. capital markets, and ultimately the economy will suffer.

B. Principle #2: Our analysis starts and ends with the long-term interests of the Main Street investor.

How does the SEC assess whether we are being true to our three-part mission? The answer: the long-term interests of the Main Street investor. Or, as I say when I walk the halls of the agency, how does what we propose to do affect the long-term interests of Mr. and Ms. 401(k)? Are these investors benefitting from our efforts? Do they have appropriate investment opportunities? Are they well informed? Speaking more granularly: what can the Commission do to cultivate markets where Mr. and Ms. 401(k) are able to invest in a better future?

I am confident this is the right lens for our analysis; and the one the American people would want the Commission to use. I am also confident that the women and men of the SEC share this perspective.

C. Principle #3: The SEC's historic approach to regulation is sound.

Disclosure and materiality have been at the heart of the SEC's regulatory approach for over eighty years. As my colleague, Commissioner Michael Piwowar, recently said, "Unlike merit-based regimes, our system of disclosure comports well with American traditions ... By arming investors with information, they can evaluate and make investment decisions that support more accurate valuations of securities and a more efficient allocation of capital."[5] The Commission, following the guidance of the Supreme Court, should continue to strive to ensure that investors have access to a well-crafted package of information that facilitates informed decision-making.[6]

In addition to disclosure-based rules, the SEC has placed heightened responsibilities on people and organizations that are central to, or actively participate in, our securities markets. The rules that apply to securities exchanges, clearing agencies, broker-dealers, and investment advisers (to name a few) protect markets and investors where information and market forces alone may not be enough.

The third leg of the stool — the anti-fraud regime established by Congress and the Commission — acts as a back-stop to the aforementioned disclosure rules and oversight systems. The government can bring to bear its extensive enforcement capabilities on those who try to circumvent established investor protections or otherwise engage in deceptive or manipulative acts in the markets.

In sum, I believe in the regulatory architecture that has governed the securities markets since 1933. It is abundantly clear that wholesale changes to the Commission's fundamental regulatory approach would not make sense.

D. Principle #4: Regulatory actions drive change, and change can have lasting effects.

Incremental regulatory changes may not seem individually significant, but, in the aggregate, they can dramatically affect the markets. For example, our public company disclosure and trading system is an incredibly powerful, efficient, and reliable means of making investment opportunities available to the general public. In fact, this disclosure-based regime has worked so well that we — not just the SEC, but lawmakers and other regulators — have slowly but significantly expanded the scope of required disclosures beyond the core concept of materiality. Those actions have been justified by regulators and lawmakers alike, often based on discrete, direct and indirect benefits to specific shareholders or other constituencies. And it has often been concluded that these benefits outweigh the marginal costs that are spread over a broad shareholder base.

But the roughly 50% decline in the total number of U.S.-listed public companies over the last two decades[7] forces us to question whether our analysis should be cumulative as well as incremental. I believe it should be. As a data point, over this period, studies show the median word-count for SEC filings has more than doubled, yet readability of those documents is at an all-time low.[8]

While there are many factors that drive the decision of whether to be a public company, increased disclosure and other burdens may render alternatives for raising capital, such as the private markets, increasingly attractive to companies that only a decade ago would have been all but certain candidates for the public markets. And, fewer small and medium-sized public companies may mean less liquid trading markets for those that remain public. Regardless of the cause, the reduction in the number of U.S.-listed public companies is a serious issue for our markets and the country more generally. To the extent companies are eschewing our public markets, the vast majority of Main Street investors will be unable to participate in their growth. The potential lasting effects of such an outcome to the economy and society are, in two words, not good.

E. Principle #5: As markets evolve, so must the SEC.

Continuing with the theme of change, technology and innovation are constantly disrupting — in mostly positive ways — the manner in which markets work and investors transact. The SEC must recognize this and strive to ensure that our rules and operations reflect the realities of our capital markets. As my colleague Commissioner Kara Stein has noted, “We need to take into account new tensions, risks, uncertainties, and conflicts.”[9]

While this dynamic atmosphere presents challenges, it also provides opportunities for improvements and efficiencies. It is our job as regulators to find these. Technology is not just the province of those we regulate. The SEC has the capability to develop and utilize it, too. We apply sophisticated analytic strategies to detect companies and individuals engaging in suspicious behavior. We are adapting machine learning and artificial intelligence to new functions, such as analyzing regulatory filings.

As the SEC evolves alongside the markets, however, we must remember that implementing regulatory change has costs. Companies spend significant resources building systems of compliance, hiring personnel to operate those systems, seeking legal advice concerning the design and effectiveness of those systems, and adapting the systems as regulations change. Shareholders and customers bear these costs, which is something that should not be taken lightly, lest we lose our credibility as regulators.

F. Principle #6: Effective rulemaking does not end with rule adoption.

With respect to rulemaking, the SEC has developed robust processes for obtaining public input and is committed to performing rigorous economic analyses of our rules, at both the proposing and adopting stages. These efforts are critical to identifying the benefits and costs of regulatory actions, including situations where a rule's effects may not be consistent with expectations. But we should not stop there.

The Commission should review its rules retrospectively. We should listen to investors and others about where rules are, or are not, functioning as intended. We cannot be shy about being introspective and self-critical.

G. Principle #7: The costs of a rule now often include the cost of demonstrating compliance.

Rules are meant to be followed, and the public depends on regulators to make sure that happens. It is incumbent on the Commission to write rules so that those subject to them can ascertain how to comply and — now more than ever — how to demonstrate that compliance. Vaguely worded rules can too easily lead to subpar compliance solutions or an overinvestment in control systems. We must recognize practical costs that are sure to arise. For example, when the SEC requires a Chief Executive Officer to make a certification that a specific requirement has been met, while he or she retains ultimate responsibility, realistically, it should be expected that the responsibility will be supported through the chain of command in a demonstrable manner. This can be an expensive practice that goes well beyond a prudent management and control architecture; when third parties, such as auditors, outside counsel, and consultants, are involved, the costs — financial costs and, in many ways more important, the cost in terms of time — can skyrocket. This may be the appropriate regulatory approach, and to be clear, in some areas I think it is. However, the Commission needs to make sure at the time of adoption that we have a realistic vision for how rules will be implemented as well as how we and others intend to examine for compliance.

H. Principle #8: Coordination is key.

Last, the SEC shares the financial services space with many other regulatory players charged with overseeing related or overlapping industries and market participants.[10] The Commission works alongside more than 15 U.S. federal regulatory bodies, over 50 state and territory securities regulators, the Department of Justice, state attorneys general, self-regulatory organizations ("SROs"), and non-SRO standard setting entities. We also participate in several major international bodies and cooperate with regulators in over 115 foreign jurisdictions. Coordination with, between, and among *all* these organizations is essential to a well-functioning regulatory environment.

One such area where coordination is essential is our regulatory scheme governing over-the-counter derivatives. Congress established, through Title VII of the Dodd-Frank Act, a dual regulatory structure for these instruments: the SEC was assigned authority over "security-based swaps," and the Commodity Futures Trading Commission ("CFTC") was assigned authority over "swaps." For this structure to be effective, there must be close coordination between the SEC and CFTC. I am fully committed to that. I am also committed to working with the CFTC to explore ways in which the agencies can achieve greater harmonization of Title VII rules and reduce unnecessary complexity as well as costs to both regulators and market participants. Having said that, importantly, all such efforts will need to take into account statutory variances as well as differences in products and markets.

Speaking more generally, cybersecurity is also an area where coordination is critical.[11] Information sharing and coordination are essential for regulators to address potential cyber threats and respond to a major cyberattack, should one arise. The SEC is therefore working closely with fellow financial regulators to improve our ability to receive critical information and alerts and react to cyber threats.[12]

II. Putting Principles into Practice

Let's turn from principles to practice. There are some particular places where I see opportunities to apply these principles to the SEC's agenda.

A. Enforcement and Examinations

The SEC has strong and active enforcement and examination programs. I fully intend to continue deploying significant resources to root out fraud and shady practices in the markets, particularly in areas where Main Street investors are most exposed. Terms like "affinity fraud" and "microcap fraud" sound unremarkable and remote on paper, but they are sinister behaviors that strike at Americans' vulnerabilities.

Investors should know that the SEC is looking out for them. In this regard, we are taking further steps to find and eliminate from our system pump-and-dump scammers, those who prey on retirees, and increasingly those who use new technologies to lie, cheat, and steal. Turning to the more sophisticated participants in our markets, the Commission will continue to use its enforcement and examination authority to support market integrity. We are committed to making our markets as fair, orderly, and efficient — and as liquid — as possible. I know market professionals are critical to, and enhance, the operation of our markets. I also know they know the rules and principles, and I expect them to adhere to and be guided by them. You have a special place in our economy, do not take unfair advantage of it.

As a final comment on enforcement, I want to go back to cybersecurity. Public companies have a clear obligation to disclose material information about cyber risks and cyber events. I expect them to take this requirement seriously. I also recognize that the cyber space has many bad actors, including nation states that have resources far beyond anything a single company can muster. Being a victim of a cyber penetration is not, in itself, an excuse. But, I think we need to be cautious about punishing responsible companies who nevertheless are victims of sophisticated cyber penetrations. Said another way, the SEC needs to have a broad perspective and bring proportionality to this area that affects not only investors, companies, and our markets, but our national security and our future.

B. Capital Formation

I have been vocal about my desire to enhance the ability of every American to participate in investment opportunities, including through the public markets. I also want American businesses to be able to raise the money they need to grow and create jobs. As I mentioned earlier, evidence shows that a large number of companies, including many of our country's most innovative businesses, are opting to remain privately held. Just yesterday I met with a broad group of businesses at different stages of capital raising and heard firsthand about the regulatory requirements and other considerations that factor into their decision to stay private or go public. One message was loud and clear: private markets operate well in many sectors and, in these areas, they offer a very attractive alternative to the public markets. I believe we need to increase the attractiveness of our public capital markets without adversely affecting the availability of capital from our private markets.

As an agency, we have learned a great deal while implementing the JOBS Act on-ramp for emerging growth companies ("EGCs").[13] The JOBS Act allows issuers with less than roughly $1 billion in revenue to submit their draft registration statements *confidentially* and phase in their reporting obligations *gradually*. This regime has had a clear appeal to EGCs. Since the enactment of the JOBS Act, approximately 87% of the initial public offerings ("IPOs") that have gone effective were for EGCs, and the vast majority of these companies have relied to some extent on the confidentiality and gradation components of the JOBS Act.[14]

Starting this past Monday, the JOBS Act approach is accessible more broadly. The SEC's Division of Corporation Finance non-public review process is now open to IPO draft registration statements from larger domestic and non-U.S. companies that do not qualify as EGCs.[15] I hope that allowing these companies to submit their sensitive information on a non-public basis while the Commission staff reviews their draft offering documents will encourage them to find the prospect of selling their shares in the U.S. public markets more attractive generally, and at an earlier stage in their development.[16]

My last point on capital formation is a reminder. There are circumstances in which the Commission's reporting rules may require publicly traded companies to make disclosures that are burdensome to generate, but may not be material to the total mix of information available to investors. Under Rule 3-13 of Regulation S-X, issuers can request modifications to their financial reporting requirements in these situations. I want to encourage companies to consider whether such modifications may be helpful in connection with their capital raising activities and assure you that SEC staff is placing a high priority on responding with timely guidance.

C. Market Structure

Regarding equity market structure, an enormous amount of thought — at the Commission, in Congress, and in the private sector — has been devoted to this topic. While there are certainly challenging issues that merit further consideration, it is time to shift the focus to action. One recommendation where there is broad consensus to proceed is the launch of a pilot program to test how adjustments to the access fee cap under Rule 610 of the Securities Exchange Act of 1934 would affect equities trading.[17] Such a pilot should provide the Commission with more data to assess the effects of access fees and rebates — including "maker-taker" and other pricing systems — on liquidity provision, liquidity taking, and order routing. These, in turn, affect the functioning of markets and investor welfare. I expect the Commission will consider a proposal of this type in the coming months.

The SEC's Equity Market Structure Advisory Committee ("EMSAC") has provided the Commission with valuable perspectives on these and many other issues. The committee's charter is set to expire next month. My hope is that EMSAC's tenure is extended into 2018.

Let me make one additional point about market structure. The time is right for the SEC to broaden its review of market structure to include specifically the efficiency, transparency, and effectiveness of our *fixed income* markets. As waves of Baby Boomers retire every month and need investment options, fixed income products, which are viewed as a stable place to store hard-earned money, will attract more and more Main Street investors. Yet, many of those investors may not appreciate that fixed income products are part of markets that differ significantly from the better-known equities markets.

The Commission must explore whether these markets are as efficient and resilient as we expect them to be, scrutinize our regulatory approach, and identify opportunities for improvement. To that end, I have asked the staff to develop a plan for creating a Fixed Income Market Structure Advisory Committee. Like the EMSAC, this committee would be made up of a diverse group of outside experts, who will be asked to give advice to the Commission on the regulatory issues impacting fixed income markets. I am also pleased to note that this week, Chairman Hensarling and Chairman Huizenga of the House Financial Services Committee and its subcommittee on Capital Markets, Securities, and Investment have called for a hearing on fixed income market structure,[18] and I look forward to working with Congress on these issues.

D. Investment Advice and Disclosures to Investors

1. Fiduciary Rule

Another area that has been the subject of extensive study is the standards of conduct that investment professionals must follow in providing advice to Main Street investors. With the Department of Labor's Fiduciary Rule now partially in effect, it is important that the Commission make all reasonable efforts to bring clarity and consistency to this area. It is my hope that we can act in concert with our colleagues at the Department of Labor in a way that best serves the long-term interests of Mr. and Ms. 401(k).

There is a lot of work to do, and this issue is complex. That should not deter us, and we are moving forward. In June, I issued a statement seeking public input on standards of conduct for investment advisers and broker-dealers.[19] The Commission had last solicited information on this issue four years ago. Suffice it to say a lot has happened since then. Robust public comment can help us evaluate potential regulatory actions in light of current market activities and risks. And, any action will need to be carefully constructed, so it provides appropriate and meaningful protections but does not result in Main Street investors being deprived of affordable investment advice or products. I encourage the public to send us feedback and any data that may be helpful to us. Instructions for how to submit this information are available on www.sec.gov.

2. Improving Disclosure to Investors

Regardless of whether investors participate in our markets directly or indirectly, and with or without investment advice, it is clear that they and their advisors must have access to information about potential investments that is easily accessible and meaningful. The Commission has several initiatives underway to improve the disclosure available to investors. For example, last November, the SEC staff issued a report recommending ways to modernize and simplify Regulation S-K disclosure rules.[20] This report also included recommendations on how to improve the readability and the navigability of disclosure. The staff is making good progress on preparing rulemaking proposals based on this report for the Commission.

E. Resources to Educate Investors

No matter how robust our enforcement and examination programs, the reality is that the SEC cannot be everywhere. The agency has exceptional tools that can help investors research professionals giving them investment advice, spot signs of fraud, and take action to protect themselves.

A priority for me is getting the wealth of information that the SEC has into the hands of investors, through whatever means can reach them. Among other things, we are leveraging technology to do this, including conducting data analyses to assess how individual investors interact with the SEC and where and how we can increase engagement. Commission staff also has efforts underway to simplify and enhance resources to educate investors on how to conduct online background searches on investment professionals and make informed decisions about whether to establish financial relationships. In this regard, I have a short but important message for Main Street investors: the best way to protect yourself is to check out who you are dealing with, and the SEC wants to make that easier.[21]

III. Conclusion

In my seventy days since joining the SEC, I have become aware of some of the challenges ahead. The Commission has no choice but to face any challenges — both the ones we know and those we will come to know — head-on. As we take that journey, I am fortunate to be surrounded by a tremendously talented set of public servants in the SEC staff and my fellow Commissioners. I aim to apply a level of dedication and hard work that matches their own.

Thank you.

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[1]   My words are my own and do not necessarily reflect the views of my fellow Commissioners or the SEC staff.

[2]   Chair Mary Jo White, "The SEC after the Financial Crisis: Protecting Investors, Preserving Markets" (January 17, 2017), https://www.sec.gov/news/speech/the-sec-after-the-financial-crisis.html.

[3]   The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub.L. 111–203, 124 Stat. 1376 (the "Dodd-Frank Act").

[4]   On February 3, 2017, President Donald J. Trump issued an executive order setting forth seven "core principles" intended to form the basis for his administration's regulation of the U.S. financial system. *See* Presidential Executive Order on Core Principles for Regulating the United States Financial System (February 3, 2017), https://www.whitehouse.gov/the-press-office/2017/02/03/presidential-executive-order-core-principles-regulating-united-states. I believe the principles articulated here are consistent with, and complementary to, the broader principles for financial regulation set forth by the President.

[5]   Acting Chairman Michael S. Piwowar, "Remarks at the "SEC Speaks" Conference 2017: Remembering the Forgotten Investor" (February 24, 2017), https://www.sec.gov/news/speech/piwowar-remembering-the-forgotten-investor.html. *See also* Commissioner Daniel M. Gallagher, "Remarks to the Forum for Corporate Directors, Orange County, California" (January 24, 2014), https://www.sec.gov/news/speech/2014-spch012413dmg ("The SEC is, first and foremost, a disclosure agency. Our bedrock premise is that public companies should be required to disclose publicly and in a timely fashion the information a person would need in order to make a rational and informed investment decision.").

[6]   *See TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) ("An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.…Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."). *See also Basic Inc.*

v. Levinson, 485 U.S. 224 (1988).

[7] The total number of listed companies in 2016 was approximately 4,300, compared to about 8,100 in 1996. Commission staff produced these estimates using data from the Center for Research in Securities Prices US Stock and US Index Databases (2016), The University of Chicago Booth School of Business.

[8] *See*, *e.g.*, Travis Dyer, Mark Lang, Lorien Stice-Lawrence, “The Evolution of 10-K Textual Disclosure: Evidence from Latent Dirichlet Allocation” (October 2016). *See also* SEC Office of the Investor Advocate, “Report on Objectives: Fiscal Year 2017” (June 30, 2016), https://www.sec.gov/advocate/reportspubs/annual-reports/sec-office-investor-advocate-report-on-objectives-fy2017.pdf, at 5 (“Given the important role of disclosure, the requirements for various types of disclosure are robust. As a result, an S-1 or 10-K can be hundreds of pages long, and the length and complexity of the disclosures has led many to question whether the disclosure requirements are properly calibrated to effectively communicate all material information to investors while eliminating immaterial, outdated, or duplicative data that may dilute the impact of the more meaningful disclosures.”).

[9] Commissioner Kara M. Stein, “Remarks at the Meeting of the Equity Market Structure Advisory Committee” (April 26, 2016), https://www.sec.gov/news/statement/stein-statement-emsac-042616.html.

[10] As the Treasury Department recently noted in its first core principles report, “Increased coordination on the part of [financial] regulators will identify problem areas and help [them] prioritize enforcement actions.” U.S. Dept. of Treasury, “A Financial System that Creates Economic Opportunities: Banks and Credit Unions” (June 2017), at 10, https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf.

[11] *See id.* at 123.

[12] The SEC is a member of the Financial and Banking Information Infrastructure Committee.

[13] The Jumpstart Our Business Startups Act, Pub. L. 112-106, H.R. 3606 (the “JOBS Act”), http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf .

[14] *See* Ernst & Young LLP, “Update on emerging growth companies and the JOBS Act” (November 2016), http://www.ey.com/Publication/vwLUAssets/ey-update-on-emerging-growth-companies-and-the-jobs-act-november-2016/$FILE/ey-update-on-emerging-growth-companies-and-the-jobs-act-november-2016.pdf , at 6.

[15] *See* “SEC’s Division of Corporation Finance Expands Popular JOBS Act Benefit to All Companies” (June 29, 2017), https://www.sec.gov/news/press-release/2017-121. *See also* SEC Division of Corporation Finance, “Voluntary Submission of Draft Registration Statements – FAQs” (last modified June 30, 2017), https://www.sec.gov/corpfin/voluntary-submission-draft-registration-statements-faqs.

[16] The Division of Corporation Finance will also accept draft registration statements for non-public review for many companies throughout their first year in the SEC’s reporting system. This is meant to encourage newly reporting companies to explore follow-on capital raises in the public markets, which could present additional investment opportunities for retail investors and add liquidity to a newly public company’s shares. *See id.* The experience with the JOBS Act confidential review process demonstrates that this approach is fully consistent with investor protection. Companies are still required to publicly file their disclosure documents well before they begin their “road shows.” That said, in the spirit of being retrospective, I am open to continuing to examine whether the SEC has struck an appropriate balance between the capital

formation and investor protection tenets of our mission.

[17] SEC Equity Market Structure Advisory Committee, "Recommendation for an Access Fee Pilot" (July 8, 2016), https://www.sec.gov/spotlight/emsac/recommendation-access-fee-pilot.pdf.

[18] *See* Hearing of the House of Representatives Committee on Financial Services, "A Review of Fixed Income Market Structure" (scheduled for July 14, 2017), https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=402101.

[19] Statement of SEC Chairman Jay Clayton, "Public Comments from Retail Investors and Other Interested Parties on Standards of Conduct for Investment Advisers and Broker-Dealers" (June 1, 2017), https://www.sec.gov/news/public-statement/statement-chairman-clayton-2017-05-31.

[20] SEC Division of Corporation Finance, "Report on Modernization and Simplification of Regulation S-K" (November 23, 2016), https://www.sec.gov/files/sec-fast-act-report-2016.pdf. This report was required by Section 72003 of the Fixing America's Surface Transportation Act, Pub. L. No. 114-94, 129 Stat. 1312 (2015).

[21] The agency is trying different approaches. For example, in addition to our ongoing efforts to create and disseminate educational content through www.investor.gov and other platforms designed for retail investors, we recently posted a short video on the SEC website that includes tips for investors to avoid falling victim to fraud. *See* SEC Office of Investor Education and Advocacy, "Straight Talk: From the SEC" (June 29, 2017), https://investor.gov/additional-resources/specialized-resources/public-service-campaign.

U.S. Department of Justice

Office of the Deputy Attorney General

The Deputy Attorney General

Washington, D.C. 20530

September 9, 2015

MEMORANDUM FOR THE ASSISTANT ATTORNEY GENERAL, ANTITRUST DIVISION
THE ASSISTANT ATTORNEY GENERAL, CIVIL DIVISION
THE ASSISTANT ATTORNEY GENERAL, CRIMINAL DIVISION
THE ASSISTANT ATTORNEY GENERAL, ENVIRONMENT AND NATURAL RESOURCES DIVISION
THE ASSISTANT ATTORNEY GENERAL, NATIONAL SECURITY DIVISION
THE ASSISTANT ATTORNEY GENERAL, TAX DIVISION
THE DIRECTOR, FEDERAL BUREAU OF INVESTIGATION
THE DIRECTOR, EXECUTIVE OFFICE FOR UNITED STATES TRUSTEES
ALL UNITED STATES ATTORNEYS

FROM: Sally Quillian Yates
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SUBJECT: Individual Accountability for Corporate Wrongdoing

Fighting corporate fraud and other misconduct is a top priority of the Department of Justice. Our nation's economy depends on effective enforcement of the civil and criminal laws that protect our financial system and, by extension, all our citizens. These are principles that the Department lives and breathes—as evidenced by the many attorneys, agents, and support staff who have worked tirelessly on corporate investigations, particularly in the aftermath of the financial crisis.

One of the most effective ways to combat corporate misconduct is by seeking accountability from the individuals who perpetrated the wrongdoing. Such accountability is important for several reasons: it deters future illegal activity, it incentivizes changes in corporate behavior, it ensures that the proper parties are held responsible for their actions, and it promotes the public's confidence in our justice system.

There are, however, many substantial challenges unique to pursuing individuals for corporate misdeeds. In large corporations, where responsibility can be diffuse and decisions are made at various levels, it can be difficult to determine if someone possessed the knowledge and criminal intent necessary to establish their guilt beyond a reasonable doubt. This is particularly true when determining the culpability of high-level executives, who may be insulated from the day-to-day activity in which the misconduct occurs. As a result, investigators often must reconstruct what happened based on a painstaking review of corporate documents, which can number in the millions, and which may be difficult to collect due to legal restrictions.

These challenges make it all the more important that the Department fully leverage its resources to identify culpable individuals at all levels in corporate cases. To address these challenges, the Department convened a working group of senior attorneys from Department components and the United States Attorney community with significant experience in this area. The working group examined how the Department approaches corporate investigations, and identified areas in which it can amend its policies and practices in order to most effectively pursue the individuals responsible for corporate wrongs. This memo is a product of the working group's discussions.

The measures described in this memo are steps that should be taken in any investigation of corporate misconduct. Some of these measures are new, while others reflect best practices that are already employed by many federal prosecutors. Fundamentally, this memo is designed to ensure that all attorneys across the Department are consistent in our best efforts to hold to account the individuals responsible for illegal corporate conduct.

The guidance in this memo will also apply to civil corporate matters. In addition to recovering assets, civil enforcement actions serve to redress misconduct and deter future wrongdoing. Thus, civil attorneys investigating corporate wrongdoing should maintain a focus on the responsible individuals, recognizing that holding them to account is an important part of protecting the public fisc in the long term.

The guidance in this memo reflects six key steps to strengthen our pursuit of individual corporate wrongdoing, some of which reflect policy shifts and each of which is described in greater detail below: (1) in order to qualify for any cooperation credit, corporations must provide to the Department all relevant facts relating to the individuals responsible for the misconduct; (2) criminal and civil corporate investigations should focus on individuals from the inception of the investigation; (3) criminal and civil attorneys handling corporate investigations should be in routine communication with one another; (4) absent extraordinary circumstances or approved departmental policy, the Department will not release culpable individuals from civil or criminal liability when resolving a matter with a corporation; (5) Department attorneys should not resolve matters with a corporation without a clear plan to resolve related individual cases, and should memorialize any declinations as to individuals in such cases; and (6) civil attorneys should consistently focus on individuals as well as the company and evaluate whether to bring suit against an individual based on considerations beyond that individual's ability to pay.[1]

I have directed that certain criminal and civil provisions in the United States Attorney's Manual, more specifically the Principles of Federal Prosecution of Business Organizations (USAM 9-28.000 *et seq.*) and the commercial litigation provisions in Title 4 (USAM 4-4.000 *et seq.*), be revised to reflect these changes. The guidance in this memo will apply to all future investigations of corporate wrongdoing. It will also apply to those matters pending as of the date of this memo, to the extent it is practicable to do so.

1. To be eligible for <u>any</u> cooperation credit, corporations must provide to the Department all relevant facts about the individuals involved in corporate misconduct.

In order for a company to receive <u>any</u> consideration for cooperation under the Principles of Federal Prosecution of Business Organizations, the company must completely disclose to the Department all relevant facts about individual misconduct. Companies cannot pick and choose what facts to disclose. That is, to be eligible for any credit for cooperation, the company must identify all individuals involved in or responsible for the misconduct at issue, regardless of their position, status or seniority, and provide to the Department all facts relating to that misconduct. If a company seeking cooperation credit declines to learn of such facts or to provide the Department with complete factual information about individual wrongdoers, its cooperation will not be considered a mitigating factor pursuant to USAM 9-28.700 *et seq.*[2] Once a company meets the threshold requirement of providing all relevant facts with respect to individuals, it will be eligible for consideration for cooperation credit. The extent of that cooperation credit will depend on all the various factors that have traditionally applied in making this assessment (*e.g.*, the timeliness of the cooperation, the diligence, thoroughness, and speed of the internal investigation, the proactive nature of the cooperation, etc.).

This condition of cooperation applies equally to corporations seeking to cooperate in civil matters; a company under civil investigation must provide to the Department all relevant facts about individual misconduct in order to receive any consideration in the negotiation. For

[1] The measures laid out in this memo are intended solely to guide attorneys for the government in accordance with their statutory responsibilities and federal law. They are not intended to, do not, and may not be relied upon to create a right or benefit, substantive or procedural, enforceable at law by a party to litigation with the United States.

[2] Nor, if a company is prosecuted, will it support a cooperation-related reduction at sentencing. *See* U.S.S.G. USSG § 8C2.5(g), Application Note 13 ("A prime test of whether the organization has disclosed all pertinent information" necessary to receive a cooperation-related reduction in its offense level calculation "is whether the information is sufficient … to identify … the individual(s) responsible for the criminal conduct").

example, the Department's position on "full cooperation" under the False Claims Act, 31 U.S.C. § 3729(a)(2), will be that, at a minimum, all relevant facts about responsible individuals must be provided.

The requirement that companies cooperate completely as to individuals, within the bounds of the law and legal privileges, *see* USAM 9-28.700 to 9-28.760, does not mean that Department attorneys should wait for the company to deliver the information about individual wrongdoers and then merely accept what companies provide. To the contrary, Department attorneys should be proactively investigating individuals at every step of the process – before, during, and after any corporate cooperation. Department attorneys should vigorously review any information provided by companies and compare it to the results of their own investigation, in order to best ensure that the information provided is indeed complete and does not seek to minimize the behavior or role of any individual or group of individuals.

Department attorneys should strive to obtain from the company as much information as possible about responsible individuals before resolving the corporate case. But there may be instances where the company's continued cooperation with respect to individuals will be necessary post-resolution. In these circumstances, the plea or settlement agreement should include a provision that requires the company to provide information about all culpable individuals and that is explicit enough so that a failure to provide the information results in specific consequences, such as stipulated penalties and/or a material breach.

2. Both criminal and civil corporate investigations should focus on individuals from the inception of the investigation.

Both criminal and civil attorneys should focus on individual wrongdoing from the very beginning of any investigation of corporate misconduct. By focusing on building cases against individual wrongdoers from the inception of an investigation, we accomplish multiple goals. First, we maximize our ability to ferret out the full extent of corporate misconduct. Because a corporation only acts through individuals, investigating the conduct of individuals is the most efficient and effective way to determine the facts and extent of any corporate misconduct. Second, by focusing our investigation on individuals, we can increase the likelihood that individuals with knowledge of the corporate misconduct will cooperate with the investigation and provide information against individuals higher up the corporate hierarchy. Third, by focusing on individuals from the very beginning of an investigation, we maximize the chances that the final resolution of an investigation uncovering the misconduct will include civil or criminal charges against not just the corporation but against culpable individuals as well.

3. Criminal and civil attorneys handling corporate investigations should be in routine communication with one another.

Early and regular communication between civil attorneys and criminal prosecutors handling corporate investigations can be crucial to our ability to effectively pursue individuals in these matters. Consultation between the Department's civil and criminal attorneys, together with agency attorneys, permits consideration of the full range of the government's potential remedies (including incarceration, fines, penalties, damages, restitution to victims, asset seizure, civil and criminal forfeiture, and exclusion, suspension and debarment) and promotes the most thorough and appropriate resolution in every case. That is why the Department has long recognized the importance of parallel development of civil and criminal proceedings. *See* USAM 1-12.000.

Criminal attorneys handling corporate investigations should notify civil attorneys as early as permissible of conduct that might give rise to potential individual civil liability, even if criminal liability continues to be sought. Further, if there is a decision not to pursue a criminal action against an individual – due to questions of intent or burden of proof, for example – criminal attorneys should confer with their civil counterparts so that they may make an assessment under applicable civil statutes and consistent with this guidance. Likewise, if civil attorneys believe that an individual identified in the course of their corporate investigation should be subject to a criminal inquiry, that matter should promptly be referred to criminal prosecutors, regardless of the current status of the civil corporate investigation.

Department attorneys should be alert for circumstances where concurrent criminal and civil investigations of individual misconduct should be pursued. Coordination in this regard should happen early, even if it is not certain that a civil or criminal disposition will be the end result for the individuals or the company.

4. Absent extraordinary circumstances, no corporate resolution will provide protection from criminal or civil liability for any individuals.

There may be instances where the Department reaches a resolution with the company before resolving matters with responsible individuals. In these circumstances, Department attorneys should take care to preserve the ability to pursue these individuals. Because of the importance of holding responsible individuals to account, absent extraordinary circumstances or approved departmental policy such as the Antitrust Division's Corporate Leniency Policy, Department lawyers should not agree to a corporate resolution that includes an agreement to dismiss charges against, or provide immunity for, individual officers or employees. The same principle holds true in civil corporate matters; absent extraordinary circumstances, the United States should not release claims related to the liability of individuals based on corporate settlement releases. Any such release of criminal or civil liability due to extraordinary circumstances must be personally approved in writing by the relevant Assistant Attorney General or United States Attorney.

5. **Corporate cases should not be resolved without a clear plan to resolve related individual cases before the statute of limitations expires and declinations as to individuals in such cases must be memorialized.**

If the investigation of individual misconduct has not concluded by the time authorization is sought to resolve the case against the corporation, the prosecution or corporate authorization memorandum should include a discussion of the potentially liable individuals, a description of the current status of the investigation regarding their conduct and the investigative work that remains to be done, and an investigative plan to bring the matter to resolution prior to the end of any statute of limitations period. If a decision is made at the conclusion of the investigation not to bring civil claims or criminal charges against the individuals who committed the misconduct, the reasons for that determination must be memorialized and approved by the United States Attorney or Assistant Attorney General whose office handled the investigation, or their designees.

Delays in the corporate investigation should not affect the Department's ability to pursue potentially culpable individuals. While every effort should be made to resolve a corporate matter within the statutorily allotted time, and tolling agreements should be the rare exception, in situations where it is anticipated that a tolling agreement is nevertheless unavoidable and necessary, all efforts should be made either to resolve the matter against culpable individuals before the limitations period expires or to preserve the ability to charge individuals by tolling the limitations period by agreement or court order.

6. **Civil attorneys should consistently focus on individuals as well as the company and evaluate whether to bring suit against an individual based on considerations beyond that individual's ability to pay.**

The Department's civil enforcement efforts are designed not only to return government money to the public fisc, but also to hold the wrongdoers accountable and to deter future wrongdoing. These twin aims – of recovering as much money as possible, on the one hand, and of accountability for and deterrence of individual misconduct, on the other – are equally important. In certain circumstances, though, these dual goals can be in apparent tension with one another, for example, when it comes to the question of whether to pursue civil actions against individual corporate wrongdoers who may not have the necessary financial resources to pay a significant judgment.

Pursuit of civil actions against culpable individuals should not be governed solely by those individuals' ability to pay. In other words, the fact that an individual may not have sufficient resources to satisfy a significant judgment should not control the decision on whether to bring suit. Rather, in deciding whether to file a civil action against an individual, Department attorneys should consider factors such as whether the person's misconduct was serious, whether it is actionable, whether the admissible evidence will probably be sufficient to obtain and sustain a judgment, and whether pursuing the action reflects an important federal interest. Just as our prosecutors do when making charging decisions, civil attorneys should make individualized assessments in deciding whether to bring a case, taking into account numerous factors, such as the individual's misconduct and past history and the circumstances relating to the commission of the misconduct, the needs of the communities we serve, and federal resources and priorities.

Although in the short term certain cases against individuals may not provide as robust a monetary return on the Department's investment, pursuing individual actions in civil corporate matters will result in significant long-term deterrence. Only by seeking to hold individuals accountable in view of all of the factors above can the Department ensure that it is doing everything in its power to minimize corporate fraud, and, over the course of time, minimize losses to the public fisc through fraud.

Conclusion

The Department makes these changes recognizing the challenges they may present. But we are making these changes because we believe they will maximize our ability to deter misconduct and to hold those who engage in it accountable.

In the months ahead, the Department will be working with components to turn these policies into everyday practice. On September 16, 2015, for example, the Department will be hosting a training conference in Washington, D.C., on this subject, and I look forward to further addressing the topic with some of you then.