CORPORATE GOVERNANCE & FINANCE LAW

ROY GIRASA

Corporate Governance and Finance Law

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Corporate Governance and Finance Law

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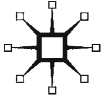

CORPORATE GOVERNANCE AND FINANCE LAW
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Dedication to my Grandchildren
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Preface

The events of the latter part of the first decade of the new century are reminiscent of the turmoil that occurred in the aftermath of October 1929 when the stock market collapsed and the Great Depression overtook the nation. Albeit mild in comparison, with unemployment substantially less than half that of the 1930s, they created widespread anxiety and questioning concerning who and what caused the latest shock and what steps are to be taken to restore U.S. global leadership. The major political parties have debated on separate rails that do not intersect, thus preventing any discussion that could lead to possible solutions that benefit the nation. The placement of blame has become the mantra of the left and the right of the political spectrum fueled by extremist commentators and new political actors rather than reasoned moderation among leaders of the diverse parties.

This text is designed to assist students and persons interested in the complex world of finance to learn about the legal bases of finance, especially in the light of congressional enactments that are reminiscent of the major pieces of legislation of the 1930s. The Sarbanes-Oxley Act, passed under the auspices of a conservative Republican president with the concurrence of both political parties, and the Dodd-Frank Act, passed in the face of unanimous opposition in Congress by the Republican Party, have profoundly affected the financial world today. The debate has now turned on whether either or both of the statutes are too stifling to businesses seeking to compete in a very difficult global environment. Laws, in part, are created to correct perceived abuses. Whether the two acts plus the enactment of the health care legislation have exacerbated the financial crisis and its aftermath remains to be determined. This text is designed to acquaint the readers of the many but not all aspects of finance affected by the said legislation.

Inasmuch as this author wrote every word of the text with heavy reliance on the works of leading scholars and commentaries to the said legislation, all errors are, of course, his. The author would deeply appreciate comments from other scholars, which will be reflected in any later edition of the text should it be published. My indebtedness is profound to the authors and works of the following authors whose volumes were examined and learned from by this author. They include the following texts:

Corporate Finance by Jeffrey J. Haas
Securities Regulation by Thomas Lee Hazen
Investment Adviser Regulation by Jeffrey J. Haas and Steven R. Howard

Broker-Dealer Regulation by Thomas Lee Hazen
Mergers and Acquisitions by Dale A. Oesterle
Antitrust Law and Economics by Ernest Gellhorn, William E, Kovacic*, and Stephen Calkins*
Banking and Financial Institutions Law by William Lovett
Real Estate Finance by Jon W. Bruce
Bankruptcy and Related Law by David G. Epstein
Also notable is *Corporate Governance: Principles and Practices* by Walter A, Effross

The said texts were recommended readings for my graduate class on the Law of Finance given for the first time in spring 2012. Having taught MBA courses at the University of Shanghai and at the University of Applied Sciences, Fachhochschule, Stralsund, Germany, lectured at numerous other locales, and having attended the College of Europe in Bruges, Belgium, decades ago, I added both Chinese and European Union components to the text.

I am deeply grateful to numerous persons without whose assistance I would not have entered into the teaching field at age 42 but would have remained a litigator without time to learn about the many advances of the law and the events in the political universe. The most important person in the academic world is my colleague Dr. Richard J. Kraus, who has influenced my life as an instructor and on a deeply personal level, having initially hired me to teach full-time when I had no such ambition. The person most instrumental for this text is Dr. P.V. Viswanath, the chairperson of the Finance Department at my university who first requested that a law course be created that would be devoted to finance. It was the lack of such a text that brought about this volume.

I am also grateful to Dr. Michael Ulinski of the Accounting Department with whom I have coauthored a number of articles; Dr. Bel Raggad who had me lead a number of conferences in Tunisia where the "Arab Spring" began; Dr. Emilio Collar of Western Connecticut State University with whom I have had many conversations concerning this text; Gary Tidwell of FINRA and IOSCO, who retained me to give a series of lectures to the Saudi Arabia Capital Markets Authority and its Institute of Banking, which opened the floodgates for this writer to the vast area of securities law on a global basis; Dr. Surendra Kaushik of my university's Finance Department who is a remarkable Professor of Finance who had me share in his creation of a women's college in India named after his wife, Helena Kaushik. From Palgrave Macmillan, this work would not have proceeded without the initial referral by the publisher's representative Christina Mastrogiovanni, the extensive assistance of senior editor Brian J. Foster, the nitty-gritty work of Leila Campoli, and the much needed editing by Flora Kenson.

My many thanks to my colleague Dr. Sharlene McEvoy of Fairfield University for her cooperation; Professor Philip Cohen for our many conversations; Professor George Pappas for his input on taxation and related areas; Dr. David Nabirahni for his unending support; Dr. Victor Lopez of Hofstra University whose textbooks and encouragement in part inspired the writing of this text; Dr. William Raynor for his review and input; and the many professors I have

intersected with in over three decades of teaching. Thanks to the Dean of the Lubin School of Business of Pace University, Neil S. Braun, who gave me a grant to allow total devotion to writing this text in the summer of 2012. I have been blessed with the kindness and assistance of program coordinators at Pace University, namely, Lucille Kenny and Patricia Saviano. Thanks to Megan Burke who assisted in the technological aspects of setting the text in a coordinated format. My son James Girasa, a day trader, gave me insights into the practical aspects of executing trades; my son Roy John Girasa, who is both a marketer and finance expert, lent his advice, and my son George Girasa aided in research and much practical assistance. Finally, my profound thanks to Camille D'Agostino without whose encouragement this text would not have been written.

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Acronyms

AIFM	Alternative Investment Fund Managers
AIG	American International Group
ARM	Adjustable Rate Mortgage
BAPCPA	Bankruptcy Abuse Prevention and Consumer Protection Act
CBRC	China Banking Regulatory Commission
CCP	(Derivatives) Central Counterparties
CEA	Commodity Exchange Act
CFPB	Consumer Financial Protection Bureau
CFTC	Commodity Futures Trading Commission
CIRC	China Insurance Regulatory Commission
CRA	Community Reinvestment Act
CRD	Central Registration Depository
CRO	Credit Repair Organization
CSR	Corporate Social Responsibility
DCGL	Delaware General Corporation Law
EDGAR	Electronic Data Gathering Analysis and Retrieval System
EU	European Union
FACT Act	Fair and Accurate Credit Transactions Act
FCM	Forex Capital Markets
FCPA	Foreign Corrupt Practices Act
FCRA	Federal Credit Reporting Act
FDCPA	Fair Debt Collection Practices Act
FINRA	Financial Industry Regulatory Association
FNMA	Federal National Mortgage Association
FSA	Financial Services Authority
FSB	Financial Stability Board
FTC	Federal Trade Commission
GNMA	Government National Mortgage Association
ILO	International Labor Organization
IOSCO	International Organization of Securities Commissions
LBO	Leveraged Buy-Out
LIBOR	London Interbank Offered Rate
LLC	Limited Liability Company
LLP	Limited Liability Partnership
LLLP	Limited Liability Limited Partnership

M&As	Mergers and Acquisitions
MBLA	Model Business Corporation Act
MERS	Mortgage Electronic Registration System
MiFID	Markets in Financial Instruments Directive
MOFCOM	Ministry of Commerce (of People's Republic of China)
NDA	Nondisclosure Agreement
NRSRO	Nationally Recognized Statistical Rating Organizations
NYSE	New York Stock Exchange
OECD	Organization for Economic Cooperation and Development
OHC	Office of Housing Counseling
OSHA	Occupational Safety and Health Administration
OTC	Over-the-Counter
PC	Professional Corporation
PCAOB	Public Company Accounting Oversight Board
PIPE	Public Equity Transactions
PLLC	Professional Limited Liability Company
PRC	People's Republic of China
PSLRA	Private Securities Litigation Reform Act
RESPA	Real Estate Procedures Act
RMBCA	Revised Model Business Corporation Act
RMB	Renminbi
SBSA	Security-Based Swap Agreement
SEC	Securities and Exchange Commission
SLUSA	Securities Litigation Uniform Standards Act
SOX	Sarbanes-Oxley Act
SRO	Self-Regulatory Organization
TARP	Troubled Assets Relief Program
TR	Trade Repository
WKSI	Well-Known Seasoned Issuer

CHAPTER 1

Overview of the Law of Finance

Introduction

Law has been described as a seamless web that for convenience and specialization is divided into a number of categories. Thus, students taking an introductory course in the study of law may be taught that the subject is divided into the categories of public or private; substantive or procedural; civil or criminal; national, regional, or international; and other artificial distinctions. Persons who have studied law for many decades see its unifying aspects as well as the subtleties of its categories. Just as a physician may specialize in one category of the human body, most lawyers tend to become competent in one particular area of the law such as criminal law, tort law, or corporate law. Nevertheless, in today's complex society an attorney must also understand the interrelationship of legal aspects outside of their competence. Corporate attorneys in the past concentrated on legal aspects of mergers and acquisitions, reorganizations, duties of corporate directors and officers, contractual issues relating to public and private offerings, and the many other substantive areas in which executives are engaged. However, today they must become aware of the possible criminal and tortious behavior of their clients.

The scandals of the past decade, which have been discussed exhaustively ad nauseam in corporate offices by corporate attorneys, and in accounting firms, led to the passage of significant congressional enactments that affect finance. These include the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Act of 2010. When this author attended law school in the late 1950s, criminal law was given very low priority, consisting of a two-credit course that mainly covered acts of violence by poor individuals living in slum-like conditions. There was no discussion of white-collar crime inasmuch as such behavior almost never resulted in prosecution and/or imprisonment. The enactment of the Sarbanes-Oxley Act, with its very significant provisions of 20-year imprisonment for certain offenses, and the conviction of Enron's chief executive officer (CEO) and other senior executives who did receive or faced such terms, finally caught the attention of corporate executives.

The lengthy terms of imprisonment, which constituted almost a life sentence for older executives; the vigorous enforcement of securities and other laws; the

demise of a major accounting firm; the spread of anticorruption enactments beyond the United States; and the protection of and significant financial incentives given to whistle-blowers mandate that executives become aware of the laws affecting their activities. They must not only become experts in managerial, marketing, accounting, and/or financial aspects of the corporation but they must also pay attention to actual or perceived wrongdoings within a firm. Executives can no longer leave it to "legal" and ignore the laws that pertain to their daily activities. The CEO and the chief financial officer (CFO) may no longer be able to hide behind the "I didn't know" defense, blaming wrongful conduct on lower-level employees or other third parties. It may be beyond the competence of corporate attorneys to salvage the tortious or criminal behavior of executives.

This text is designed to acquaint students, both graduate and undergraduate, as well as corporate executives and other interested parties of the legal aspects of the world of finance. Specific advances in the law tend to be emphasized at different times. Thus, there were many changes in criminal law following numerous rulings by the U.S. Supreme Court (Warren Court) in the 1960s that continue to greatly have an impact to the present day (e.g., the Miranda Rule). Employment law changed dramatically in the 1960s and early 1970s with the passage of the Equal Pay Act of 1963, Title VII in the Civil Rights Act of 1964, the Age in Discrimination Employment Law of 1967, and other employment-related legislation. Marital law took a giant leap forward in the 1980s with the enactment of equitable distribution laws in many states as well as with the liberalization of the grounds for a divorce. Entirely new areas of the law, such as cyberlaw, which had its dramatic upswing in the 1990s and early 2000s, sprung up thereafter. After such sudden bursts, persons affected, including practitioners and judges, go about interpreting and enforcing these areas of the law, which then become more staid with few dramatic changes.

Great advances are being made in the law of finance due to the statutory and regulatory changes in the legal landscape. It is anticipated that this area of the law is and will continue to be "hot" over the next decade with the likelihood of additional legislative enactments. It is incumbent upon all students entering the business world to have at least an awareness of the law affecting their activities. Senior officers are now required, in most instances, to ensure that there are systems in place to detect fraud and other wrongful acts or omissions in which they have been personally involved or whose existence they know of.

Contents of the Text

Deciding which subjects and their subcategories to include, as well as the degree of attention to be paid to them, in a text on the law of finance is necessarily subjective. Authors of various texts tend to emphasize the areas of law of their expertise and may ignore or inadvertently deemphasize subjects that are important for the reader. Although this author is aware of the pitfalls of making choices, it is suggested that the sequence of the subjects covered be as stated hereinafter. Due to the size of the initial text, which consisted of 14 chapters, it was decided that the subject matter be divided into two volumes of six and eight chapters respectively.

The first volume (this text) is entitled *Corporate Governance and Finance Law*. It is divided into two sections; the first section covers corporate governance, which includes a detailed examination of securities laws. Included in the discussion are an introduction to the outline of the text; a review of the basic forms of doing business; a discussion of corporate governance; an examination of the impact of recent federal legislation particularly as they affect corporate governance; and an examination of other basic forms of corporate governance globally. In this chapter, the basic legal forms of doing business are reviewed. We begin briefly with individual proprietorships, and then proceed to general partnerships and their later evolution to limited partnerships, limited liability partnerships, and even limited liability limited partnerships. Thereafter, we examine in greater detail the types of corporations and recent additions of hybrid forms such as the limited liability company.

In chapters 2 and 3, we examine corporate governance within the United States and some of the varied forms thereof in other countries. As the reader will note, corporate governance differs substantially from country to country and from continent to continent. It continues to evolve as businesses and the legal regimes of many countries seek to find the forms of business that will maximize the welfare and betterment of corporate entities and their stakeholders. Thus, for example, Japanese companies, which had their own unique form of corporate governance that included lifetime employment for employees, have been compelled to adopt some aspects of "Western" corporate governance.

Thereafter, we review securities laws and regulations that have undergone seismic changes. In Chapter 4, we commence the discussion with a brief overview of the major statutes affecting securities—the focus, however, is on the Securities Act of 1933. In Chapter 5, we continue with a discussion of the Securities Exchange Act of 1934, as well as a brief discussion of comparable legislation in the European Union (EU) and in the People's Republic of China. Chapter 6 contains a discussion of swaps, which was one of the areas of concern during the financial crisis of 2007–2009 and continues to be a subject of major importance to the present day. In addition, we examine U.S. and international efforts to combat corruption of foreign persons by business personnel.

In the second volume entitled *Laws and Regulations in Global Financial Markets*, we continue with a discussion of laws and regulations affecting the many areas of finance. In Chapter 1 of the second volume, we examine in depth the rules and regulations affecting investment advisers In Chapter 2 thereof, we review the issues affecting broker-dealers and how they are regulated both within the United States and abroad. A discussion of mergers and acquisitions including a discussion of the antitrust implications thereof follows in Chapter 3. In Chapter 4, we discuss bankruptcy, particularly reorganization, which permits the filing of plans that enabled many companies to rid themselves of contractual and other obligations that prevented them from being competitive in the global marketplace. Thereafter, we review the very important changes in the law and regulations affecting banks and credit ratings organizations in Chapter 5.

In Chapter 6 of the second volume, we discuss new rules governing real estate financing. Many observers have placed the blame for the financial crisis

of 2007–2009 on the collapse of the real estate market, which was caused by a near-total refusal by lending institutions to observe fundamental rules that assure repayment of mortgage loans by borrowers. In Chapter 7 we review insurance topics of major concern today including the controversial Patient Protection and Affordable Care Act. In Chapter 8 we conclude with personal finance and the related federal statutes, as well as the promotion of financial literacy especially among consumers. The international developments in each of the subject areas are also discussed. Large corporate entities have not been purely domestic for many decades. Many of them lost their national identities because of greater opportunities abroad especially in Asia; tax avoidance; the cost of doing business; stability within the nation-state; or a myriad other reasons.

The laws and regulations of the EU are reviewed at the end of most chapters. The reason for this arbitrary selection is that the EU consists of 27 member states, most of which have advanced economies. We have also added the rules and regulations of the People's Republic of China (hereinafter China), which is the second largest economic power in the world today and will likely surpass the United States in the near future. The addition of China came about when I was teaching the Law of Finance to a graduate class for the first time at my university. Almost all the students in my class were from China and all but one of the students from China were women. I have observed the immense growth of China since I had the honor of teaching courses therein, including at the University of Shanghai, over the past few decades. There are substantial similarities among the rules and regulations adopted by the various nations with respect to the topics covered in this text. China, for example, did not have to "reinvent the wheel" but rather reflected upon and enacted laws and regulations that emulate Western legal concepts with some changes that reflect its tradition and mores. Although the EU and the United States have much in common with respect to cultural and social norms, there are variations especially in the area of common accounting standards and principles. Attempts to unify auditing and other accounting norms globally continue to the present day, but a deep divide due mainly to the unwillingness of the SEC and other governmental and non-governmental bodies to adopt to global standards in place of the current U.S. generally accepted accounting standards.

Forms of Business Enterprises

Individual Proprietorship

The individual or sole proprietorship form of business has been in existence from time immemorial, with a person or persons initiating a business for which he or she is ultimately solely responsible, receiving all of the benefits but also the entire liabilities attendant to the business enterprise. The advantages and disadvantages are obvious. It is the simplest, cheapest, and most private of all business forms. The proprietor receives all of the financial benefits but such person exposes his or her personal assets should the enterprise fail. It exists globally and is universal

in less developed countries. Individuals with little or no education may simply set up shop, as evident from the corner jeans proprietor on the streets of Ho Chi Minh City in Vietnam, to the midstreet barbershop in Mumbai, or to the "Mom and Pop" store in any community in the United States.

There may be legal requirements such as the collection of sales taxes, licenses, and other local obligations for the sale of products or the provision of services to consumers. Federal, state, and local taxes may be imposed on earnings from the business. Tax avoidance of business profits is common to such enterprises because of the difficulty in ascertaining the actual receipts and expenditures of small enterprises. This form of business is abhorrent to the attorney who often suggests the use of a corporate form to lessen the possible personal liability that is attendant to individual enterprises. Nevertheless, and especially if the business has little risk, this form of doing business may be appropriate, especially if one possesses few assets that may be seized in the event of business losses. If the individual wishes to use an assumed or trade name such as "Mary Smith d/b/a/ Smith's Stylish Dress Shop," he or she may have to file a certificate with the local county clerk's office or other such documentation or office as the state or local governmental entity may require.

Partnerships

Prior to the 1970s, there were three basic forms of doing business: the individual proprietorship discussed above, the general partnership, and the corporate form. Sometime in the mid-1970s, states began to permit a variety of other forms of doing business that were hybrid elements of the three types. At one time partnerships were designated as "general partnerships," which, like individual proprietorships, were highly risky to the persons entering into this mode of doing business. There were numerous horror stories of persons subjected to individual liability for actions of the partnership that often left one of several partners fully liable without the ability to compel the remaining partners to contribute to the payment of partnerships debts. As a result, states enacted legislation to permit alternative forms of partnerships that provide some relief from full exposure of one's personal assets. These additional forms are "limited partnerships," "limited liability partnerships" (LLPs), and the "limited liability limited partnership" (LLLP), a more recent addition in a few U.S. states.

General Partnership

A partnership is defined as two or more persons who join together as co-owners to operate a business for a profit. It need not be an equal partnership. It could be as extreme as one partner who receives almost all of the profit while the remaining partner receives a very small percentage of the profit of the enterprise generally coupled with a salary. The agreement to operate as a partnership may be oral or in writing. If in writing, the partnership agreement is generally filed with the local county clerk's office or remains in the possession of the partners. If oral, and especially if a dispute arises, a court, in determining whether a partnership

arrangement existed between the parties, looks mainly at whether the parties intended to operate a business for profit and whether each of the parties is to receive a share of the profits. Other factors may include how they are designated on an office letterhead, who may sign checks, and whether they participate in managing the business.

Liability. In a general partnership each of the partners may be *jointly* and *severally* (individually) liable for contractual debts owed by the partnership, that is, both the partnership and each of the partners may become liable for partnership debts provided *all* partners are named in the lawsuit. They are also *jointly and severally liable* for torts committed by any of the partners, which means that each of the partners may be sued individually and may be personally liable for a tort committed by a partner in course of partnership business, even if he or she did not participate in the tort. A "tort" is a wrongful act by a party that causes harm to another party whether intentionally, negligently, or where the law imposes strict liability. For example, a number of years ago, there were two law partners who maintained a sizeable trust account on behalf of their clients. One of the partners absconded with the several millions of dollars in the partnership trust account. The innocent partner was sued and held liable to the clients for the amount stolen but was not held liable additionally for punitive damages inasmuch as he had not participated in the wrongful conversion of funds.

Taxation. Partnerships are governed by "flow-through taxation" provisions of the U.S. Internal Revenue Code, which means that the partnership must file a partnership return but need not pay any taxes. The individual partners pay taxes on their respective share of the profits, if any.

Dissolution and Dissociation. A partnership may be dissolved in a number of ways: (1) a partner may simply decide to leave the partnership; (2) the original agreement forming the partnership may have provided for a termination date (usually seen in a *joint venture* that may take the form of a partnership to accomplish a single purpose or objective); (3) the death or physical or mental inability of a partner to participate in the partnership; (4) the expulsion of a partner; or (5) by court order. Once a partner's relation to the partnership is ended, either the partnership may terminate and wind up its affairs or a majority of the remaining partners may elect to continue the partnership usually by buying out the said partner's interest. If the partnership ceases, all assets and debts are determined and the creditors are paid the sums due and owing to them. Any remaining funds are distributed to pay for a partner's monetary contribution to the partnership, with the remaining profits, if any, divided in accordance with the terms of the partnership agreement.

Limited Partnership

As was stated above, a partnership arrangement is fraught with considerable risk to individual partners for partnership indebtedness. Individuals lacking in legal sophistication often came together unaware that their personal assets would be subject to seizure for the torts committed by other partners and for the contracts of the partnership beyond their individual percentage ownership of the

business. Accordingly, most U.S. states enacted the Uniform Limited Partnership Act (ULPA) that was later followed by the Revised Uniform Limited Partnership Act (RULPA). A limited partnership is a hybrid of a general partnership and a corporate form of doing business. To create a limited partnership, there must be at least one general partner who is fully liable personally for the torts and contracts of the partnership, while the remaining partners may limit their personal liability to the capital contribution invested in the enterprise. The caveat is that the limited partners must refrain from active participation in the day-to-day operation of the partnership business, which is the responsibility of the general partner. It was this author's experience that entrepreneurs avoided personal liability by having a new corporation with few, if any, assets assume the role of a general partner.

Unlike a general partnership that may exist without a written agreement, the limited partnership must (1) be permitted by state law; (2) have a written agreement known as the "certificate of limited partnership" that spells out the details of the partnership, which include the name of the partnership, the nature of the business, the person designated as agent to receive legal process, the names and addresses of the general and limited partners, the financial contribution of the each party, the date of dissolution, and other pertinent information; and (3) file the certificate with the Secretary of State of the state in which the enterprise is registered. In order to protect against individual personal liability for partnership losses, the general partner may be a corporation, a trust, or even another partnership. If a limited partner leaves the partnership, the partnership entity continues to survive but if a general partner no longer remains in such capacity and is not replaced by another general partner, the partnership dissolves and the winding-up process takes place. The tax requirements are similar to that of a general partnership.

Limited Liability Partnership and Limited Liability Limited Partnership
An "LLP is essentially the same as a limited partnership except that there is no requirement that there be at least one general partner. No partner is liable or accountable for any debts, obligations, or liabilities chargeable to the LLP arising out of tort, contract, or otherwise solely by having the status as a partner in the conduct of partnership business. This includes a partner in a partnership that renders professional services unless the said partner has committed a negligent or wrongful act that is the subject of a lawsuit or the act was committed under his or her supervision and control while rendering the said professional service. In the few states that permit an LLLP, the said partnership form is one that is similar to an LLP but has a general partner and limited partners. The general partner, however, has no personal liability for partnership obligations (Figure 1.1).

Corporations

A corporation is an artificial entity created by state or federal law. As stated by the U.S. Supreme Court in *Dartmouth College v. Woodward*,[1] corporations are artificial entities "invisible, intangible, and existing only in contemplation

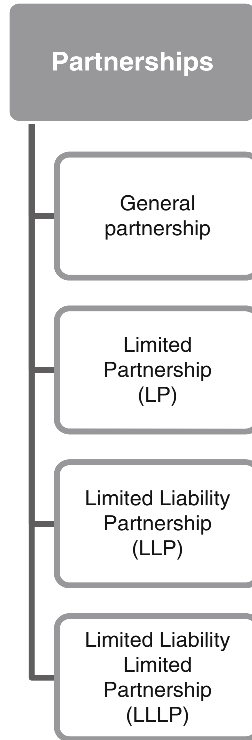

Figure 1.1 Types of partnerships

of law . . . ." Almost all corporations are created under state law, although a few corporations, mainly government entities such as the Federal Deposit Insurance Corporation (FDIC) or the New York and New Jersey Port Authority, may be creatures of federal or state law. A corporation possesses almost all of the rights and obligations of individuals. It can own property in its name, it has potentially unlimited duration, and it can sue and be sued provided certain legal requirements have been met; also, its shares may be freely transferable and it has most of the constitutional rights of individuals. One constitutional right it does not possess is the Fifth Amendment right to remain silent.

Although, historically, until the 1970s, corporations had limited rights under the First Amendment of the U.S. Constitution, the U.S. Supreme Court had expanded commercial speech protections in two earlier 1970 cases, albeit in favor of an individual and a consumer organization. In *Bigelow v. Commonwealth of Virginia*,[2] the court extended the right to advertise when it held that a newspaper editor could allow the advertisement of abortion services by an out-of-state abortion provider even though abortion was a crime in the state of publication at that time. The case initially preceded the *Roe v. Wade* decision,[3] which upheld the right of privacy and freedom of choice of women to have an abortion. In *Virginia*

State Pharmacy Board v. Virginia Citizens Consumer Council,[4] the Supreme Court ruled that the Virginia State Board of Pharmacy could not limit a pharmacist's right to provide information about prescription drug prices to potential customers. The Court distinguished the type of speech of corporations that would be constitutionally protected based on the social value of the speech. For example, protecting corporate speech concerning the sale of pots and pans, automobiles, cigarettes, and the like, has limited constitutional rights, while commercial speech that the court deems the public has a right to hear is given rights comparable to that of individuals.

Notwithstanding prior precedents, in the following 2010 decision the U.S. Supreme Court, wherein there were four dissenting votes of the nine justices perhaps reflecting ideological prerogatives, greatly expanded corporate freedom of speech protections.

Citizens United v. Federal Election Commission

558 U.S. 50 (USSC 2010)[5]

FACTS[6]: Citizens United is a nonprofit corporation . . . . It has an annual budget of about $12 million. Most of its funds come from donations by individuals; but, in addition, it accepts a small portion of its funds from for-profit corporations. In January 2008, Citizens United released a film entitled *Hillary: The Movie* . . . , a 90-minute documentary about the then-Senator Hillary Clinton, who was a candidate in the Democratic Party's 2008 presidential primary elections. *Hillary* mentions Senator Clinton by name and depicts interviews with political commentators and other persons, most of them quite critical of her. *Hillary* was released in theaters and on DVD, but Citizens United wanted to increase distribution by making it available through video-on-demand.

Video-on-demand allows digital cable subscribers to select programming from various menus, including movies, television shows, sports, news, and music. The viewer can watch the program at any time and can elect to rewind or pause the program. In December 2007, a cable company offered, for a payment of $1.2 million, to make *Hillary* available on a video-on-demand channel called "Elections '08 . . . ." Some video-on-demand services require viewers to pay a small fee to view a selected program, but here the proposal was to make *Hillary* available to viewers free of charge. To implement the proposal, Citizens United was prepared to pay for the video-on-demand; and to promote the film, it produced two 10-second ads and one 30-second ad for *Hillary*. Each ad includes a short (and, in our view, pejorative) statement about Senator Clinton, followed by the name of the movie and the movie's website address . . . . Citizens United desired to promote the video-on-demand offering by running advertisements on broadcast and cable television.

Citizens United wanted to make *Hillary* available through video-on-demand within 30 days of the 2008 primary elections. It feared, however, that both the film and the ads would be covered by [the Federal Election Commission's (FEC's)] §441b's ban on corporate-funded independent expenditures, thus subjecting the corporation to civil and criminal penalties under §437g. In December 2007, Citizens United sought declaratory and injunctive relief against the FEC. It argued that the act is unconstitutional as applied to *Hillary;* and (2) BCRA's [Bipartisan Campaign Reform Act's] disclaimer and disclosure requirements are unconstitutional as applied to *Hillary* and to the three ads for the movie.

ISSUES: (1) Whether §441b is unconstitutional as applied to the ad Citizens United sought to issue?

(2) Whether BCRA's disclaimer, disclosure, and reporting requirements, BCRA §§201 and 311, were unconstitutional as applied to *Hillary* and the ads?

DECISION: The court, in a 5-4 decision, with concurring opinions and dissenting opinions as to all or part of the majority decision, decided that the said §441b was an unconstitutional violation of the First Amendment of the U.S. Constitution.

REASONING (Kennedy, J.): Before the Bipartisan Campaign Reform Act of 2002 (BCRA), federal law prohibited—and still does prohibit—corporations and unions from using general treasury funds to make direct contributions to candidates or independent expenditures that expressly advocate the election or defeat of a candidate, through any form of media, in connection with certain qualified federal elections . . . . BCRA §203 amended §441b to prohibit any "electioneering communication" as well . . . . An electioneering communication is defined as "any broad cast, cable, or satellite communication" that "refers to a clearly identified candidate for Federal office" and is made within 30 days of a primary or 60 days of a general election . . . . The Federal Election Commission's (FEC) regulations further define an electioneering communication as a communication that is "publicly distributed . . . ." "In the case of a candidate for nomination for President . . . *publicly distributed* means" that the communication "[c]an be received by 50,000 or more persons in a State where a primary election . . . is being held within 30 days . . . ."

Corporations and unions are barred from using their general treasury funds for express advocacy or electioneering communications. They may establish, however, a "separate segregated fund" (known as a political action committee, or PAC) for these purposes . . . The moneys received by the segregated fund are limited to donations from stockholders and employees of the corporation or, in the case of unions, members of the union . . . .

The First Amendment provides that "Congress shall make no law . . . abridging the freedom of speech." Laws enacted to control or suppress speech may operate at different points in the speech process. The following are just a few examples of restrictions that have been attempted at

different stages of the speech process—all laws found to be invalid: restrictions requiring a permit at the outset, *Watchtower Bible & Tract Soc. of N.Y., Inc. v. Village of Stratton*, 536 U.S. 150, 153 (2002); imposing a burden by impounding proceeds on receipts or royalties, *Simon & Schuster, Inc. v. Members of N.Y. State Crime Victims Bd.*, 502 U.S. 105, 108, 123 (1991); seeking to exact a cost after the speech occurs, *New York Times Co. v. Sullivan*, 376 U.S., at 267; and subjecting the speaker to criminal penalties, *Brandenburg v. Ohio*, 395 U.S. 444, 445 (1969) *(per curiam).*

The law before us is an outright ban, backed by criminal sanctions. §441b makes it a felony for all corporations—including nonprofit advocacy corporations—either to expressly advocate the election or defeat of candidates or to broadcast electioneering communications within 30 days of a primary election and 60 days of a general election. Thus, the following acts would all be felonies under §441b: The Sierra Club runs an ad, within the crucial phase of 60 days before the general election, that exhorts the public to disapprove of a congressman who favors logging in national forests; the National Rifle Association publishes a book urging the public to vote for the challenger because the incumbent U.S. Senator supports a handgun ban; and the American Civil Liberties Union creates a Web site telling the public to vote for a Presidential candidate in light of that candidate's defense of free speech. These prohibitions are classic examples of censorship. §441b is a ban on corporate speech notwithstanding the fact that a PAC created by a corporation can still speak . . . . A PAC is a separate association from the corporation. So the PAC exemption from §441b's expenditure ban, §441b(b)(2), does not allow corporations to speak.

Even if a PAC could somehow allow a corporation to speak—and it does not—the option to form PACs does not alleviate the First Amendment problems with §441b. PACs are burdensome alternatives; they are expensive to administer and subject to extensive regulations. For example, every PAC must appoint a treasurer, forward donations to the treasurer promptly, keep detailed records of the identities of the persons making donations, preserve receipts for three years, and file an organization statement and report changes to this information within 10 days . . . . And that is just the beginning. PACs must file detailed monthly reports with the FEC, which are due at different times depending on the type of election that is about to occur:

These reports must contain information regarding the amount of cash on hand; the total amount of receipts, detailed by 10 different categories; the identification of each political committee and candidate's authorized or affiliated committee making contributions, and any persons making loans, providing rebates, refunds, dividends, or interest or any other offset to operating expenditures in an aggregate amount over $200; the total amount of all disbursements, detailed by 12 different categories; the names of all authorized or affiliated committees to whom expenditures

aggregating over $200 have been made; persons to whom loan repayments or refunds have been made; the total sum of all contributions, operating expenses, outstanding debts and obligations, and the settlement terms of the retirement of any debt or obligation . . . .

PACs have to comply with these regulations just to speak. This might explain why fewer than 2,000 of the millions of corporations in this country have PACs. PACs, furthermore, must exist before they can speak. Given the onerous restrictions, a corporation may not be able to establish a PAC in time to make its views known regarding candidates and issues in a current campaign. Section 441b's prohibition on corporate independent expenditures is thus a ban on speech. As a "restriction on the amount of money a person or group can spend on political communication during a campaign," that statute "necessarily reduces the quantity of expression by restricting the number of issues discussed, the depth of their exploration, and the size of the audience reached . . . ." Were the Court to uphold these restrictions, the Government could repress speech by silencing certain voices at any of the various points in the speech process . . . . (Government could repress speech by "attacking all levels of the production and dissemination of ideas," for "effective public communication requires the speaker to make use of the services of others.") If §441b applied to individuals, no one would believe that it is merely a time, place, or manner restriction on speech. Its purpose and effect are to silence entities whose voices the Government deems to be suspect.

Speech is an essential mechanism of democracy, for it is the means to hold officials accountable to the people . . . . The right of citizens to inquire, to hear, to speak, and to use information to reach consensus is a precondition to enlightened self-government and a necessary means to protect it. The First Amendment " 'has its fullest and most urgent application' to speech uttered during a campaign for political office."

For these reasons, political speech must prevail against laws that would suppress it, whether by design or inadvertence . . . .

Dissenting Opinion (Stevens, J). The real issue in this case concerns how, not if, the appellant may finance its electioneering. Citizens United is a wealthy nonprofit corporation that runs a PAC with millions of dollars in assets. Under BCRA 2002, it could have used those assets to televise and promote *Hillary: The Movie* wherever and whenever it wanted to. It could also have spent unrestricted sums to broadcast *Hillary* at any time other than the 30 days before the last primary election. Neither Citizens United's nor any other corporation's speech has been "banned." . . . . All that the parties dispute is whether Citizens United had a right to use the funds in its general treasury to pay for broadcasts during the 30-day period.

The notion that the First Amendment dictates an affirmative answer to that question is, in my judgment, profoundly misguided. Even more misguided is the notion that the Court must rewrite the law relating to

campaign expenditures by *for-profit* corporations and unions to decide this case. The basic premise underlying the Court's ruling is its iteration, and constant reiteration, of the proposition that the First Amendment bars regulatory distinctions based on a speaker's identity, including its "identity" as a corporation. While that glittering generality has rhetorical appeal, it is not a correct statement of the law. Nor does it tell us when a corporation may engage in electioneering that some of its shareholders oppose. It does not even resolve the specific question whether Citizens United may be required to finance some of its messages with the money in its PAC. The conceit that corporations must be treated identically to natural persons in the political sphere is not only inaccurate but also inadequate to justify the Court's disposition of this case.

In the context of election to public office, the distinction between corporate and human speakers is significant. Although they make enormous contributions to our society, corporations are not actually members of it. They cannot vote or run for office. Because they can be managed and controlled by nonresidents, their interests may conflict in fundamental respects with the interests of eligible voters. The financial resources, legal structure, and instrumental orientation of corporations raise legitimate concerns about their role in the electoral process. Our lawmakers have a compelling constitutional basis, if not also a democratic duty, to take measures designed to guard against the potentially deleterious effects of corporate spending in local and national races. The majority's approach to corporate electioneering marks a dramatic break from our past. Congress has placed special limitations on campaign spending by corporations ever since the passage of the Tillman Act in 1907 . . . We have unanimously concluded that this "reflects a permissible assessment of the dangers posed by those entities to the electoral process," *FEC v. National Right to Work Comm.*, 459 U.S. 197, 209 (1982)*(NRWC)*, and have accepted the "legislative judgment that the special characteristics of the corporate structure require particularly careful regulation," *id.*, 209–210. The Court today rejects a century of history when it treats the distinction between corporate and individual campaign spending as an invidious novelty born of *Austin v. Michigan Chamber of Commerce*, 494 U.S. 652 (1990).

Questions:

(1) The decision was determined by a 5-4 vote with the conservative justices on the court being in the majority and the four liberal justices on the court voting in strong opposition to the decision. Would a replacement of one of the conservative justices by a more liberal justice hereafter cause a reversal of the decision?

(2) Which view do you agree with? Should a corporation have the same rights under the Constitution as individuals? Would distinguishing a publicly traded corporation from a closed or family corporation

consisting of one or very few shareholders matter in your opinion?

(3) Corporations do not have the right to remain silent under the Fifth Amendment of the U.S. Constitution. In light of the decision, what are your views as to whether corporations should also have the right to remain silent in a court of law, especially if the corporation is owned exclusively by one, two, or three individuals as most corporations are composed?

Liability

Unlike general partnerships wherein partners may be personally liable for debts of the partnership, a corporation alone is responsible for its debts unless claimants can "pierce the corporate veil," that is, sue the shareholders individually when they use the corporation as an alter ego, for example, by commixing corporate assets and indebtedness with their individual ones. As stated previously, in the 1960s, a person commencing a new business had essentially three forms of structuring the governance thereof, that is, an individual proprietorship, a partnership, or a corporation. Most attorneys counseled clients to use a corporate form to protect them against being subject to personal liability for debts of the business. Inasmuch as most businesses fail within two years of commencement, such counsel was appropriate even though theoretically there could be dual tax liability, that is, on corporate profits and on the individual receiving dividends from the corporation. Nevertheless, additional forms of corporations that allow pass-through tax liability were created by states commencing in the 1970s and continuing to the present day.

Types of Corporations

Corporations, historically, have undertaken a variety of forms. They may be:

Publicly Traded or Closely Held Corporations. "Publicly traded" corporations are corporations whose stock is owned by many persons. The stock is listed publicly on exchanges and is usually sold and purchased through brokerage firms. Almost always, the corporation has a board of directors elected by the shareholders that makes the major decisions of the corporation including the appointment of senior officers. Shareholders, in reality, have little power other than electing the board members at annual meetings of the shareholders. Most corporations, however, are formed by one or several individuals commencing a business but who wish to be shielded from personal liability. Whereas state corporate statutes require a high degree of formality, such as the calling of annual shareholders meetings for the election of directors and other business, small firms comprise individuals who own all or almost all of the stock, work with each other daily, and dispense with legal formalities. These corporations are called "closely held" or "closed" corporations whereby formalities take place only in unusual circumstances, for example, when there are hostile actions taking place among the few shareholders.

There are substantial advantages to these private corporations including exemption from Securities and Exchange Commission (SEC) report filing requirements. Generally, the parties to a closely held corporation enter or should enter into a shareholders' agreement that delineates the rights and responsibilities of the shareholders, as well as contains provisions for buyouts in the event of death, disability, or resignation of a shareholder.

Public or Governmental Corporations. There are a number of federal, state, municipal, and state compact corporations that are formed for specified governmental purposes. They include the Federal Savings and Loan Insurance Corporation, the Federal Deposit and Insurance Corporation, the New York and New Jersey Port Authority, and many other such entities. Most cities are corporations as, for example, the City of New York.

Foreign or Alien Corporations. A "foreign" corporation is a domestic corporation formed under the laws of a U.S. state but considered to be a "foreign" corporation in another U.S. state. It is generally not recognized as a legal person in other states until it complies with filing requirements such as applying for and receiving a certificate of doing business within those states. An "alien" corporation is an out-of-country corporate entity.

Profit or Nonprofit Corporations. Most corporations are business corporations that are run for profit. Nevertheless, there are varieties of corporations that are designated as "nonprofit" or "not-for-profit" corporations. They may be formed for charitable, social, religious, educational, or philanthropic purposes. They do not have shares of stock but are governed by a board of trustees in accordance with state and federal statutes. They may be very large entities, such as the American Red Cross, the American Legion, or small entities such as a local social organization. They may qualify for relief from taxation under §501(c)(3) of the Internal Revenue Code provided that they do not engage in political and other restricted activities.

"C" Corporations or "S" Corporations. A "C" corporation is the more common form of corporation and refers to a corporation that is separate from its shareholders, that is, it has tax liability apart from the shareholders. An "S" corporation is one that is elected by the shareholders and formed pursuant to Subchapter S of Chapter 1 of the Internal Revenue Code. Provided the statutory requirements are met (one class of securities, no more than 100 natural U.S. citizens or residents, and a domestic corporation or limited liability company), the tax liability flows through from the corporation to the individual shareholder. This right may be important especially in the first two years of a business when there is a likelihood of losses or little or no gain. The "C" corporate form is the type used by almost all corporations whose shares are publicly traded while the "S" corporate form is utilized by most closed corporations that have few members. We will discuss corporate governance of publicly traded corporations in the next chapter.

Professional Corporation (PC). PCs were created in the 1970s to take advantage of tax benefits which no longer are applicable. A "PC" is one that is created under state law for professionals such as attorneys, physicians, chiropractors, architects, certified public accountants, and other legally recognized persons of professional

standing. Unlike other corporations that offer exemption from liability for corporate acts, PCs do not protect the professional person from liability for contracts or torts unless state law permits otherwise. Today, other entities, for example, LLPs, offer greater individual protection.

Commencing in the 1970s, states have permitted a variety of alternative modes of business enterprises, such as the nongeneral partnerships stated above, and also the use of different corporate and quasi-corporate forms. They include the following entities:

Limited Liability Company (LLC)
An "LLC" is particularly common for the ownership of real estate. It is created under state law and is similar to a partnership or S-type corporation in that the LLC is not taxed. The profits, if any, are taxable to the "members" of the LLC. The members have limited liability and all members have the right to manage the business. The LLC is contractually run by means of an "operating agreement" that details the rights and duties of its members.

Professional Limited Liability Company (PLLC)
A PLLC, like a PC, is limited to professional persons. Also, like an LLC, it is formed under state laws that permit it. Strict compliance with statutory requirements is necessary by the filing of the appropriate application with the Secretary of State of the state where the services are to be rendered, payment of filing fees, and such other requirements as the particular state may require. The advantages include a pass-through tax liability, that is, the professional members must pay federal tax in the same manner as sole proprietorships and partnerships rather than be subject to possible corporate double taxation. Another major advantage is the protection of individual assets from malpractice inasmuch as only the assets of the PLLC may be seized in the event of an adverse judgment. The few states that permit the PLLC charge a franchise tax (aka capital values or margin tax).

New forms of corporations continue to evolve—the latest is the Public Benefit Corporation (PBC). In the State of New York, the stated mission of the PBC is that it is "organized to construct or operate a public improvement wholly or partly within the state, the profits from which inure to the benefit of this or other states or the people thereof." PBCs must be created by a special act of the legislature and usually have one defined purpose, although they may have additional functions such as a service provision and administration. They may add capital improvements to designated programs and may work in partnership with state and local governments but remain separate from them.

Rules-Based Approach versus Principles-Based Approach

There is a great deal of literature concerning which approach regulators should take concerning the regulation of the marketplace. The debate centers on whether a "rules-based approach" or a "principles-based approach" to regulation best meets the needs of investors and other stakeholders. It appears that the Wall Street

debacle of 2007–2009 and its earlier dot-com predecessor have caused the United States to expand its rules-based approach. A "rules-based approach" is one in which laws and regulations are very detailed, offering bright lines for affected parties to follow. A person seeking to know which path to follow need only refer to the specific rules and regulations of the regulatory authority to ascertain how to proceed. For example, if a person wishes to become an investment adviser or a broker-dealer, he or she need only refer to the laws and regulations specifically related to the desired status. These laws and regulations are promulgated and enforced by the SEC, and by self-regulatory organizations (SROs). They spell out in specific detail the procedure, forms, and other requirements to become licensed and to carry out their functions. The Sarbanes-Oxley Act, the Dodd-Frank Act, and the rules and regulations enacted pursuant to the said statutes, which constitute thousands of pages and are discussed hereafter, exemplify the explicit details governing almost all aspects of the financial industry.

It is common to distinguish the U.S. rules-based approach from the traditional U.K. principles-based approach. For example, the United Kingdom's Financial Services Authority (FSA) website[7] is called "Principles-based regulation: Focusing on the outcomes that matter." As stated therein, the principles-based approach places greater emphasis on principles and outcomes to achieve the desired regulatory outcome rather than detailed rules and regulations. It is believed that prescriptive (rules-based) standards do not prevent misconduct but rather are burdensome, ineffective, and not in keeping with the continuous innovation and new product development that cause financial markets to change constantly. According to this view, thousands of rules make financial markets inaccessible and bewildering especially to smaller firms and, thus, is less likely to lead to regulatory goals. The FSA's principles for business are as follows:

- Integrity. A *firm* must conduct its business with integrity.
- Skill, care, and diligence. A *firm* must conduct its business with due skill, care, and diligence.
- Management and control. A *firm* must take reasonable care to organize and control its affairs responsibly and effectively, with adequate risk management systems.
- Financial prudence. A *firm* must maintain adequate financial resources.
- Market conduct. A *firm* must observe proper standards of market conduct.
- Customers' interests. A *firm* must pay due regard to the interests of its *customers* and treat them fairly.
- Communications with clients. A *firm* must pay due regard to the information needs of its *clients*, and communicate information to them in a way that is clear, fair, and not misleading.
- Conflicts of interest. A *firm* must manage conflicts of interest fairly, both between itself and its *customers* and between a *customer* and another *client*.
- Customers: relationships of trust. A *firm* must take reasonable care to ensure the suitability of its advice and discretionary decisions for any *customer* who is entitled to rely upon its judgment.

- Clients' assets. A *firm* must arrange adequate protection for *clients'* assets when it is responsible for them.
- Relations with regulators. A *firm* must deal with its regulators in an open and cooperative way, and must disclose to the *FSA* appropriately anything relating to the *firm* of which the *FSA* would reasonably expect notice.

The principles-based approach is also adhered to by Canada, Hong Kong, and Germany. Which approach is better is certainly debatable with both approaches having positive and negative aspects. Although the FSA explicitly mandates a principles-based approach, it does state that detailed rules remain part of its regulatory toolkit when necessary to implement detailed requirements of EU directives or where justified by the need for consistency in a given industry, for consumer protection, and for other situations where detailed rules become necessary.

In the United States, the Sarbanes-Oxley Act has clearly changed the regulatory landscape that has compelled many companies to restate earnings that were previously deceptive to investors and other stakeholders. The Volcker Rule in the Dodd-Frank Act and its myriad of rules and forthcoming regulations have been bitterly opposed by banks, especially vocally and in testimony by the CEO of JPMorgan Chase, Jamie Dimon, before congressional committees. The rule was designed to prevent banks from speculating on high-risk investments, as later exemplified by JPMorgan Chase's European multibillion dollar loss on credit derivatives. Whether or not the Volcker Rule would have prevented the loss remains questionable. Most commentators believe that the Sarbanes-Oxley Act and its regulatory framework did improve investors' safeguards substantially and made the chief officers of public companies much more compliant concerning the finances of the firms. The Dodd-Frank Act, with its thousands of pages of rules and regulations, most of which are still being prepared, is far more controversial. Both acts and other legislative enactments will be detailed in later chapters.[8]

A commissioner of the SEC, Roel C. Campos, said that the difference between the U.S. and U.K. approaches is overblown. Broad principles are found in the U.S. securities' enactments of 1933, 1934, and 1940 in addition to numerous rulings. Similarly, he noted that although the FSA subscribes to the eleven basic principles, the FSA's entire book of rules is over 8,500 pages, far more than the SEC's rules and regulations. His comment may no longer be accurate after all of the regulations required by the Dodd-Frank Act have been enacted. Part of the dichotomy between the two national approaches may be due to the fact that the United States has the largest and deepest retail securities' markets in the world while the United Kingdom is dominated more by institutional and controlling shareholders. Thus, it is contended that in the United States, where corporate equity shares are greatly disbursed among both sophisticated and nonsophisticated investors, there is a need for clear, specific rules and regulations to guide less sophisticated investors. The chapters that follow are U.S. rules-based enactments that are strictly adhered to by all parties in the financial services industry.[9]

The American Legal System

Two questions that college students usually answer incorrectly are "How many constitutions are there in the United States" and "How many courts systems are there in the United States?" The correct answers, of course, would reflect that there is a federal system and 50 state systems with comparable numbers of constitutions and court systems. Thus, there are two major divisions of court structures, the federal system of courts and the numerous types of state systems. Superficially, they all possess the same three-tier structure of a trial court, a first appeals court, and a highest appeals court but there are many variations among the states from relatively simple and clear jurisdictional lines of authority and at least one court system, that of New York State, that is the most inordinately complex and confusing.[10]

Federal Judicial System

In the federal system, there are three tiers of courts commencing with the U.S. District Courts, with appeals made to the U.S. Court of Appeals, and, ultimately, although extremely rarely, to the U.S. Supreme Court, which is the highest court of the United States.[11] There are also specialized courts including military courts, the U.S. Tax Court, and courts within administrative agencies, for example, courts that resolve immigration issues. Our discussion will focus on the three-tier federal system, consisting of the U.S. District Court, the U.S. Court of Appeals, and the U.S. Supreme Court. The judicial system arises out of the U.S. Constitution, Article III, Section 1, that states:

> The judicial power of the United States shall be vested in one Supreme Court and in such inferior courts as the congress may from time to time ordain and establish. The Judges, both of the supreme and inferior courts, shall hold their Offices during good Behaviour, and shall, at Times, receive for their Services, a Compensation, which shall not be diminished during their Continuance in Office.

District Court

All trials take place at the district court level.[12] Though located at the lowest level of the judicial hierarchical system, in practical terms, it is the most important court for litigants. It is where evidence is presented before a presiding judge who determines what law is applicable to the facts of the case and the judge or the jury, if there is a jury, applies the law to the facts and outcome of the case. For example, if a person is being tried for a homicide, the judge decides which law applies to the facts of the case (murder, manslaughter, negligent homicide, etc.). After both counsels have made their closing arguments to the jury, the judge then instructs the jury the applicable law to consider and to determine whether the accused did in fact commit the elements of the crime. In a civil case wherein a private party sues another party, the same basic rules apply except that the burden of proof needed to win the case is far less than in a criminal case. For a person to

be convicted of a crime, the prosecutor must prove that the accused committed each and every element of the crime beyond a reasonable, but not any, doubt. In a civil case, the person who sues another person must prove his or her case by a fair preponderance of the evidence, that is, proof that it is more likely than not that the person sued did violate the rights of the person who instituted the lawsuit.

To institute a civil lawsuit, a summons (generally, with a complaint) is filed with the court by the complainant (the *plaintiff*), and service of the papers is made upon the party being sued (the *defendant*). Thereafter, the defendant files and serves an answer to the complaint and may also serve a counterclaim alleging facts that, if proven, would render the plaintiff liable to the defendant. In the interim, before the actual trial takes place, the parties are entitled to, and almost always conduct, examinations of the parties and/or witnesses before trial to ascertain the nature of the claims and defenses to the lawsuit. Once the depositions and other discovery take place, the case is made ready for trial. At a trial, as stated above, the presiding judge and/or the jury listen to the evidence, determine the alleged true facts amidst the often contradictory testimony, and apply the law to the facts at hand. In the end, a verdict is rendered in favor of one or the other party, which thereupon is reduced to a judgment of the court. Upon entry of the judgment, the prevailing party will have the right to the relief granted by the court that is usually a money judgment plus interest and costs or a dismissal of the action.

There are 94 judicial districts in the federal system. Every state must have at least one federal district court, although some states have more than one district court due to their larger populations and geographical distances. Thus, Wyoming has one federal district court located in Cheyenne (Wyoming has a population of only a half million inhabitants) but California has district courts in San Diego, Los Angeles, San Francisco, and Sacramento.

Court of Appeals

The party who loses or is dissatisfied with the outcome of the decision may appeal to the U.S. Court of Appeals. There are 11 circuit courts of appeals whose territory encompasses a number of states from which district courts' appeals may be taken. A 12th court of appeals, known as the District of Columbia Circuit, sits in Washington, D.C., and resolves appeals from within the district. A 13th circuit court (court of appeals for the Federal Circuit) resolves appeals in specialized cases, such as from the court of international trade (customs cases), trademark and patent appeals cases, and from the court of claims.

The right to appeal is absolute to any party in the litigation who timely files a "Notice of Appeal" with the sole exception that a prosecutor in a criminal case may not appeal a "Not Guilty" verdict. The court of appeals does not hear or accept new evidence. It renders its decision based on the stenographic record of a transcript of the trial, the written briefs of the attorneys, and the oral presentations by the said attorneys to the presiding judges. Generally, three judges sit in an appeals case, with the exception of an *en banc* proceeding wherein all of the

judges of the court of appeals for a particular Circuit listen and determine the merits of the appeal, generally in unusual and/or important cases, with permission of the court. Its decision by a majority of two judges of three or more than half of the judges in an *en banc* proceeding finally ends the litigation, unless the U.S. Supreme Court, in very rare circumstances, grants permission for a further appeal to its Court (such permission is called a "writ of *certiorari*").

Supreme Court
The highest court of the land is the U.S. Supreme Court. It comprises nine justices whose majority decision renders finality to the issue or case at hand. Its decision is binding upon all persons (including the president and the Congress) and courts within the United States. It hears only a very limited number of cases (usually fewer than 100 cases annually, not including the many writs of habeas corpus brought on by prisoners confined to prison facilities). The cases taken for review are usually those where two or more federal courts of appeals have rendered contradictory decisions in similar cases and those wherein the court wishes to set a "bright-line" policy (specific guidelines) for lower courts to follow. In theory, the Supreme Court may act as a court of original jurisdiction, that is, as a trial court in all cases affecting ambassadors and other ministers and counsels, and where a state institutes a claim against another state. In practice, the court appoints a Master to hear the case and submit a recommendation that the court is free to decree in such manner as it deems just and appropriate. Such cases are quite rare. To assure impartiality in their decision making, all federally appointed judges are appointed for life terms whose compensation may not be diminished during their tenure (Figure 1.2).

State Judicial Systems

Just as there are 50 states in the United States, there are also 50 state constitutions and 50 executive, legislative, and judicial systems. The judicial systems may vary significantly. They all have the three-tier system of trial courts, the appeals from which are to the first appellate level, and, ultimately, to the highest court of the state, normally called the Supreme Court. Nevertheless, whereas most state court systems are similar and uncomplicated, a review of the New York State system will dismay even the most seasoned observer. Its trial courts are numerous with different named courts that often perform the same functions and have comparable jurisdictions. Thus, its trials courts include village courts, district courts, city courts, county courts, family courts, court of claims, small claims courts, surrogate's courts; its supreme court is a trial court too. Attempts made for decades to unify the New York court system have not succeeded mainly because such unification would numerically diminish the number of judges needed for the courts thereby depriving political parties of desired judgeships to give as rewards for party loyalty. In all judicial systems there are divisions and subdivisions in addition to the three-tier system, generally to resolve special areas of the law. Thus, there may be courts that adjudicate eminent domain cases, matrimonials, claims

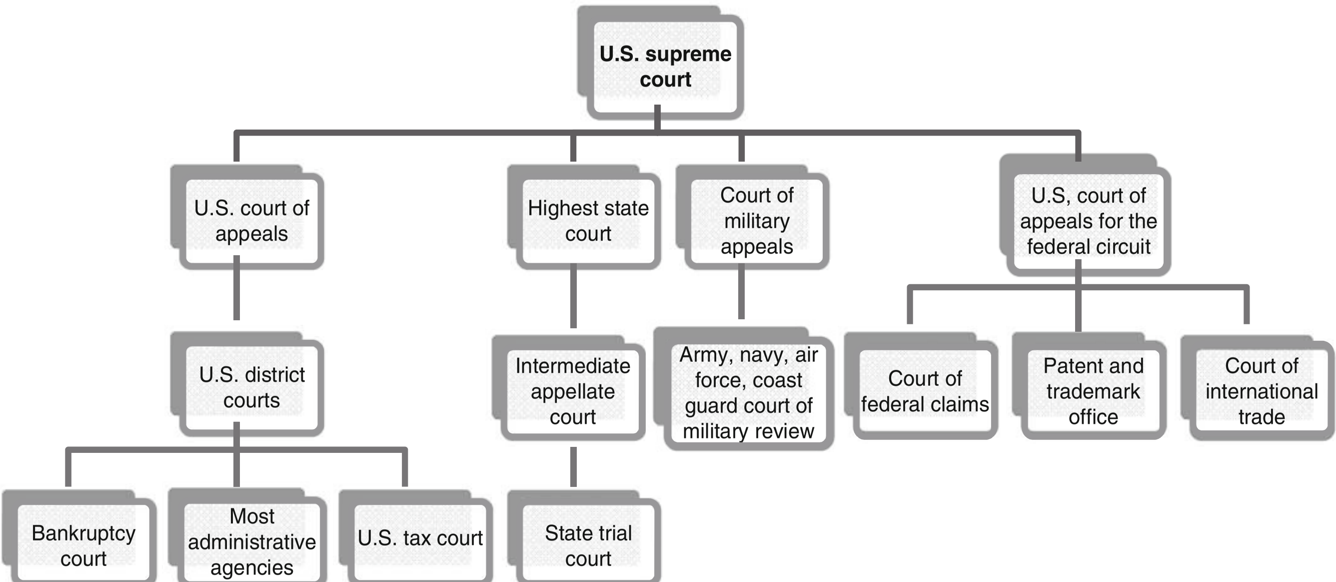

Figure 1.2 U.S. federal court system

against the state, small claims, and other areas of expertise. An examination of the variations of the state court systems is beyond the scope of this text.

Jurisdiction

The dual U.S. federal-state system raises the issue of which courts have the right to hear a particular grievance. The power to hear a case is the meaning of "jurisdiction." Federal jurisdiction is both exclusive and concurrent with the states. Thus, the U.S. Constitution and laws pursuant thereto have placed exclusive jurisdiction in the federal courts for all matters relating to bankruptcy, federal tax, federal crimes, intellectual property cases (patent, copyright, and trademarks), antitrust, admiralty, and lawsuits against the United States. The federal courts have concurrent jurisdiction with the states when the issue arising concerns a federal question or where there is diversity of citizenship, that is, where the parties are residents of different states. Federal courts may entertain diversity cases if the amount of money sued for exceeds $75,000, although there is no minimum monetary sum for federal question cases.

Just as the federal courts have exclusive jurisdiction in certain types of cases, state courts may also have exclusive jurisdiction. In all instances where the federal courts are not granted the right to hear cases under the Constitution or laws made pursuant to powers granted to Congress under the Constitution, they are left to the state courts, which have the exclusive right to preside over them. At times there may be a conflict concerning the respective jurisdiction of state and federal courts. Its resolution is left ultimately to the U.S. Supreme Court.

In addition to the question of jurisdiction over the type of case before the courts, there are other aspects of jurisdiction, namely, that of jurisdiction over the parties, called *in personam* jurisdiction. Such jurisdiction normally takes place when a plaintiff is able to serve process on the defendant within the state where the case is to be tried. A state may also have "long-arm statutes" whereby a person who resides in another state may be sued so long as the action, accident, or event took place in the state of the lawsuit. Just because an accident takes place in a state does not automatically mean that the state may exercise power over the case. An example is the case of *World-Wide Volkswagen v. Woodson*.[13] A husband and wife, Harry and Kay Robinson, purchased a new Audi automobile from a dealer in Massena, New York. A year later, they decided to travel from New York, where they resided previously, to their new home in Arizona. On the way to Arizona while in Oklahoma, another automobile struck their automobile in the rear causing a fire that severely burned Kay Robinson and her two children. They commenced a lawsuit in Oklahoma claiming defective design of their automobile. They sued the manufacturer, Audi, located in Germany, its importer, Volkswagen of America, its regional dealer World-Wide Volkswagen, and the New York retail dealer. Although the accident took place in Oklahoma, the U.S. Supreme Court determined that it was a violation of the due process clause of the U.S. Constitution to have the case tried in Oklahoma where none of the parties resided therein or have any contacts, or relations therein other than that the incident

occurred therein. The due process clause is based on the concept of fairness—the court believed it would be unfair to require New York parties to appear in the Oklahoma courts to respond to a lawsuit solely because of the location of the incident.

A case may also be denied by a court on the basis of a lack of *venue*, even though it has the power to hear the case. Thus, where a case is commenced in a part of a state where none of the parties reside, the incident did not occur there, and, in essence, there was little or no connection to the particular court, the court may transfer the case to another court of competent jurisdiction most convenient to the parties, generally at the request by motion of a party to the litigation. Although the particular court possesses the right to hear the case by law, the transfer takes place because it is inconvenient for the parties and their witnesses for the case to be heard in the said court.

Deciphering Court Citations

The reader will come across many cases throughout the text. Generally, there are citations after a case. Whenever one sees a citation containing "U.S.," as in 471 U.S. 462 (1985), it refers to U.S. Supreme Court decisions reported in U.S. Reports. Thus, the above-mentioned citation refers to volume 471, U.S. Reports, page 462, decided in 1985. These are the official reports. The citation may also consist of the designation of "S.Ct." in place of "U.S.," which are unofficial reports of cases. "F.2d" or "F.3d" pertains to a U.S. Court of Appeals decision. The particular court of appeals as well as the year is stated in parenthesis. Thus, 89 F.2d 1257 (6th Cir.1996) means that the decision made in 1996 is by the U.S. Court of Appeals for the Sixth Circuit and is found in Volume 89, Federal Reports, Second Series, page 1257. "D.C.Cir." means Court of Appeals for the District of Columbia. If one sees "F.Supp.," as in 937 F.Supp. 295 (S.D.N.Y. 1996), it is a decision of the U.S. District Court found in a series of law volumes known as the Federal Supplement. Therefore, the case may be found in Volume 937, Federal Supplement, page 295. The decision was made in 1996 by the single judge sitting in the U.S. District Court located in the Southern District of New York. "S.D.Ca." is Southern District of California (San Diego). "D.Md." is the district court sitting in Maryland. "D.D.C." refers to the District Court of the District of Columbia.

Civil Litigation Procedure

Throughout this text, the law cases often reflect aspects of litigation that are unfamiliar to college and graduate students. Motions, depositions, and other pretrial procedures are important in the process of litigation, particularly in the federal courts where there is a much greater likelihood of relief being granted without the necessity of having a plenary trial to determine the outcome. The steps generally followed before a case goes to trial are set forth hereafter. Inasmuch as there are

51 federal and state court systems, the reader should be aware that there might be some variations to the procedure discussed herein.

Pleadings

A case is begun by the preparation and the filing of a summons and complaint with the clerk of the court in which the case is to be heard. The summons is generally signed by the clerk and bears the court's seal. The summons indicates the name and locality of the court; the parties known as the plaintiff (person who instituted the lawsuit), and the defendant (person who is sued); the name, address, telephone number of the attorney for the plaintiff; and a demand that the defendant interpose a notice of appearance by his or her attorney and an answer to the complaint that is served together with the summons. The complaint must set forth a claim on which the court may grant relief. It has to contain a statement concerning the jurisdiction of the court; the basis for the claim in sufficient form so as to compel a court to grant relief if no answer is interposed; and a demand for judgment stating the relief demanded. It need only be "a short and plain statement of the claim showing that the pleader [person making the claim] is entitled to relief" (Federal Rules of Civil Procedure P. 8(a)).

The complaint states the causes of action alleged by the plaintiff. For example, in a typical state automobile accident case, the complaint will begin with a recitation that the plaintiff (person suing) and/or the defendant (person being sued) are residents of a particular city, county, state where the court has jurisdiction. It then recites that when, where, and how the accident took place followed by a statement that the accident was caused by the defendant, specifying the type of negligence committed. It continues with a statement that the plaintiff was injured, which is then coupled with a demand for damages. In a federal court case, unlike in most state court cases, counsel must pay close attention to the preparation of the complaint to make sure it complies strictly with federal rules and statutes as interpreted by the courts. Class actions, in particular, face close scrutiny by the federal courts as a result of the passage of the "Private Securities Litigation Reform Act of 1995 (PSLRA),"[14] which added substantial pleading requirements that had to be met before the lawsuit could proceed. The reason for the statute was to discourage what Congress and the laws proponents alleged were frivolous lawsuits that enriched attorneys for class action plaintiffs but caused considerable expense for companies to defend against such lawsuits and provided little benefit to the plaintiffs in whose names the actions were brought.

The following U.S. Supreme Court case is illustrative of pleading requirements to survive dismissal of a case. We limited the discussion of the case to the discussion on pleading requirements. Please note that, unlike most state court cases, the title of the case in the U.S. Supreme Court is interchangeable depending on which party is presenting the appeal. The party that appeals the case from the lower court, almost always from the U.S. Court of Appeals of the given Circuit, is called the "petitioner" while the party that prevailed in the immediate lower

court is called the "respondent." Thus, in the case below, the persons who initially commenced the lawsuit are Twombly and others but in the appeal before the U.S. Supreme Court are referred to as the respondents because they won the appeal before the U.S. Court of Appeals. The defendants are Bell Atlantic and others and are the petitioners on appeal (the names are shortened to the initial names of each of the parties inasmuch as the names of parties suing and being sued may be pages long). Twombly's case was dismissed by the district court that initially heard the case but the court's decision was reversed by the Court of Appeals.

Bell Atlantic Corp. v. Twombly

550 U.S. 544 (2007)

FACTS: Respondents William Twombly and Lawrence Marcus (hereinafter plaintiffs) represent a putative class consisting of all "subscribers of local telephone and/or high speed internet services . . . from February 8, 1996 to present." . . . . In this action against petitioners, a group of ILECs [Incumbent Local Exchange Carriers aka "Baby Bells"], plaintiffs seek treble damages and declaratory and injunctive relief for claimed violations of §1 of the Sherman Act, . . . which prohibits "[e]very contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations."

The complaint alleges that the ILECs conspired to restrain trade in two ways, each supposedly inflating charges for local telephone and high-speed Internet services. Plaintiffs say, first, that the ILECs "engaged in parallel conduct" in their respective service areas to inhibit the growth of upstart CLECs [competitive local exchange carriers] . . . . Their actions allegedly included making unfair agreements with the CLECs for access to ILEC networks, providing inferior connections to the networks, overcharging, and billing in ways designed to sabotage the CLECs' relations with their own customers. According to the complaint, the ILECs' "compelling common motivation" to thwart the CLECs' competitive efforts naturally led them to form a conspiracy; "[h]ad any one [ILEC] not sought to prevent CLECs . . . from competing effectively . . . , the resulting greater competitive inroads into that [ILEC's] territory would have revealed the degree to which competitive entry by CLECs would have been successful in the other territories in the absence of such conduct."

Second, the complaint charges agreements by the ILECs to refrain from competing against one another. These are to be inferred from the ILECs' common failure "meaningfully to pursue" "attractive business opportunities" in contiguous markets where they possessed "substantial competitive advantages," and from a statement of Richard Notebaert, chief executive officer (CEO) of the ILEC Qwest, that competing in the territory of

another ILEC "might be a good way to turn a quick dollar but that doesn't make it right."

The complaint couches its ultimate allegations this way:

> In the absence of any meaningful competition between the [ILECs] in one another's markets, and in light of the parallel course of conduct that each engaged in to prevent competition from CLECs within their respective local telephone and/or high speed internet services markets and the other facts and market circumstances alleged above, Plaintiffs allege upon information and belief that [the ILECs] have entered into a contract, combination or conspiracy to prevent competitive entry in their respective local telephone and/or high speed internet services markets and have agreed not to compete with one another and otherwise allocated customers and markets to one another.

ISSUE: Whether a complaint alleging liability under §1 of the Sherman Act can survive a motion to dismiss when it alleges that major telecommunications providers engaged in certain parallel conduct unfavorable to competition, absent some factual context suggesting agreement, as distinct from identical, independent action?

DECISION (Souter, J.): The complaint should be dismissed because of its failure to plead sufficient facts that the Sherman Act was violated.

REASONING: This case presents the antecedent question of what a plaintiff must plead in order to state a claim under §1 of the Sherman Act. Federal Rule of Civil Procedure 8(a)(2) requires only "a short and plain statement of the claim showing that the pleader is entitled to relief," in order to "give the defendant fair notice of what the . . . claim is and the grounds upon which it rests." . . . . While a complaint attacked by a Rule 12(b)(6) motion to dismiss does not need detailed factual allegations, . . . a plaintiff's obligation to provide the "grounds" of his "entitlement to relief" requires more than labels and conclusions, and a formulaic recitation of the elements of a cause of action will not do . . . . Factual allegations must be enough to raise a right to relief above the speculative level . . . .

In applying these general standards to a §1 claim, we hold that stating such a claim requires a complaint with enough factual matter (taken as true) to suggest that an agreement was made. Asking for plausible grounds to infer an agreement does not impose a probability requirement at the pleading stage; it simply calls for enough fact to raise a reasonable expectation that discovery will reveal evidence of illegal agreement. And, of course, a well-pleaded complaint may proceed even if it strikes a savvy judge that actual proof of those facts is improbable, and "that a recovery is very remote and unlikely." In identifying facts that are suggestive enough to render a §1 conspiracy plausible, we have the benefit of the prior rulings and considered views of leading commentators, already quoted, that lawful parallel conduct fails to bespeak unlawful agreement. It makes sense to say, therefore,

that an allegation of parallel conduct and a bare assertion of conspiracy will not suffice. Without more, parallel conduct does not suggest conspiracy, and a conclusory allegation of agreement at some unidentified point does not supply facts adequate to show illegality. Hence, when allegations of parallel conduct are set out in order to make a §1 claim, they must be placed in a context that raises a suggestion of a preceding agreement, not merely parallel conduct that could just as well be independent action.

The need at the pleading stage for allegations plausibly suggesting (not merely consistent with) agreement reflects the threshold requirement of Rule 8(a)(2) that the "plain statement" possess enough heft to "show that the pleader is entitled to relief." A statement of parallel conduct, even conduct consciously undertaken, needs some setting suggesting the agreement necessary to make out a §1 claim; without that further circumstance pointing toward a meeting of the minds, an account of a defendant's commercial efforts stays in neutral territory. An allegation of parallel conduct is thus much like a naked assertion of conspiracy in a §1 complaint: it gets the complaint close to stating a claim, but without some further factual enhancement it stops short of the line between possibility and plausibility of "entitlement to relief." . . . .

Thus, it is one thing to be cautious before dismissing an antitrust complaint in advance of discovery, . . . but quite another to forget that proceeding to antitrust discovery can be expensive. As we indicated over 20 years ago . . . "a district court must retain the power to insist upon some specificity in pleading before allowing a potentially massive factual controversy to proceed." . . . . ("[T]he costs of modern federal antitrust litigation and the increasing caseload of the federal courts counsel against sending the parties into discovery when there is no reasonable likelihood that the plaintiffs can construct a claim from the events related in the complaint."); . . . . That potential expense is obvious enough in the present case: plaintiffs represent a putative class of at least 90 percent of all subscribers to local telephone or high-speed Internet service in the continental United States, in an action against America's largest telecommunications firms (with many thousands of employees generating reams and gigabytes of business records) for unspecified (if any) instances of antitrust violations that allegedly occurred over a period of seven years.

It is no answer to say that a claim just shy of a plausible entitlement to relief can, if groundless, be weeded out early in the discovery process through "careful case management," given the common lament that the success of judicial supervision in checking discovery abuse has been on the modest side . . . . And it is self-evident that the problem of discovery abuse cannot be solved by "careful scrutiny of evidence at the summary judgment stage," much less "lucid instructions to juries"; the threat of discovery expense will push cost-conscious defendants to settle even anemic cases before reaching those proceedings. Probably, then, it is only by taking care to require allegations that reach the level suggesting conspiracy that we

can hope to avoid the potentially enormous expense of discovery in cases with no "reasonably founded hope that the [discovery] process will reveal relevant evidence" to support a §1 claim . . . .

Questions

1. Rule 8 of the Federal Rules of Civil Procedure provides that a pleading that states a claim for relief must contain (1) a short and plain statement of the grounds for the court's jurisdiction, (2) a short and plain statement of the claim showing that the pleader is entitled to relief; and (3) a demand for the relief sought, which may include relief. Do you agree with the Court's interpretation of pleading requirements?
2. State courts are much more permissible in allowing general rather than specific allegations to be stated in a complaint. Explain the court's reasoning in imposing a stricter requirement for class action lawsuits.

After the papers are filed with the clerk, an index or file number of the case is assigned. A copy thereof is served upon the defendant in a federal case by a federal marshal, by his or her deputy or agent, or by process servers, or in a state case by the Sheriff's office or process servers. There are other modes of service that may be permitted by law especially if the defendant is a corporation or where the defendant cannot be found.

Once the papers are served, the defendant, through his or her attorney, serves a notice of appearance, which consists of a paper indicating that the defendant has retained his or her attorneys as set forth in the document. All of the pleadings thereafter are transmitted among the attorneys for the parties. An answer to the complaint is served upon the attorney for the plaintiff, which answer ordinarily denies those parts of the complaint that allege the defendant to have committed some wrongful act. In addition, the defendant may wish to file a claim against the plaintiff; such pleading is called a counterclaim. The answer may contain special defenses known as "affirmative defenses" such as alleging that the time to sue has expired (statute of limitations) or that the plaintiff failed to reduce an agreement to a written form (statute of frauds). The plaintiff may then serve a reply denying the allegations of the defendant's counterclaim.

Pretrial Disclosure

U.S. jurisprudence, unlike in most other countries, provides extensive pretrial disclosures that parties to the litigation may avail themselves. Once the initial pleadings have been exchanged, the parties ordinarily proceed to conduct pretrial discovery. U.S. procedural laws compel parties to disclose extensive details concerning the nature of the case, the witnesses that are expected to testify, and

photographs and other matters that may be offered in evidence. The theory is that once the parties become fully aware of the other party's evidence, there is a significant possibility that the matter will be settled. In fact, almost all cases are settled before trial, especially when the parties are about to select a jury to determine the outcome of the case. The discovery includes a demand for a bill of particulars (questions seeking responses to the allegations made in the pleadings); depositions whereby each of the parties are called upon to be examined under oath before trial concerning the litigation; written interrogatories (written responses to questions under oath); production of documents; examinations of the physical and/or mental condition of a party suing in accident cases; and other disclosures that may be ordered by a court or allowed by law.

When the parties complete their pretrial discovery, they may make a series of motions or requests to the court. These motions are set forth at length herein because they are used very extensively in federal court proceedings. The most pertinent motions for our purposes are stated hereafter:

Motion for Summary Judgment

A motion for summary judgment is a request to the court to enter a judgment in favor of the moving party without having to proceed to trial. A trial is necessary for a judge, hearing a case without a jury, or a jury if one is present, to determine the facts of a given case. Each side of the litigation will almost always present very different versions of the alleged facts of the case. It is for the judge or jury to decide whose version is the most truthful and accurate so that it may render a decision after the application of the law to the particular case. Under Federal Rules of Civil Procedure 56(c), summary judgment "shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law." In other words, if the facts of the case are clear and not in dispute there is no need for a trial to take place. The court is able to render a decision by the application of the law to the undisputed facts. There are a number of court decisions that have elaborated upon the federal rule.

Burden of Proof

The moving party "always bears the initial responsibility of informing the district court of the basis for its motion, and identifying those portions of 'the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any,' which it believes demonstrate the absence of a genuine issue of material fact."[15]

"If he meets this burden, the moving party is then entitled to judgment as a matter of law when the non-moving party fails to make a sufficient showing on an essential element of his case with respect to which he bears the burden of proof at trial." A court must "view the evidence presented through the prism of the substantive evidentiary burden 'that would operate at trial.' . . . . The court must view all facts and inference to be drawn therefrom in the light most favorable to the non-moving party. To defeat summary judgment, the non-moving party

may not merely act on conclusory allegations contained in the complaint, but must respond with affirmative evidence supporting its claims and establish the existence of a genuine issue of material fact. The non-moving party 'must set forth specific facts showing that there is a genuine issue for trial' " Fed. R. Civ. P. 56(e). The facts brought forth must be material, that is, "facts that might affect the outcome of the suit under the governing law . . . . Factual disputes that are irrelevant or unnecessary will not be counted."[16] "Sufficient evidence supporting the claimed factual dispute" must be shown, thereby requiring resolution of the parties' differing versions of the truth by a jury or judge.[17]

It is the court's responsibility "to determine whether the 'specific facts' set forth by the nonmoving party, coupled with undisputed background or contextual facts, are such that a rational or reasonable jury might return a verdict in its favor based on the evidence" (*T.W. Elec. Service*).[18] "Summary judgment will not lie if the dispute about a material fact is 'genuine,' that is, if the evidence is such that a reasonable jury could return a verdict for the nonmoving party." An issue of material fact is one which, under the substantive law governing the issue, might affect the outcome of the suit. However, "where the record takes as a whole could not lead a rational trier of fact to find for the non-moving party, there is no "genuine issue for trial,"[19] since the preponderance of the evidence standard is used in the determination, more than a mere scintilla of evidence in support of the plaintiff's position is required. The U.S. Supreme Court said a court must determine "whether the evidence presents a sufficient disagreement to require submission to a jury or whether it is so one-sided that one party must prevail as a matter of law."[20]

Motion to Dismiss

After the summons and complaint is served, the defendant, in lieu of answering the complaint, may make a request to the court in the form of a motion to dismiss the complaint. The grounds upon which the motion may be brought are set forth in Rule 12(b) of the federal Rules of Civil Procedure. There are seven enumerated grounds upon which the motion may be based. They are:

1. Lack of jurisdiction over the subject matter
2. Lack of jurisdiction over the person
3. Improper venue
4. Insufficiency of process
5. Insufficiency of service of process (the defendant was not properly served with the summons and complaint)
6. Failure to state a cause of action upon which relief can be granted
7. Failure to join a party under Rule 19 (persons needed to be joined in the proceeding for adjudication to take place)

A court will review the affidavits upon which the request is made. In the event that the court grants the motion to dismiss, the case is not necessarily ended. The court ordinarily permits the losing party to remedy the defects enunciated above. The court will assume that the factual allegations stated in the complaint are true

and must give all reasonable inferences in favor of the plaintiff.[21] The court will grant the motion only if it is clear that the allegations stated in the plaintiff's complaint cannot be established. If the complaint states allegations that, even if proven, would not lead to a grant of relief in favor of the plaintiff, then the court will dismiss the complaint.[22] Bald assertions and conclusions of law will not suffice to state a claim.[23] The burden is upon the moving party to show to the court that the claimant's case is so utterly lacking in merit as to prevent him or her to offer evidence at a trial to support the claims made against the defendant. The motion to dismiss is rarely allowed and is ordinarily disfavored by a court.

Congress enacted a much higher standing of pleadings in securities fraud cases. The following U.S. Supreme Court case states the statute and the requirements under the new standards of pleadings in such cases. The defendants [petitioners], through their attorneys, made a motion to dismiss the cases. The motion was granted by the U.S. District [trial] Court but the U.S. Court of Appeals reversed the decision of the lower court. The case was appealed to the U.S. Supreme Court, which reversed the decision of the Court of Appeals and upheld the dismissal of the case. The case is a good example of the use of a motion to dismiss.

Tellabs v. Makor Issues & Rights, Ltd.

551 U.S. 208 (2007)

FACTS: Petitioner Tellabs, Inc. [defendant], manufactures specialized equipment used in fiber-optic networks. During the time period relevant to this case, petitioner Richard Notebaert was Tellabs chief executive officer and president. Respondents [plaintiffs] Shareholders are persons who purchased Tellabs stock between December 11, 2000, and June 19, 2001. They accuse Tellabs and Notebaert et al. of engaging in a scheme to deceive the investing public about the true value of Tellabs stock.

Beginning on December 11, 2000, the Shareholders allege, Notebaert (and by imputation Tellabs) falsely reassured public investors, in a series of statements that Tellabs was continuing to enjoy strong demand for its products and earning record revenues, when, in fact, Notebaert knew the opposite was true. From December 2000 until the spring of 2001, the Shareholders claim, Notebaert knowingly misled the public in four ways. First, he made statements indicating that demand for Tellabs flagship networking device, the TITAN 5500, was continuing to grow, when in fact demand for that product was waning. Second, Notebaert made statements indicating that the TITAN 6500, Tellabs next-generation networking device, was available for delivery, and that demand for that product was strong and growing, when in truth the product was not ready for delivery and demand was weak. Third, he falsely represented Tellabs financial results for the fourth quarter of 2000 (and, in connection with those results, condoned the practice of channel stuffing, under which Tellabs flooded its customers with unwanted products). Fourth, Notebaert made a series

of overstated revenue projections, when demand for the TITAN 5500 was drying up and production of the TITAN 6500 was behind schedule. Based on Notebaert's sunny assessments, the Shareholders contend, market analysts recommended that investors buy Tellabs stock.

The first public glimmer that business was not so healthy came in March 2001 when Tellabs modestly reduced its first quarter sales projections. In the next months, Tellabs made progressively more cautious statements about its projected sales. On June 19, 2001, the last day of the class period, Tellabs disclosed that demand for the TITAN 5500 had significantly dropped. Simultaneously, the company substantially lowered its revenue projections for the second quarter of 2001. The next day, the price of Tellabs stock, which had reached a high of $67 during the period, plunged to a low of $15.87.

On December 3, 2002, the Shareholders filed a class action in the district court for the Northern District of Illinois. Their complaint stated, inter alia, that Tellabs and Notebaert had engaged in securities fraud in violation of §10(b) of the Securities Exchange Act of 1934:

Tellabs moved to dismiss the complaint on the ground that the Shareholders had failed to plead their case with the particularity the PSLRA requires. The district court agreed, and therefore dismissed the complaint without prejudice. The Shareholders then amended their complaint, adding references to 27 confidential sources and making further, more specific, allegations concerning Notebaert's mental state. The district court again dismissed, this time with prejudice. The Shareholders had sufficiently pleaded that Notebaert's statements were misleading, the court determined, *but* they had insufficiently alleged that he acted with scienter. The Court of Appeals for the Seventh Circuit reversed. Like the district court, the court of appeals found that the Shareholders had pleaded the misleading character of Notebaert's statements with sufficient particularity. Unlike the district court, however, the Seventh Circuit concluded that the Shareholders had sufficiently alleged that Notebaert acted with the requisite state of mind.

ISSUE: Whether under the statute the plaintiffs had stated with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind?

DECISION: The court upheld the dismissal of the case stating that the respondents [plaintiffs] had failed to plead with particularity facts giving rise to a strong inference that the defendant had acted with the required state of mind as required under the statute.

REASONING (Ginsburg, J.). This Court has long recognized that meritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by the Department of Justice and the Securities and Exchange Commission . . . . Private securities fraud actions,

however, if not adequately contained, can be employed abusively to impose substantial costs on companies and individuals whose conduct conforms to the law . . . . As a check against abusive litigation by private parties, Congress enacted the Private Securities Litigation Reform Act of 1995 ("PSLRA"), 109 Stat. 737.

Exacting pleading requirements are among the control measures Congress included in the PSLRA. The Act requires plaintiffs to state with particularity both the facts constituting the alleged violation and the facts evidencing scienter, *i.e.*, the defendant's intention to deceive, manipulate, or defraud . . . . This case concerns the latter requirement. As set out in §21D(b)(2) of the PSLRA, plaintiffs must state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind . . . . Congress left the key term strong inference undefined, and Courts of Appeals have divided on its meaning. In the case before us, the Court of Appeals for the Seventh Circuit held that the strong inference standard would be met if the complaint allege[d] facts from which, if true, a reasonable person could infer that the defendant acted with the required intent . . . . That formulation we conclude, does not capture the stricter demand Congress sought to convey in §21D(b)(2).

It does not suffice that a reasonable fact finder plausibly could infer from the complaint's allegations the requisite state of mind. Rather, to determine whether a complaint's scienter allegations can survive threshold inspection for sufficiency, a court governed by §21D(b)(2) must engage in a comparative evaluation; it must consider not only inferences urged by the plaintiff, as the Seventh Circuit did, but also competing inferences rationally drawn from the facts alleged. An inference of fraudulent intent may be plausible, yet less cogent than other, nonculpable explanations for the defendant's conduct. To qualify as strong within the intendment of §21D(b)(2), we hold, an inference of scienter must be more than merely plausible or reasonable. It must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.

Section 10(b) of the Securities Exchange Act of 1934 forbids the use or employ, in connection with the purchase or sale of any security, [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors. 15 U.S.C. §78j(b). SEC Rule 10b.5 implements §10(b) by declaring it unlawful:

(a) To employ any device, scheme, or artifice to defraud
(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made not misleading, or
(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security . . . .

Section 10(b), this Court has implied from the statute's text and purpose, affords a right of action to purchasers or sellers of securities injured by its violation.

In an ordinary civil action, the Federal Rules of Civil Procedure require only a short and plain statement of the claim showing that the pleader is entitled to relief. Fed. Rule Civ. Proc. 8(a)(2). Although the rule encourages brevity, the complaint must say enough to give the defendant fair notice of what the plaintiff's claim is and the grounds upon which it rests. Prior to the enactment of the PSLRA, the sufficiency of a complaint for securities fraud was governed not by Rule 8, but by the heightened pleading standard set forth in Rule 9(b) . . . .

We have previously reserved the question whether reckless behavior is sufficient for civil liability under §10(b) and Rule 10b.5. Every Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly, though the Circuits differ on the degree of recklessness required . . . . The question whether and when recklessness satisfies the scienter requirement is not presented in this case . . . . Rule 9(b) applies to all averments of fraud or mistake; it requires that the circumstances constituting fraud be stated with particularity but provides that[m]alice, intent, knowledge, and other condition of mind of a person, may be averred generally . . . .

[I]n §21D(b) of the PSLRA, Congress impose[d] heightened pleading requirements in actions brought pursuant to §10(b) and Rule 10b.5. Under the PSLRA heightened pleading instructions, any private securities complaint alleging that the defendant made a false or misleading statement must: (1) specify each statement alleged to have been misleading [and] the reason or reasons why the statement is misleading, . . . and (2) state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind . . . .

Nothing in the Act, we have previously noted, casts doubt on the conclusion that private securities litigation [i]s an indispensable tool with which defrauded investors can recover their losses, a matter crucial to the integrity of domestic capital markets . . . . The strong inference standard unequivocally raise[d] the bar for pleading scienter . . . But Congress did not . . . throw much light on what facts . . . suffice to create [a strong] inference, or on what degree of imagination courts can use in divining whether the requisite inference exists. Our task is to prescribe a workable construction of the strong inference standard, a reading geared to the PSLRA's twin goals: to curb frivolous, lawyer-driven litigation, while preserving investors ability to recover on meritorious claims.

[Accordingly] We establish the following prescriptions: *First*, faced with a Rule 12(b)(6) motion to dismiss a §10(b) action, courts must, as with any motion to dismiss for failure to plead a claim on which relief can be granted, accept all factual allegations in the complaint as true.

On this point, the parties agree . . . .

Second, courts must consider the complaint in its entirety, as well as other sources courts ordinarily examine when ruling on Rule 12(b)(6) motions to dismiss, in particular, documents incorporated into the complaint by reference and matters of which a court may take judicial notice . . . . The inquiry, . . . have recognized, is whether *all* of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard . . . .

Third, in determining whether the pleaded facts give rise to a strong inference of scienter, the court must take into account plausible opposing inferences . . . . Congress did not merely require plaintiffs to provide a factual basis for [their] scienter allegations, . . . *i.e.*, to allege facts from which an inference of scienter rationally *could* be drawn. Instead, Congress required plaintiffs to plead with particularity facts that give rise to a strong i.e., a powerful or cogent inference . . . . The strength of an inference cannot be decided in a vacuum. The inquiry is inherently comparative: How likely is it that one conclusion, as compared to others, follows from the underlying facts? To determine whether the plaintiff has alleged facts that give rise to the requisite strong inference of scienter, a court must consider plausible nonculpable explanations for the defendant's conduct, as well as inferences favoring the plaintiff. The inference that the defendant acted with scienter need not be irrefutable, *i.e.*, of the smoking-gun genre, or even the most plausible of competing inferences . . . . .

Yet the inference of scienter must be more than merely reasonable or permissible; it must be cogent and compelling thus strong in light of other explanations. A complaint will survive, we hold, only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged. [The Court found that as a whole the plaintiffs/respondents had not met the requirements of the PSLRA.]

Questions:

1. The PSLRA was enacted in 1995. It raised the standard of pleading that requires the parties commencing a lawsuit to state specifically in the initial complaint the elements of fraud alleged before being permitted to engage in depositions in an endeavor to find alleged malfeasance. What effect, if any, do you believe that the statute led to the Enron and other malfeasance by corporations?
2. In a dissenting opinion by Justice John Paul Stevens, he regretted that the Court had set up a standard of proof that makes the commencement of a civil action more difficult than a criminal action. Do you agree or disagree? Give reasons.

Declaratory Judgment

A "declaratory judgment" is a binding judgment from a court defining the legal relationship between parties and their rights in the matter before the court. It states the court's authoritative opinion regarding the exact nature of the legal matter without requiring the parties to do anything.[24]

Note

Stages of a Civil Proceeding

Pretrial Procedures

- Pleadings
  - Summons and complaint—filed initially with the clerk of the court and served upon the defendant
    - Requires that the court possess jurisdiction and venue
  - Notice of appearance and answer
    - May be preceded by a motion to dismiss
    - Answer may contain affirmative defenses, counterclaims, cross-claims, and/or third-party claims
  - Reply by plaintiff to counterclaims
- Discovery
  - Depositions
  - Interrogatories
  - Production requests
  - Examination of mental or physical condition
  - Admissions
- Motions
  - Dismiss
  - Default
  - Summary judgment
- Trial
- Posttrial Motions
- Appeal

Subpoenas

Subpoenas are utilized to compel the appearance of witnesses to a litigation or information in the form of documents and other evidentiary material. They consist of two types: A subpoena issued by an attorney for a party or by the

court is used to compel a person to appear at a court proceeding or other pretrial proceeding as a deposition. If the attorney seeks information in the form of documents a subpoena *duces tecum* is served (literally, "to take with you")—a demand that documents be brought to the court or other discovery proceeding. Occasionally, a subpoena either alone or *duces tecum* is served on a nonparty witness. When a third party is involved, the court may disallow the appearance or request for documents for a variety of reasons. In *Zoe v. 2TheMart.com Inc.*,[25] a nonparty witness using a pseudonym, who was an Internet service provider served with a subpoena by 2The Mart, asked the court to quash the subpoena alleging that its First Amendment right of freedom of speech by users of their service would be violated if compliance was compelled. The court stated that the nonparty plaintiff would be compelled to give testimony that interfered with the free exchange of ideas only if the following elements were met:

> (1) the subpoena seeking the information was issued in good faith and not for any improper purpose; (2) the information sought relates to a core claim or defense; (3) the identifying information is directly and materially relevant to that claim or defense; and (4) information sufficient to establish or to disprove that claim or defense is unavailable from any other source.

The court found that the defendant failed to meet the standard. The underlying lawsuit concerned a derivative class action brought by shareholders of the defendant corporation alleging fraud by its directors. The corporation sought by subpoena the identity of 23 speakers who participated anonymously on the Internet message board, InfoSpace, a Seattle-based Internet company that operated a website containing a series of electronic bulletin boards wherein users could freely post, anonymously and otherwise, and exchange messages. Some of the messages were critical of the defendant alleging deceit and other unflattering comments. The court decided that the First Amendment protected the anonymity of Internet speech, having precedents that extend back to the founding of the United States, for example, Madison, Alexander Hamilton, and John Jay, who used anonymous names in authoring the Federalist Papers. Balancing the right of a party to gain information needed for proof of the claims of the litigation versus the right to speak anonymously, the court recited the above-stated limitations and found that the requested information did not relate to a core claim or defense and/or was materially relevant to its claim or defense.

A contrary decision was rendered in *America Online, Inc. v. Nam Tai Electronics, Inc.,*[26] wherein the court denied AOL's request to quash a *subpoena duces tecum* served upon it that requested information concerning the identity of the person who posted anonymously certain alleged derogatory, libelous statements concerning stock issued by Nam Tan Electronics. The Virginia court was requested assistance with respect to a lawsuit commenced in the State of California by Nam Tam against the anonymous sender. The court said that the subpoena did not infringe upon the First Amendment rights of the person posting the message.

The Virginia court permitted the examination of AOL in accordance with the request of the California court on the principle of "comity" (legal reciprocity, that is, the courts of one state will extend courtesies to the courts of another state or foreign nation). The Virginia court found the necessary elements for extending comity to the California court: (1) that the foreign court had personal and subject matter jurisdiction; (2) that the applicable law of the foreign state be comparable to that of Virginia; (3) that the order of the foreign court be obtained properly without falsity or fraud; and (4) that the enforcement of the foreign state's order not be contrary to the policy of the state of Virginia.

Injunctions

Often, a party to a lawsuit will ask the court to impose immediate relief so as to prevent or cease an alleged harm from taking place or continuing to take place. An injunction is an order of the court barring the commission of an act or affirmatively compelling a person to act. Injunctions are often granted in cases concerning violation of intellectual property rights. Courts, upon a showing of a meritorious claim, will ordinarily issue an order compelling the offending party to cease his or her violation of the plaintiff's ownership rights. The injunction may be "temporary" (preliminary) or "permanent." A "temporary injunction," that is, one that is issued pending the final determination of the litigation, may be granted when the court is given sufficient initial proof by affidavits that the plaintiff is likely to prevail in his or her lawsuit. The issuance thereof is to prevent any further damage to the plaintiff pending a final outcome of the case at hand. A grant of "preliminary injunctive relief" will be given if the moving party establishes "(a) that it will suffer irreparable harm in the absence of an injunction and (b) either (i) a likelihood of success on the merits or (ii) sufficiently serious questions going to the merits to make them a fair ground for litigation and a balance of hardships tipping decidedly in the movant's favor."[27] At the cessation of a case, the court may issue a "permanent injunction," which is an order barring a party thereafter from acting in a manner in violation of the plaintiff's rights. In chapters 2 and 3, we will commence a discussion on corporate governance. In Chapter 2, we will examine U.S. corporate governance and the latest statutory requirements that have affected it.

CHAPTER 2

Corporate Governance in the United States

Introduction

The study of corporate governance has undergone major changes in the past two decades, not only in the United States but also globally. Factors that have led to the study of what constitutes effective corporate governance include the fall of the Soviet Union coupled with the near elimination of communism both in theory and in practice; the internationalization of corporations; and the recent global economic crisis. Other factors are the worldwide expansion of capital markets; the fall of trade barriers due in large part to the agreements entered into in the World Trade Organization that replaced the General Agreement on Tariffs and Trade; the transparency of financial information about corporate performance; and the great improvements in information technology that almost single-handedly have united peoples of the world.

Corporate governance is an area of major concern because investors have become much more sophisticated, especially with the growth of institutional investors, which have trillions of dollars or their equivalent in other currencies at their disposal. Companies in search of capital have come to the realization that good governance is the key to receipt of needed capital for ongoing expenses and expansion of their enterprises. The Bank of Reconstruction and Development (World Bank), nongovernmental organizations, and many other public and private entities have trained their spotlights on the management practices and the internal mechanisms and controls in place in order to permit a transparent view of corporate finances and to prevent rogue destructive practices. A survey by McKinsey & Company found that corporate governance is at the heart of investment decisions. Investors stated that governance was on a par with financial indicators when deciding whether or not to invest. Most investors indicated that they were ready to pay a premium for companies that exhibit good governance especially with respect to investments in Eastern Europe and Africa. Among the major considerations were financial disclosure at the apex; followed by the quality of market regulation and infrastructure; independent boards; greater commitment of time by directors; and tighter enforcement of regulations.[1]

"Corporate governance" has been given a number of definitions but, in essence, as stated in the classic formulation by Adolph A. Berle, Jr., and Gardiner C. Means in "The Modern Corporation and Private Property,"[2] it is defined as the processes and means by which a corporation is operated, regulated, and controlled. Other definitions include "a system of checks and balances between the board, management, and investors to produce an efficiently functioning corporation, ideally geared to produce long-term value" (U.S. Senate testimony). It is supposed to provide a check on senior management, be a nexus between the management and its shareholders, and satisfy the demands of the many constituencies such as directors, suppliers, employees, creditors, and consumers.

The Berle-Means classic formulation espouses the theoretical proposition that the shareholders, who own the corporation, select the members of the board of directors to make the fundamental decisions on behalf of the corporation. The board members then select the major officers of the firm to carry out its mandates. Thus, in a corporation where shares are publicly traded, its shareholders almost never play a role in its management. The board is charged with making the significant decisions of the corporation, depending on the nature of the corporation, such as budgets, corporate expansion, mergers and acquisitions, and, most importantly, the selection and supervision of the major officers of the corporation who are responsible for the day-to-day operation of the corporate enterprise.

This classic formulation often lacks reality. As illustrated by the board of directors of Enron Corporation, the alleged supervision of the officers by the board may be extraordinarily deficient. Enron's board, selected in great part by the president of Enron, included the former dean of Stanford's Graduate School of Business, the former chairwoman of the U.S. Commodity Futures Trading Commission, the chairman of an oil and gas corporation, the former chief executive officer (CEO) and Secretary General of the U.S. Olympic Committee, and the president of the University of Texas. Due to the failures of the boards of directors of Enron and boards of some other companies the question of the need for greater shareholder involvement arises.

The problem is that the senior officers of a corporation (president, treasurer, senior vice-presidents and other senior officials) are often not supervised properly. The blame, according to many scholars and students of corporate governance, is that in many corporations, especially in the United States, the officers of the corporation control the board of directors. This reality is illustrated by innumerable examples wherein the CEO and other top management executives often select the members of the board of directors, who, in turn, are beholden to the management for their salary and perks that accompany their selection as board members. It is common in U.S. publicly owned corporations for the CEO to be also the chairperson of the board of directors. Thus, the board that is given the responsibility to supervise the officers of the corporate entity is often controlled by the persons they are to supervise (Figures 2.1 and 2.2).

In this chapter, we will discuss a development that is taking place in corporate governance, namely, a small but significant shift in the Berle and Means model whereby shareholders do participate more actively in the affairs of the

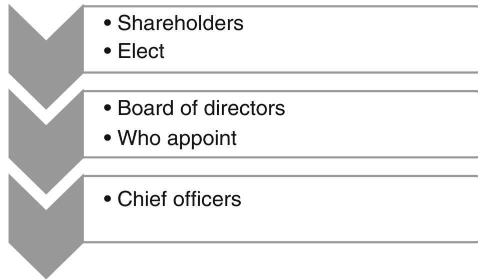

Figure 2.1 Berle-Means model of corporate governance

Figure 2.2 Corporate governance in many publicly traded corporations

corporation. This is due to a number of factors including the influence of institutional investors and the statutory and regulatory changes that have come about in the past decade. The discussion that follows concerns business corporations rather than other forms of corporations such as not-for-profit corporations and public (governmental) corporations. The bursting of the dot-com boom, major corporate scandals, and the ever-increasing disconnect between the incomes of top managers and lower-level salaried employees brought about demands for significant changes in the corporate landscape.

Although much has been said about the failures of Congress to perform its investigative functions owing to extreme ideological views of both ends of the political spectrum, both political parties have acted decisively in addressing some of the major issues raised by economic and financial events that have troubled the United States in the first decade of the twenty-first century. The two major statutes affecting corporate governance are the Sarbanes-Oxley Act (SOX) of 2002,[3] passed under the Republican administration of President George W. Bush, and the Dodd-Frank Act,[4] enacted under the Democrat administration of President Barack Obama. Both statutes substantially impacted corporate boardrooms and continue to be part of a major debate concerning whether government interference has undermined job creation due to alleged governmental overregulation. Prior to reviewing the changes brought about by the two statutes that touched upon corporate governance, we will begin with a discussion of the two major models of corporate governance.

Models of Corporate Governance

Shareholder Model

There are two basic models of corporate governance with many variations among them, namely, the *shareholder* model and the *stakeholder* model. The "shareholder model" is the model that dominates U.S. corporations and, to some extent, corporations in other Anglo-Saxon countries, especially Great Britain. In essence, it reflects the views of its main proponent, the late professor and Nobel Laureate Milton Friedman, of the University of Chicago, who fostered the idea that a corporation's sole duty is to maximize its profits for the benefit of its shareholders, provided that the corporation does not violate the laws and regulations of the country wherein it conducts business. It has no obligation to other third-party stakeholders. He believed that if each corporation acted to maximize its profits in competition with other companies, the ultimate result would be to the greater benefit of all persons including employees and especially consumers who profit from the competition. Thus, he espoused the view that corporate donations for charitable purposes constituted a theft of corporate profits that would best be given to the shareholders or retained for corporate purposes. The grant of moneys to specified charities reflects the biases of the decision makers, which often are in conflict with the preferences of many shareholders. For example, moneys given to a particular political party or to a public television station or other cause will invariably be contrary to the views and desires of some shareholders of the publicly owned corporation.

Stakeholder Model

The second major model, which will be elaborated upon in the next chapter, is the "stakeholder model." This model is the basis for corporations that operate in most countries. It supports the idea that a corporation owes its duties to a relatively wide range of stakeholders, namely, to its employees, suppliers, customers, the government, society in general, and of, course, shareholders. There are many variations in the model. For example, in Germany, corporations possess two corporate boards: a supervisory board (Aufsichtsrat) and a management board (Vorstand). In larger German corporations of over 2,000 employees, the shareholders elect one-half of the supervisory board members while their employees elect the other half. Inasmuch as the supervisory board appoints and removes members of the management board, employees have substantial powers in their governance. Thus the emphasis is on corporation's social responsibility, which is much more important than making as much money as quickly as possible for its shareholders.

U.S. Shareholder Model

The United States, comprising 50 states, has many variations of business incorporation laws, although approximately 24 states follow the American Bar

Association's (ABA's) Model Business Corporation Act (MBCA). As previously stated, there are also federal and state public governmental corporations. In the United States, until relatively recent legislative enactments, corporations were free to act with few legal restrictions. Commencing a corporation is easily accomplished in most states, often not requiring the services of an attorney if the corporation is composed of one or very few individuals. There are almost no financial requirements other than paying the state's filing and franchise fees and making and filing mandatory disclosures and tax returns. It is only when corporations issue publicly available securities on exchanges that most legislative rules come into play.

The major difference between the U.S. corporate model and that of the rest of the world is the degree of dispersion of corporate shares. In the United States, shares are generally owned by a large number of persons, either individually or through institutional firms such as TIAA-CREF, Fidelity Funds, and the like. Shareholders almost never have or control a majority of the voting shares. As a result, they have little power to name or direct the board of directors, which, in turn, allegedly controls the officers that the board names. The absence of shareholder power has led to substantial abuses by corporate management that have been ratified by a compliant board of directors whose members were named at the behest of the management leadership. The board members, historically, retain their position by proxy vote 99.6 percent of the time. Few shareholders ever vote and almost none ever attends the annual shareholders' meetings that often occur at a remote location, thus enabling the board to cast the shareholders' votes in their favor. The insulation from shareholder disapproval has permitted senior management officials, often with impunity, to cut back on research and development or to make investments that would maximize the next quarter's earnings so as to enhance their bonuses.

These senior officers often failed to maintain a "Chinese Wall" between analysts and investment banking operations. Senior corporate officials lobbied successfully to have states enact antitakeover statutes that had the effect of dissuading mergers and insulating poor managers. These abuses, especially in an economy that suffered substantial decline, coupled with the rise in the influence of institutional investors able to vote large percentage shares, led to a call for changes in the corporate governance landscape. Thus, the result was the passage of the SOX and the Dodd-Frank Act. We will discuss the changes both in this chapter and in subsequent chapters that, in essence, transformed corporate law from one that was essentially principles-based to one that is rules-based. The alleged need for extensive rule making is one of the major issues currently dividing the political parties today.

SOX and Major Provisions

The demise and/or misuse of corporate funds at Enron, WorldCom, Adelphia Communications Corp., other major corporations, created an atmosphere of dismay and cynicism among investors who perceived that corporate earnings

statements were unreliable. The use of accounting techniques to shield offshore investments and other accounting devices revealed that alleged corporate profits often were in reality a cover for extensive liabilities. Investors and in particular employees at Enron suffered major losses on their investments. Many employees at Enron, who were urged to invest their savings in the company while, at the same time, the senior officers were unloading theirs, lost their entire savings. The publicity surrounding corporate scandals led to the passage of a stringent statute by an otherwise corporate-friendly Congress and president.

PCAOB

SOX contains 11 titles that altered the regulatory landscape. Title I created the Public Company Accounting Oversight Board (PCAOB), an independent, private, nonprofit body with semigovernmental functions. The five board members, including the chairman, are appointed to staggered five-year terms by the Securities and Exchange Commission (SEC), after consultation with the chairman of the Board of Governors of the Federal Reserve System and the Secretary of the Treasury. With oversight authority by the SEC, it is funded by annual fees imposed on public companies in proportion to their market capitalization and on brokers and dealers based on their net capital.

Inspection

The PCAOB's duties include the registration and annual inspection of all public audit accounting firms that issue more than 100 audit reports for companies and other issuers annually and inspections every three years for firms that issue 100 or fewer audit reports. Firms that are required to register with the PCAOB but do not perform audit work are not subject to inspection unless an alleged violation or other substantial basis arises. The board renders a report that is publicly available concerning each audit completed with criticisms removed from public view if corrected within a 12-month period.[5] Its other duties are to adopt auditing, quality control, ethics, independence and other standards relating to the preparation of audit reports, and to conduct investigations and impose sanctions where appropriate.

Registration

Section 102 of SOX makes it unlawful for any person that is not a registered public accounting firm to prepare or issue an audit report or participate therein with respect to an issuer (any person who issues or proposes to issue any security). Registration consists of filing the appropriate form with PCAOB. The required information includes the following:

- The identities of all issuers for which the firm prepared or issued audit reports for the past calendar year and for the current calendar year
- The annual fees charged for all services provided to the issuers
- The firm's quality control processes in place

- A list of all accountants working with the audit and whether any such person has been subject to disciplinary procedures
- Other information as PCAOB may require

The audit firm must comply with the board's auditing and quality control standards. The standards encompass the maintenance of audit work papers and other information relating to the report for a period of seven years. The report is to provide a concurring or second partner review and the scope of the auditor's testing of the internal control structure and procedures of the issuer.

Investigation
The board has the power to conduct an investigation of any act or practice with respect to the accounting firm to ascertain its compliance with statutory, regulatory, and board requirements concerning the preparation and issuance of the audit report. It may require testimony of the firm and any person associated with the firm; the production of audit work papers and related documents; the testimony of any person, including the client; and may subpoena witnesses and documents. Failure to cooperate may result in suspension of the individual or the firm, revocation of registration, and other sanctions. The board is required to notify the SEC of any potential violation of the securities laws or any other appropriate federal regulator.

Confidentiality
An alleged weakness in Title I is that all proceedings and documents are to remain confidential except that availability of the data may be made to another government agency. If the board brings charges against an individual or a firm, the hearing is private. A finding of fault by the board may result in temporary or permanent suspension of the individual or firm; censure; required additional professional education; and/or a civil monetary penalty of not more than $100,000 for an individual or $2 million for any other person, or up to $750,000 or $15 million for intentional violation of the act.

The Director of Enforcement for the board has called upon Congress, to no avail, to make the proceedings public. As he stated, the confidentiality requirement is unique among federal agencies. The "non-public nature of Board disciplinary proceedings has serious adverse consequences for the investing public, audit committees, the auditing profession, the Board, and other interested parties, such as Congress." The public is denied access to important information concerning its cases. The persons charged with violations have little or no incentive to settle their cases because the proceedings are closed to the public, which causes the board to expend significant resources to prove its complaint against the alleged offending firm.[6]

Auditor Independence
Section 210 requires the PCAOB to ensure auditor independence by making it unlawful for the auditor to have a conflict of interest with its duties to provide

full and accurate audits. The reason for the provision in part was that the now-defunct Arthur Andersen accounting firm received far more earnings from its nonaudit services on behalf of Enron than for its auditing services. Thus, there was the almost inevitable temptation to "fudge," deemphasize, or omit important financial data on behalf of the company for which it was to provide an independent audit analysis. Among the non-audit services that are banned, subject to exceptions permitted by the PCAOB, are:

- Bookkeeping
- Financial information systems design and implementation
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports
- Actuarial services
- Internal audit outsourcing services
- Management functions or human resources
- Broker or dealer, investment adviser, or investment banking services
- Legal services and expert services unrelated to the audit

Moreover, the lead audit partner that has responsibility for the audit has to be rotated ever five years; nonlead auditors have a seven-year rotation mandate. The rotation rule has engendered much controversy and may be modified in the future.

Public Company Audit Committees

Section 301 requires that the audit committee of the board of directors of each issuer be directly responsible for the appointment, selection, and oversight of the work to be performed by the registered accounting firm of the issuer. Each member of the committee is to be a member of the board but independent thereof. The committee member may not accept any consulting, advisory, or other compensatory fee from the issuer or be an affiliated person of the issuer or its subsidiary. The committee must establish procedures for the receipt, retention, and treatment of complaints regarding accounting, internal accounting controls, or auditing matters, which complaints are to be kept confidential.

Foreign Public Accounting Firms

Section 106 is controversial in that it has caused much debate and controversy, the latest of which, as of this writing, concerns Deloitte & Touche in Shanghai (discussed below). Section 106 requires that "[a]ny foreign public accounting firm that prepares or furnishes an audit report with respect to any issuer, shall be subject to this Act [SOX]" as well as to the rules of the board and the SEC in the same manner and to the same extent that domestic accounting firms are bound. Thus, the foreign firm is deemed to have consented to the production of audit work papers to the PCAOB or to the SEC and be subject to the jurisdiction of

the U.S. courts with respect to the enforcement of this provision. Domestic registered public accounting firms that rely on opinions by foreign public accounting firms are also deemed to have consented to provide the audit work papers of the particular public accounting firm. The board may determine that a foreign public accounting firm that does not issue an audit report but, nonetheless, participates substantially in the report may be treated as a firm required to be registered under the act.

A controversial issue that arose is the said provision that a foreign firm required to be registered under the act is deemed to have consented to produce audit work papers for the board or the SEC and be subject to the jurisdiction of U.S. courts for enforcement purposes. The SEC and the board may exempt such firm where appropriate. The problem is that the European Union (EU) has very strict privacy laws. The EU initially rejected SOX's requirement concerning the retention of audit and review records because by doing so, it encompasses foreign audit firms, which will draw in EU auditors to enforcement actions by the SEC and inspections by the PCAOB. The EU explicitly rejected the idea that a foreign government can conduct investigations directly and inspections within the jurisdiction of another country, particularly in a member state of the EU. In addition, the SEC's desire for access to foreign auditor's work papers is strongly opposed by the EU audit profession and EU companies for confidentiality reasons.[7] The following excerpt is illustrative of the dilemma faced by U.S.-based firms doing business or providing services abroad.

SEC Charges Deloitte & Touche in Shanghai with Violating U.S. Securities Laws in Refusal to Produce Documents

SEC Press Release 2012–2087 (May 9, 2012)[8]

On May 9, 2012, the SEC commenced an enforcement action under SOX §106 against Shanghai-based Deloitte Touche Tohmatsu CPA Ltd. (D&T) for its willful refusal to provide the agency with audit work papers related to a China-based company under investigation for potential accounting fraud against U.S. investors. The SEC alleges that the SEC has been trying to obtain audit documents from D&T, a registered auditing firm, for a period of two years to no avail. The firm was thus charged with violating the SOX, §107, which requires foreign public accounting firms to provide audit work papers concerning U.S. issuers to the SEC upon request. D&T Shanghai has failed to provide the documents, citing Chinese law as the reason for its refusal.

The director of the SEC's Division of Enforcement SEC, Robert Khuzami, stated that "as a voluntarily registered U.S. public accounting firm, D&T Shanghai cannot benefit from the financial and reputational rewards that come with auditing U.S. issuers without also meeting its U.S. legal obligations." "Foreign firms auditing U.S. issuers should not be permitted to shield themselves from regulatory scrutiny to the detriment of

U.S. investors." The SEC further stated that without the required papers, it is unable to test the quality of the underlying audits and fulfill our responsibilities to investors.

The SEC, in a separate action in 2011, filed a request for a subpoena enforcement action in a federal court against D&T after the firm failed to produce documents in response to a subpoena related to an SEC investigation into possible fraud by one of its longtime clients, Longtop Financial Technologies Limited. The SEC later filed charges against Longtop for alleged reporting failures.

According to the SEC's order in this latest enforcement action, D&T Shanghai is a public accounting firm registered with the PCAOB. In April 2010, SEC staff began seeking D&T Shanghai's audit work papers related to its independent audit work for the client involved in an SEC investigation. The SEC served Deloitte, LLP, the U.S. member firm, with a subpoena requesting various related documents. Counsel for Deloitte, LLP, informed the staff that the U.S. firm did not perform any audit work for the client and therefore did not possess the documents related to the subpoena.

According to the SEC's order, in the SEC staff's continuing quest for the audit work papers in D&T Shanghai's possession, it was later informed by counsel for Deloitte's global firm that the agency's request for audit work papers had been specifically communicated to D&T Shanghai. Subsequently, the staff served D&T Shanghai with a request through Deloitte, LLP, for the audit work papers pursuant to §106 of the SOX. D&T Shanghai would not produce the relevant audit work papers because of its interpretation that it is prevented from doing so by Chinese law. SEC staff also sought to obtain the relevant audit work papers through international sharing mechanisms, yet these efforts have been unsuccessful.

This is the first time the commission has brought an enforcement action against a foreign audit firm for failing to comply with a §106 request. A D&T spokespersons said that the firm "is caught in the middle of conflicting laws of two different governments." . . . . "This is a profession-wide issue and not one that is specific to Deloitte Shanghai," Deloitte said in the statement. "Because the China legal impediments apply to all accounting firms in China, if a diplomatic resolution is not reached, it is likely that all of the major accounting firms in China will find themselves having to choose between violating their own national laws or facing a similar [SEC action]."[9]

Comment. In the above proceeding, D&T has the option to cease its operations in China, seek judicial intervention, or ask Congress to resolve these conflicts of laws issues. The best alternative is a diplomatic solution based in part on existing international treaties of friendship, navigation, and commerce. The problem with the treaties is that there are gaps that do not cover specific problems such as that which arose in the D&T case. The SEC's demand illustrates a classic dilemma for a company or a service firm like D&T. It is a conflict between violating the laws and regulations

of the home country of the firm or the laws and regulations of the country wherein it conducts its business. Similar confrontations occur between the United States and the EU that concern privacy and, also, the lack of international accounting standards.

As stated previously, the PCAOB was created by the SOX. An issue arose that concerned the constitutionality of the law's restriction on presidential power to remove a principal officer of the board, which a chief executive would most often possess. The following case raised the constitutionality of the PCAOB itself. The plaintiff, Free Enterprise Fund, sought to have the board declared as unconstitutional. The U.S. Supreme Court decided a particular aspect of the law to be unconstitutional but the board itself was permitted to continue its operations.

Free Enterprise Fund v. Public Company Accounting Oversight Board

561 U.S. (USSC 2010)

FACTS: Beckstead and Watts, LLP, is a Nevada accounting firm registered with the board. The board inspected the firm, released a report critical of its auditing procedures, and began a formal investigation. Beckstead and Watts and the Free Enterprise Fund, a nonprofit organization of which the firm is a member, then sued the board and its members, seeking (among other things) a declaratory judgment that the board is unconstitutional and for an injunction preventing the board from exercising its powers.

ISSUE: May the president be restricted in his ability to remove a principal officer, who in turn is restricted in his ability to remove an inferior officer, even though that inferior officer determines the policy and enforces the laws of the United States?

DECISION: The multilevel protection from removal is contrary to Article II's vesting of the executive power in the president and, therefore, is unconstitutional.

REASONING (Roberts, J.): After a series of celebrated accounting debacles, Congress enacted the Sarbanes-Oxley Act of 2002 (or Act), 116 Stat. 745. Among other measures, the Act introduced tighter regulation of the accounting industry under a new Public Company Accounting Oversight Board [PCAOB]. The Board is composed of five members, appointed to staggered 5-year terms by the Securities and Exchange Commission. It was modeled on private self-regulatory organizations in the securities industry—such as the New York Stock Exchange—that investigate and discipline their own members subject to Commission oversight. Congress created the Board as a private "nonprofit corporation," and Board members and employees are not considered Government "officer[s] or employee[s]" for statutory purposes . . . . The Board can thus recruit its members and

employees from the private sector by paying salaries far above the standard Government pay scale . . . .

Unlike the self-regulatory organizations, however, the Board is a Government-created, Government-appointed entity, with expansive powers to govern an entire industry. Every accounting firm—both foreign and domestic— that participates in auditing public companies under the securities laws must register with the Board, pay it an annual fee, and comply with its rules and oversight . . . . The Board is charged with enforcing the Sarbanes-Oxley Act, the securities laws, the Commission's rules, its own rules, and professional accounting standards . . . . To this end, the Board may regulate every detail of an accounting firm's practice, including hiring and professional development, promotion, supervision of audit work, the acceptance of new business and the continuation of old, internal inspection procedures, professional ethics rules, and "such other requirements as the Board may prescribe . . . . "

The Board promulgates auditing and ethics standards, performs routine inspections of all accounting firms, demands documents and testimony, and initiates formal investigations and disciplinary proceedings . . . . The willful violation of any Board rule is treated as a willful violation of the Securities Exchange Act of 1934 . . . — a federal crime punishable by up to 20 years' imprisonment or $25 million in fines ($5 million for a natural person) . . . . And the Board itself can issue severe sanctions in its disciplinary proceedings, up to and including the permanent revocation of a firm's registration, a permanent ban on a person's associating with any registered firm, and money penalties of $15 million ($750,000 for a natural person) . . . . Despite the provisions specifying that Board members are not Government officials for statutory purposes, the parties agree that the Board is "part of the Government" for constitutional purposes, . . . and that its members are "Officers of the United States" who "exercis[e] significant authority pursuant to the laws of the United States," . . . places the board under the SEC's oversight, particularly with respect to the issuance of rules or the imposition of sanctions (both of which are subject to Commission approval and alteration) . . . . But the individual members of the Board—like the officers and directors of the self-regulatory organizations—are substantially insulated from the Commission's control. The Commission cannot remove Board members at will, but only "for good cause shown," "in accordance with" certain procedures.

Our Constitution divided the "powers of the new Federal Government into three defined categories, Legislative, Executive, and Judicial . . . . " Article II vests "[t]he executive Power . . . in a President of the United States of America," who must "take Care that the Laws be faithfully executed." Art. II, §1, cl. 1 . . . . In light of "[t]he impossibility that one man should be able to perform all the great business of the State," the Constitution provides for executive officers to "assist the supreme Magistrate in discharging the duties of his trust . . . . " Since 1789, the Constitution has been

understood to empower the President to keep these officers accountable—by removing them from office, if necessary . . . . This Court has determined, however, that this authority is not without limit . . . . [W]e held [in a prior case] that Congress can, under certain circumstances, create independent agencies run by principal officers appointed by the President, whom the President may not remove at will but only for good cause. Likewise, . . . the Court sustained similar restrictions on the power of principal executive officers—themselves responsible to the President—to remove their own inferiors . . . . substantially insulated from the Commission's control. The Commission cannot remove Board members at will, but only "for good cause shown," "in accordance with" certain procedures . . . .

Removal of a Board member requires a formal Commission order and is subject to judicial review . . . . Similar procedures govern the Commission's removal of officers and directors of the private self-regulatory organizations . . . . The parties agree that the Commissioners cannot themselves be removed by the President except . . . under the standard of "inefficiency, neglect of duty, or malfeasance in office," and we decide the case with that understanding.

The Constitution provides that "[t]he executive Powers shall be vested in a President of the United States of America." Art. II, §1, cl. 1. As Madison stated on the floor of the First Congress, "if any power whatsoever is in its nature Executive, it is the power of appointing, overseeing, and controlling those who execute the laws."

The removal of executive officers was discussed extensively in Congress when the first executive departments were created. The view that "prevailed, as most consonant to the text of the Constitution" and "to the requisite responsibility and harmony in the Executive Department," was that the executive power included a power to oversee executive officers through removal; because that traditional executive power was not "expressly taken away, it remained with the President . . . " And it soon became the "settled and well understood construction of the Constitution . . . "

The landmark case of *Myers v. United States* reaffirmed the principle that Article II confers on the President "the general administrative control of those executing the laws . . . . " It is *his* responsibility to take care that the laws be faithfully executed. The buck stops with the President, in Harry Truman's famous phrase. As we explained in *Myers*, the President therefore must have some "power of removing those for whom he cannot continue to be responsible . . . . "

Nearly a decade later in *Humphrey's Executor*, this Court held that *Myers* did not prevent Congress from conferring good-cause tenure on the principal officers . . . . As explained, we have previously upheld limited restrictions on the President's removal power. In those cases, however, only one level of protected tenure separated the President from an officer exercising executive power. It was the President—or a subordinate he could remove at will—who decided whether the officer's conduct merited

removal under the good-cause standard. The Act before us does something quite different. It not only protects Board members from removal except for good cause, but withdraws from the President any decision on whether that good cause exists. That decision is vested instead in other tenured officers—the Commissioners—none of whom is subject to the President's direct control. The result is a Board that is not accountable to the President, and a President who is not responsible for the Board. The added layer of tenure protection makes a difference. Without a layer of insulation between the Commission and the Board, the Commission could remove a Board member at any time, and therefore would be fully responsible for what the Board does. The President could then hold the Commission to account for its supervision of the Board, to the same extent that he may hold the Commission to account for everything else it does.

A second level of tenure protection changes the nature of the President's review. Now the commission cannot remove a Board member at will. The President therefore cannot hold the commission fully accountable for the Board's conduct, to the same extent that he may hold the commission for everything else it does. This novel structure does not merely add to the Board's independence, but transforms it. Neither the President, nor anyone directly responsible to him, nor even an officer whose conduct he may review only for good cause, has full control over the Board. The President is stripped of the power our precedents have preserved, and his ability to execute the laws—by holding his subordinates accountable for their conduct—is impaired.

That arrangement is contrary to Article II's vesting of the executive power in the President. Without the ability to oversee the Board, or to attribute the Board's failings to those whom he *can* oversee, the President is no longer the judge of the Board's conduct. He is not the one who decides whether Board members are abusing their offices or neglecting their duties. He can neither ensure that the laws are faithfully executed, nor be held responsible for a Board member's breach of faith. This violates the basic principle that the President "cannot delegate ultimate responsibility or the active obligation to supervise that goes with it," because Article II "makes a single President responsible for the actions of the Executive Branch." . . .

The diffusion of power carries with it a diffusion of accountability. The people do not vote for the "Officers of the United States." Art. II, §2, cl. 2. They instead look to the President to guide the "assistants or deputies . . . subject to his superintendence . . . . " Without a clear and effective chain of command, the public cannot "determine on whom the blame or the punishment of a pernicious measure, or series of pernicious measures ought really to fall . . . . " That is why the Framers sought to ensure that "those who are employed in the execution of the law will be in their proper situation, and the chain of dependence be preserved; the lowest officers, the middle grade, and the highest, will depend, as they ought, on the President, and the President on the community . . . . "

By granting the Board executive power without the Executive's oversight, this Act subverts the President's ability to ensure that the laws are faithfully executed—as well as the public's ability to pass judgment on his efforts. The Act's restrictions are incompatible with the Constitution's separation of powers.

[The decision invalidated only the one aspect of the Sarbanes-Oxley Act; the remainder of the Act remained intact including the continued existence of the PCAOB. The inability of the President to remove a PCAOB member was declared illegal but with its provision excised, its powers remain intact.]

In a dissent by Justice Bryer on behalf of four dissenting Justices, he emphasized in his decision and listed in an Appendix 24 stand-alone federal agencies (i.e., "departments") whose heads are, by statute, removable by the President only "for cause." In addition, he noted that there were 24 additional offices, boards, or bureaus situated within departments that are similarly subject, by statute, to for cause removal provisions.

Questions

(1) The legal problem is that PCAOB members are appointed for fixed five-year terms by the SEC, which is an independent regulatory agency insulated from direct presidential control. According to the statute, PCAOB members are removable only by the SEC and only for willful or unjustifiable transgressions. The dissenting opinion recites many other agencies that are insulated from presidential power of removal without cause. How does lack of presidential power in this case differ from lack of power over other agencies?

(2) Was the PCAOB's independence compromised as a result of the decision?

Enhanced Financial Disclosures

Section 401 addresses the problem raised in the Enron debacle wherein the quarterly and annual reports filed with the SEC did not contain or minimized the extent of offshore investments, which, in Enron's domain, substantially and negatively changed its bottom line. Thus, SOX requires that the said reports shall disclose all material off-balance sheet transactions, arrangements, obligations, and other relationships of the issuer with unconsolidated entities or other persons that may have a material current or future effect on the financial condition of the company. Material changes required to be filed as 8-K reports must be filed within four business days of the occurrence.

Management Assessment of Internal Controls

Section 404 of the act mandates that the SEC prescribe rules requiring (1) each annual report contain an internal control report that states the responsibility of

management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) an assessment of the issuer at the end of the fiscal year of the effectiveness of the internal control structure and procedures of the issuer for financial reporting. Furthermore, the audit report prepared by the registered accounting firm shall also be attested to and report on the assessment made by management.

Companies complained most bitterly about this section of the act citing the near prohibitive costs of installation and report of the internal control system. There were estimates, initially, that the costs of compliance for larger entities would be several million dollars. In a study by Financial Executives International, however, it found that, in the fourth year after enactment, the average cost for compliance by 185 companies that had average annual revenues of $4.7 billion was $1.7 million. As each year has gone by, companies have learned to adapt greater efficiencies in compliance, thereby reducing overall costs. The average people-hours for the preparation of the reports were 11,100 hours. The auditor attestation fees paid by accelerated filers in 2007 constituted 23.7 percent of the accelerated filer's total annual audit fees and averaged $846,000, representing a 5.4 percent decrease from 2006 with increasing efficiencies thereafter.[10]

In a report by the SEC, based primarily on numerous academic studies, it found that there were offsetting benefits of §404. They include greater accurate and reliable disclosure and greater investor confidence in the financial data of the issuer. The report further noted that the Dodd-Frank Act, §989G(b), directs the SEC to conduct a study with respect to the auditor attestation requirement under §404(b) of Sarbanes-Oxley for issuers whose market capitalization is between $75 and $250 million. The study is to include how the SEC can reduce the burden of complying with the said §404(b) for such companies for the relevant reporting period while maintaining investor protections for such companies. Further, the study is to consider whether the reduction of compliance would encourage companies to list on exchanges in the United States in their initial public offerings (IPOs).[11] The reason for the emphasis of IPO listings is that SOX caused many companies to delist or not list on U.S. exchanges and instead list with exchanges in the United Kingdom and other exchanges.[12]

Executive Officers' Responsibility

An additional aspect of the act that caused much anguish in corporate boardrooms is the §302 requirement that the principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, certify in each annual or quarterly report filed or submitted under either such section of such act that:

- The signing officer has reviewed the report
- Based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading

- Based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report
- The signing officers (a) are responsible for establishing and maintaining internal controls; (b) have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared; (c) have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and (d) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date
- The signing officers have disclosed to the issuer's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function)—(a) all significant deficiencies in the design or operation of internal controls that could adversely affect the issuer's ability to record, process, summarize, and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls
- The signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Thus, inasmuch as the possible penalty for false certification is up to 20 years in prison, which effectively is a life sentence for most senior executives, the burden placed upon them is extraordinary.

Code of Ethics for Senior Financial Officers

Section 301 of the act provides that the issuer in its periodic reports shall disclose whether or not it has adopted a code of ethics for senior financial officers particularly with respect to the principal financial officer and comptroller or principal accounting officer. The code of ethics is to be disclosed to shareholders. The purpose is to encourage companies to adopt the code for the issuer.

Loans to Directors or Officers

Congress ascertained that "sweetheart" loans were made often to senior executives with exceptionally low, if any, interest rates attendant thereto. Accordingly, §402 of the act, "Enhanced Conflict of Interest Provisions," makes it unlawful for any issuer or subsidiary to extend credit, or renew credit with respect to a personal loan to or for any director or executive officer with exceptions for certain

loans made in the ordinary course of consumer credit business or made under conditions normally given to the general public.

Analyst Conflict of Interest

The purpose for §501, "Analyst Conflict of Interest," was the misuse of analyst's reports by companies and brokers and dealers. There was substantial evidence that such reports were influenced by outside factors that colored their legitimacy. Thus, SOX requires each securities analyst to disclose in public appearances, and each registered broker or dealer to disclose in each research report, known conflicts of interest that existed when the reports were issued. Among the possible conflicts of interest that may arise and must be reported include (1) the extent to which the securities analyst has debt or equity investments in the issuer that is the subject of the appearance or research report; (2) whether any compensation was paid to the registered broker or dealer or any affiliate thereof; (3) whether an issuer during the past year or currently was or is a client of the registered broker or dealer and, if so, the nature of the relationship; and (4) whether the securities analyst received compensation with respect to a research report, based upon the investment banking revenues earned from the issuer being analyzed.

Whistle-blower Protection

Whistle-blowers were rarely protected by law. The reason is that most employee positions in the United States are "at will," which means that the employee's position could be terminated at any time provided it does not violate a statute such as Title VII protections of the Civil Rights Act of 1964 (discrimination) or other federal or state legal requirements. Thus, if an employee complained about wrongful conduct by the employer, the employee most often suffered loss of his or her position. Usually, the employer would find some other alleged reason for the termination to avoid the claim that it was due to the whistle-blowing.

Protection for whistle-blowers is now found in a number of statutes.[13] Pertinent to our discussion, however, are the sections of Sarbanes-Oxley that grant private relief and criminal sanctions. Section 806 of the act, "Protection for Employees of Public Traded Companies Who Provide Evidence of Fraud," amended Title 18 U.S.C. §1514A to permit a civil action by an employee of a public traded company who provides evidence of fraud concerning the companies for which they are employed. The protection extends to actions by the company's officer, other employee, contractor, subcontractor, or agent thereof concerning that consists of discrimination, harassment, demotion, threats, or discharge.

The types of whistle-blowing specifically mentioned are as follows: provide information or otherwise assist in an investigation regarding conduct that the employee believes is a violation of 18 U.S.C. §1341 (frauds and swindles); §1343 (fraud by wire, radio, or television); §1344 (bank fraud); or §1348 (securities fraud); or any rule or regulation of the SEC; or any provision of federal law relating to fraud against shareholders, when the information or assistance is provided

to or the investigation is conducted (1) by a federal regulatory or law enforcement agency; (2) any Member of Congress or any committee of Congress; a person with supervisory authority over the employee who has the authority to investigate, discover, or terminate misconduct); or (3) file, testify, or assist in a proceeding concerning the said violations.

A person who alleges that he or she was discriminated against because of the whistle-blowing may seek relief by (1) filing a complaint with the Secretary of Labor, or, (2) if no decision is made within 180 days by the secretary, and there is no showing that the delay is due by bad faith by the claimant, then he or she may sue for a *de novo* review of the case by the appropriate federal district court that has jurisdiction over the parties within 90 days after receipt or communication of an adverse decision. Relief consists of reinstatement of the employee's status together with any seniority the employee had or would have had but for the discrimination; back pay with interest; and/or compensation for special damages as a result of the discrimination, including the costs of litigation, expert witness fees, and reasonable attorneys' fees. The following case is illustrative of some of the procedural issues in presenting a whistle-blower case.

Van Asdale v. International Game Technology (IGT)

577 F.3d 989 (9th Cir. 2009)

FACTS: The Van Asdales filed a complaint for retaliatory discharge that was dismissed by the district court on a Motion for Summary Judgment. IGT employed the Van Asdales to work as in-house intellectual property attorneys. Both husband and wife were hired in 2001 and received promotions a year later. When IGT entered into merger negotiations with Anchor Gaming, they were fired for allegedly reporting possible shareholder fraud in connection with the merger. Prior to the merger of IGT and Anchor, Bally Gaming (Bally), one of Anchor's competitors, advertised a new "Monte Carlo" slot machine featuring a "bonus wheel." Two high-level Anchor employees asserted that the Monte Carlo machine infringed on a particular patent owned by Anchor known as the "wheel" patent. Bally argued, however, that the wheel patent was invalidated by prior art, specifically, Bally's vintage 1970s Monte Carlo machine. The wheel patent was a very valuable part of Anchor's holdings.

As part of his department's due diligence, Shawn Van Asdale investigated this dispute to allow IGT's litigation counsel to assess the impact of the machine on Anchor's patent. Shawn had questioned the validity of Anchor's claim of patent right to the machine. He claimed that he had informed corporate counsel of a possible fraud on the Patent Office by filing for a patent that the company knew was not valid due to prior art (the machine was not original but had been preceded by a similar machine or components). As a result, the Van Asdales claimed their positions were

terminated because of the claims that Shawn told his supervisors of two possible frauds, namely, a general fraud on IGT, including Shawn Van Asdale and other IGT shareholders arising out of the omissions by Anchor during due diligence affecting the value of its Wheel patents, and, second, a specific fraud against the U.S. Patent Office arising out of the nondisclosure of the prior art.

ISSUE: Whether the plaintiffs made out a prima facie case of violation of the Sarbanes-Oxley's whistle-blowing protection statute and thus withstand a motion for summary judgment to dismiss their claims?

DECISION: The court of appeals reversed the grant of dismissal by the district court and ordered the case to proceed to trial.

REASONING (Bybee, J.): Sarbanes-Oxley Act, Section 806, that amended §1514A(a)(1) of Title 18 prohibits employers of publicly traded companies from "discriminat[ing] against an employee in the terms and conditions of employment" for "provid[ing] information . . . regarding any conduct which the employee reasonably believes constitutes a violation of §1341 [mail fraud], §1343 [wire fraud], §1344 [bank fraud], or §1348 [securities fraud], any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders."

§1514A(b)(2) further specifies that §1514A claims are governed by the procedures applicable to whistleblower claims brought under 49 U.S.C. §42121(b). § 42121(b)(2)(B), in turn, sets forth a burden-shifting procedure by which a plaintiff is first required to make out a prima facie case of retaliatory discrimination; if the plaintiff meets this burden, the employer assumes the burden of demonstrating by clear and convincing evidence that it would have taken the same adverse employment action in the absence of the plaintiff's protected activity.

Protected Activity. [T]o constitute protected activity under Sarbanes-Oxley, an employee's communications must "definitively and specifically" relate to [one] of the listed categories of fraud or securities violations under 18 U.S.C. §1514A(a)(1). The Court found that Shawn met this criteria in his conversations and documents given to corporate counsel and other executives met this element of a prima facie case. Whether or not the disputed testimony is proven is to be left to the trier of fact [jury or judge acting as a trier of fact.].

We conclude that the Van Asdales' theory of fraud approximates a securities fraud claim. It seems clear that the wheel patent was an important asset that Anchor brought to the merger with IGT. Matthews stated in his declaration that the "Wheel Patents, and the machines that are covered by the patents, generate a substantial portion of IGT's total income." Johnson, for his part, testified that "the wheel patent is of such importance to IGT that it utterly eclipses the relative importance of any . . . other claimed accomplishments. It's [sic] wheel is the Crown Jewel of IGT's intellectual property portfolio."

In reaching this conclusion, we wish to make absolutely clear that we are not suggesting that former Anchor officials *actually did* engage in wrongdoing prior to the merger with IGT. As IGT points out, there is no evidence that anyone at Anchor instructed the company's outside counsel not to disclose the [alleged prior art] prior to the merger . . . . It is not critical to the Van Asdales' claim that they prove that Anchor officials actually engaged in fraud in connection with the merger; rather, the Van Asdales only need show that they reasonably believed that there might have been fraud and were fired for even suggesting further inquiry.

We also conclude that the Van Asdales had a subjective belief that the conduct that they were reporting violated a listed law. The legislative history of Sarbanes-Oxley makes clear that its protections were "intended to include all good faith and reasonable reporting of fraud, and [that] there should be no presumption that reporting is otherwise, absent specific evidence." . . . . In this case, there is no evidence that Shawn's various complaints were made in bad faith and IGT does not suggest otherwise.

b. Knowledge of Decision-Maker. To establish a prima facie case under §1514A, the Van Asdales also must establish that "[t]he named person knew or suspected, actually or constructively, that the employee engaged in the protected activity." . . . . This language is hardly a model of clarity (for example, it is not at all clear to us how one can constructively suspect someone of engaging in protected activity) but under any interpretation this element is satisfied here. As we have stated above, taking the Van Asdales' deposition testimony and Shawn's sworn declaration as true, the Van Asdales engaged in protected activity during the November 24, 2003 [with company officials] . . . . It is undisputed that these persons have "supervisory authority" over the Van Asdales. 18 U.S.C. §1514A(a)(1)(c).

c. Unfavorable Personnel Action. IGT does not dispute that the Van Asdales satisfy this required element.

d. Contributing Factor. The final element of a prima facie case under §1514A is that "[t]he circumstances were sufficient to raise the inference that the protected activity was a contributing factor in the unfavorable action." 29 C.F.R. §1980.104(b)(1)(iv). As the district Court correctly observed, the Van Asdales have not put forth any direct evidence that their protected activity was a §1980.101, in turn, defines "person" as "the employer and/or the company or company representative named in the complaint who is alleged to have violated the Act." . . .

Burden-Shifting Analysis

Because we conclude that the Van Asdales have made out a prima facie showing of retaliatory termination in violation of §1514A, IGT cannot obtain summary judgment unless it shows by clear and convincing evidence that it would have terminated the Van Asdales even absent any

protected activity. . . . On appeal, IGT does not argue that it can satisfy this requirement.

We thus hold that the district Court erred in granting IGT summary judgment on the Van Asdales' Sarbanes-Oxley claim.

Questions

1. The claim was made by in-house counsel for the company. Doesn't counsel have to abide by the attorney-client privilege that prevents an attorney from disclosing privileged information?
2. What impact would such a decision have on future attorney-client discussions between corporate officers and corporate attorneys whether they are in-house or retained outside the corporation?

The odds of having the Secretary of Labor enforce the Act were almost nonexistent. Between 2002 and 2011, the Occupational Safety and Health Administration (OSHA) found merit in only 21 whistle-blower complaints under Sarbanes-Oxley and dismissed 1,211 others.[14] Thus, unless a private lawsuit was timely commenced, it appears that whistle-blowing relief was more theoretical than practical. As stated below, the Dodd-Frank Act altered the whistle-blower program substantially.

International employment presents an additional problem with respect to whistle-blowing. Section 301 states that with respect to complaints, "each audit committee shall establish procedures for—(A) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and (B) *the confidential, anonymous* submission by employees of the issuer of concerns regarding questionable accounting or auditing matters [emphasis added]." The difficulty with this "hotline" provision is that it conflicts with European doctrines of labor and data protection laws that protect the due process rights and presumption of innocence of the targets of whistle-blowers. Europeans are loathe to permit anonymous complaints against parties who are not allowed to know the identities of the complainants.[15]

A tactic used by employers to avoid possible jury runaway verdicts is the compulsion of employees who are employed to sign an agreement whereby they agree that any lawful termination lawsuit be subject to arbitration. Although the act was silent on this issue, courts have uniformly held that when parties to an agreement consent to arbitration, then they are bound to proceed to arbitration, unless they mutually agree otherwise. In the following case, decided before the Dodd-Frank Act provision in §921 that gives the authority to the SEC to prohibit or limit the use of such predispute arbitration agreements in future disputes, it was held by a federal court of appeals that the said provision in an agreement is binding on the parties. The result of the decision was to limit in practice the remedies available to an aggrieved party.

Guyden v. Aetna Inc.

No. 06-4954-cv (2d Cir. October 2, 2008)

FACTS: In January 2004, Guyden joined Aetna as its Director of Internal Audit. Soon after starting, Guyden alleges that she discovered that Aetna's Internal Audit Department was "ineffective, demoralized, and without independence or objectivity." According to Guyden's complaint, these problems were so serious that she believed that Aetna was in danger of violating the SOX of 2002 . . . and regulations promulgated thereunder, which require corporate officers to report on the effectiveness of internal controls over financial reporting, and they prohibit those officers from characterizing the controls as "effective" if "there are one or more material weaknesses . . . . " Guyden claims that she reasonably believed that Aetna was at risk of violating this regulation because (1) the Internal Audit Department was ineffective, and (2) that ineffectiveness, if left unaddressed, would become a material weakness in the company's internal controls.

Guyden responded by attempting to rehabilitate the Internal Audit Department. In need of more resources and greater authority to make changes within the department, she also brought her concerns to the attention of senior management. During the course of her discussions with senior management, Guyden and management clashed over a number of issues, including the possibility of an outside audit and Guyden's efforts to restructure her department. Over the spring of 2004, Guyden sought assistance from Aetna's Chief Financial Officer, Alan Bennett. Guyden found Bennett's response wanting, and on August 16, 2004, she raised her concerns to Chairman and CEO John (Jack) Rowe, President Ron Williams, and General Counsel Lou Briskman. About one week after this meeting, Bennett gave Guyden a "withering" performance review, despite having given her a positive review one month earlier.

Guyden eventually prevailed in hiring an outside auditor to review Aetna's internal controls. According to the complaint, senior management prevented the distribution of the outside auditor's report until September 30, 2004, one week after the Audit Committee had held its scheduled meeting. That committee's next scheduled meeting was to take place on December 2, 2004. Guyden planned to discuss her concerns with the committee then, where she also hoped to present the outside auditor's report.

Ten days before the meeting, however, Aetna terminated Guyden's employment. After being terminated, Guyden requested to speak at the Audit Committee meeting about her concerns. Senior management denied that request. Guyden believes that Aetna fired her to prevent her from bringing attention to deficiencies in Aetna's internal controls, and she

points to management's refusal to allow her to speak at the committee meeting as evidence of its desire to prevent further discussion of her concerns.

[The agreement signed with Aetna provided for mandatory arbitration of all disputes with Aetna. It also had provisions that allowed limited discovery, confidentiality of the proceedings, and for an abbreviated written decision. Guyden filed her complaint with the office of the Secretary of Labor which did not act on it. She then timely brought the within proceeding. Aetna moved to dismiss the case stating that the contract of employment provided for mandatory arbitration of all disputes concerning her employment]

ISSUE: (1) Whether, under SOX, whistle-blower claims are nonarbitrable because mandatory arbitration of such claims conflicts with SOX's provisions?

(2) Whether the procedural requirements established in the agreement will prevent the plaintiff from enforcing her statutory rights?

DECISION: The court held in favor of Aetna holding that the claims were arbitrable and that the procedural requirements did not prevent the plaintiff from enforcing her rights.

REASONING (Hall, J.): A Court determining whether to stay proceedings pending arbitration must resolve four issues: first, it must determine whether the parties agreed to arbitrate; second, it must determine the scope of that agreement; third, if federal statutory claims are asserted, it must consider whether Congress intended those claims to be nonarbitrable; and, fourth, if the Court concludes that some, but not all, of the claims in the case are arbitrable, it must then decide whether to stay the balance of the proceedings pending arbitration.

Guyden does not challenge the existence of the arbitration agreement or that it covers most employment-related disputes. Her appeal concerns the third prong: "whether Congress intended [SOX whistleblower] claims to be nonarbitrable." She asserts that Congress did so intend. Under the Federal Arbitration Act ("FAA"), arbitration agreements "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." . . . The FAA embodies the "liberal federal policy favoring arbitration agreements" and "establishes that, as a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration." . . .

When statutory claims are involved, a party can prevent enforcement of the arbitration agreement only by showing that "Congress intended to preclude a waiver of judicial remedies for the statutory rights at issue." . . . Proof of that intent could "be discoverable in the text of the [statute], its legislative history, or an inherent conflict between arbitration and the [statute's] underlying purposes." . . .

Our review of the legislative history of the SOX whistle-blower provision confirms that the result is the same here. The primary purpose of the

statute is to provide a private remedy for the aggrieved employee, not to publicize alleged corporate misconduct. Although Guyden correctly points out that the broad purpose of the Sarbanes-Oxley Act is to strengthen the integrity of capital markets, the whistleblower provision in particular fills a far narrower gap in the law—it protects "employees when they take lawful acts to disclose information or otherwise assist . . . in detecting and stopping actions which they reasonably believe to be fraudulent." That protection, designed to "make [the] victim whole," takes the form of remedies that include "both reinstatement of the whistleblower, backpay, and compensatory damages . . . . " Remedies that "make [the] victim whole" protect and compensate whistle-blowers, but they do little to publicize the conduct of the corporate defendant. Tellingly, and further undermining Guyden's argument that the public purpose of SOX should preclude arbitration, both Houses of Congress, acting separately, rejected versions of SOX that would have prohibited mandatory arbitration of whistle-blower claims.

Moreover, a whistleblower need not show that the corporate defendant committed fraud to prevail in her retaliation claim under §1514A. The statute only requires the employee to prove that she "reasonably believe[d]" that the defendant's conduct violated federal law. 18 U.S.C. §1514A(a)(1). The provision's focus on the plaintiff's state of mind rather than on the defendant's conduct is inconsistent with what Guyden argues is the statutory purpose—to employ SOX retaliation litigation as a vehicle for publicizing corporate misconduct. It is far more consistent with a statutory purpose to provide a strong compensatory mechanism for employees subjected to adverse employment action as a result of their whistleblowing conduct. This compensatory scheme is entirely consistent with mandatory arbitration, and Guyden's ability to "vindicate [her] statutory cause of action in the arbitral forum" ensures that SOX "will continue to serve both its remedial and deterrent function." . . .

We recognize that arbitration is more private than litigation and that Guyden will not have the same opportunity to expose publicly Aetna's alleged wrongdoing—however, the loss of a public forum in which to air allegations of fraud does not undermine the statutory purpose of a whistle-blower protection provision.

[The court left the remaining issue for the arbitrator to determine].

Questions

1. What are the advantages of arbitration to a corporation in place of a jury trial in a court?
2. The court stated that the loss of a public forum in which to air allegations of fraud does not undermine the statutory purpose of the whistle-blower protection provision. Do you agree? Give reasons.

Sanctions

Civil Sanctions

In addition to the remedies for whistle-blowing, SOX contains a number of provisions that potentially can affect seriously wrongdoers for violations thereof.

Section 803 makes debts nondischargeable in bankruptcy if they were incurred as a result of a violation of *any* federal or state securities laws or *any* regulation or order issued under such federal or state securities laws, or for common law fraud, deceit, or manipulation in connection with the purchase or sale of any security. The proviso is that the debt arose as a result of a judgment, order, consent order, or decree entered in any federal or state judicial or administrative proceeding. They are also nondischargeable if they occur as a result from any settlement agreement entered into by the debtor or any court or administrative order for any damages, fine, penalty, citation, restitutionary payment, disgorgement payment, attorney fee, cost, or other payment owed by the debtor. This provision is particularly onerous because fines can be rather sizeable which the violator will not be able to discharge by using the bankruptcy laws. Note that it concerns *any* statutory provision, regulation, or order.

Section 804 extended the statute of limitations for a private lawsuit to two years after discovery of the facts constituting the violation and five years after the violation.

Criminal Sanctions

The last section of the Act, §1107, "Retaliation Against Informants," concerns criminal sanctions for whistle-blowing. It states as follows:

> (a) In general . . . :
>
> (e) Whoever knowingly, with the intent to retaliate, takes any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any federal offense, shall be fined under this title or imprisoned not more than 10 years, or both.

The section appears to be more extensive than the act inasmuch as it is not limited to the SOX but applies to the commission of *any* federal offense. The statute, however, refers to providing truthful information to a law enforcement officer or to the commission rather than any internal report.

With respect to intentional violations of the SOX in addition to the whistle-blowing provision, the act imposed onerous criminal sanctions when compared to the earlier sanctions of the Securities and Exchange Act of 1934. Individual fines were increased from $1 million to $5 million and the maximum sentence was changed from 10 years to 20 years. Firms may be required to pay up to $25 million in fines for intentional violation of the act.

Section 802 of the act imposes substantial prison sentences for the destruction, alteration, or falsification of records in federal investigations and bankruptcy.

A person who commits a violation of this section is subject to a fine and up to 20 years in prison. An accountant who conducts an audit under the Exchange Act is required to maintain all audit or review work papers for five years after the conclusion thereof. If the accountant or any person willfully violates this section of the act, he or she is subject to a fine and/or imprisonment of up to ten years.

Effectiveness of the Act

Given the number of restatements of earnings by companies and the potential for extraordinary fines and prison sentences, most companies have complied substantially with SOX requirements. There has been, however, a paucity of criminal prosecutions even after the financial crisis of 2007–2009, albeit there have been civil actions against offending companies. The reason likely is that proving a criminal case against senior executives, who have sizeable financial resources to defend against personal liability, is quite difficult. As is well known, the government would have to prove that the offending executive was guilty beyond a reasonable doubt of each and every element of the alleged crime. It is far easier to bring civil actions that only require proof by a fair preponderance of the evidence (more likely than not) and most often result in a civil fine wherein the company agrees to pay a sum of money to the government but does not admit to the alleged infraction. There have been numerous articles as well as a "60 Minutes" segment discussing the lack of prosecutions, especially against bank executives who played a significant role in the financial crisis. To date, however, the government has been content to seek civil enforcement.[16]

Dodd-Frank Act and Corporate Governance

Although the SOX appears to have lessened a number of abuses by issuers and their senior management, nevertheless, the financial crises of 2007–2009 revealed a number of areas which Congress believed required additional regulation, especially as they concerned corporate governance and the banking sector of the economy. The Dodd-Frank Act made significant changes in the corporate governance framework—changes that continue to reverberate today and will continue to do so in the indefinite future. The areas of governance affected are discussed hereafter. We will discuss Dodd-Frank in specific contexts in the chapters that follow. Commencing with the SOX but made more onerous by Dodd-Frank, senior corporate executives can no longer hide behind the "I didn't know defense" that enabled them to escape criminal and civil liability.

In the United States wherein the greatly diverse shareholders have almost no say in corporate matters, the Dodd-Frank Act sought to give them a greater voice, albeit continued little actual power in corporate governance matters. The change in the landscape was also affected by the increasing influence of large institutional investors and by the social media, which has been highly critical of some of the more outlandish actions of corporate boards and executives.[17] Title IX, "Investor Protections and Improvements to the Regulation of Securities,"

contains provisions that have caused great consternation in many boardrooms of U.S. companies.

Executive Compensation

"Say-on-Pay"

Section 951 of the Dodd-Frank Act amended the Securities and Exchange Act of 1934 by adding a new Section 14A, "Shareholder Approval of Executive Compensation." The section, effective as of January 21, 2011, provides that at least once every three years, a proxy, consent, or authorization, as provided for by the SEC, is to be presented in a separate resolution to shareholders for a vote to approve the compensation of executives. At least once every six years, the shareholders are to determine whether such vote concerning compensation is to be made every one, two, or three years. In past decades, obtaining sufficient votes to approve decisions by a board of directors almost never posed a problem because of the wide dispersion of votes among shareholders who rarely voted at annual shareholders meetings or returned proxy statements. Inasmuch as institutional shareholders hold some three-quarters of the votes of public companies, their influence is now quite substantial.

Note

Executive Resignation after Negative Vote on Pay

The CEO of Aviva resigned after shareholders rebelled against awarding executive pay and bonuses to Andrew Moss after the value of their shares had declined by one-third during the past year. In May, 2012, shareholders voted 823 million votes against the compensation and 670 million votes in favor with 152 million shares in abstention. A similar result took place when shareholders voted against the pay plan for Sterling Bancorp. Other corporations did not experience shareholder revolt even in the absence of positive earnings.[18] The *New York Times* reported that 55 percent of Citigroup shareholders rejected the bank's $15 million pay package that was to be given to its chief executive, Vikram S. Pandit, and pay packages to four other senior executives, which was the first time that its shareholders had ever united to oppose such pay packages. Led by a management company holding five million shares, its principal acknowledged that CEOs deserve good pay but there is a distinction between good pay and obscene pay.[19] Alan Fishman was CEO of Washington Mutual for 17 days before it failed. He received $19 million in severance pay and signing bonuses. Stan O'Neal, CEO of Merrill Lynch, left the company with a $165 million pay package although the company posted losses of $8 billion.[20] There are numerous other comparable payouts, often granted as thousands of employees were dismissed outright or with miniscule pay packages.

The following case concerns the award of substantial bonuses to directors as the company's income and share price suffered a significant decline. The say-on-pay provision of the Dodd-Frank Act is discussed in connection with the decision. Note, however, the underlying legal bases for the decision.

NECA-IBEW Pension Fund v. Cox

No. 1:11-cv-451 (S.D. Ohio, September 20, 2011)

FACTS: The directors granted $4 million dollars in bonuses, on top of $4.5 million dollars in salary and other compensation, to the CEO in the same year the company incurred a $61.3 million dollar decline in net income, a drop in earnings per share from $0.37 to $0.09, a reduction in share price from $3.45 to $2.80, and a negative 18.8 percent annual shareholder return. Pursuant to the Dodd-Frank Wall Street Reform Act, the Cincinnati Bell Board included a shareholder resolution in its March 21, 2011, proxy seeking shareholder approval of the 2010 executive compensation. The board recommended that the shareholders vote in support of the resolution. On May 3, 2011, 66 percent of voting shareholders voted against the 2010 executive compensation. The board proceeded to grant the bonuses irrespective of the negative shareholder vote.

Citing the overwhelming rejection by shareholders of 2010 executive compensation, plaintiff filed this lawsuit alleging that the Cincinnati Bell Board breached its fiduciary duty of loyalty when it decided to approve large pay raises and bonuses to its top three officers in a year when, according to plaintiff, the company performed dismally. The directors and officers, in turn, have filed their motion to dismiss the lawsuit.

ISSUE: Whether a shareholder of a public company may sue its directors for breach of the duty of loyalty when the directors received $4 million in bonuses, although the company during the same period incurs a substantial decline in net income and share price?

DECISION: The court refused to dismiss the case stating that the facts alleging breach of fiduciary duty and unjust enrichment were sufficiently pled.

REASONING (Black, J.): Normally, a board of directors is protected by the "business judgment rule" when making decisions about executive compensation, and Courts "will not inquire into the wisdom of actions taken by a director in the absence of fraud, bad faith, or abuse of discretion . . . ." However, the business judgment rule is a presumption that may be rebutted by a plaintiff with factual evidence that board members acted disloyally, i.e., not in the best interests of the company or its shareholders . . . .

Under the recently enacted federal law, The Dodd-Frank Wall Street Reform Act, publicly traded companies must include a separate shareholder resolution to approve executive compensation in their proxies at least once every three years . . . . Pursuant to that requirement, the Cincinnati Bell Board included a shareholder resolution in its March 21, 2011, proxy

seeking shareholder approval of the 2010 executive compensation. The Board recommended that the shareholders vote in support of the resolution. On May 3, 2011, 66% of voting shareholders voted against the 2010 executive compensation.

Directors owe two separate fiduciary duties to the corporation: the duty of loyalty and the duty of care . . . . The duty of loyalty requires that directors perform their duties "in good faith, in a manner the director reasonably believes to be in or not opposed to the best interests of the corporation . . . . " Plaintiff alleges that Cincinnati Bell's directors breached their duty of loyalty when they approved the 2010 executive compensation.

Informed decisions on compensation rendered by disinterested directors are presumed to be the product of a valid business judgment . . . . Plaintiff bears the burden to establish facts rebutting the business judgment rule's presumption of good faith of directors . . . .

Here, plaintiff has pled specific facts to give reason to doubt that the directors could make unbiased, independent business judgments about whether to sue. The director defendants are the very same people who approved the pay hikes and bonuses, and plaintiff has named all directors who approved the compensation as defendants. Moreover, in this case, the directors did not merely approve the transaction, they also recommended to the shareholders that the shareholders approve the compensation. Given that the director defendants devised the challenged compensation, approved the compensation, recommended shareholder approval of the compensation, and suffered a negative shareholder vote on the compensation, plaintiff has demonstrated sufficient facts to show that there is reason to doubt these same directors could exercise their independent business judgment over whether to bring suit against themselves for breach of fiduciary duty in awarding the challenged compensation. The Court concludes, at the dismissal stage, that plaintiff's allegations create a reasonable doubt that the challenged transaction is the result of a valid business judgment, and, accordingly, the directors possess a disqualifying interest sufficient to render presuit demand futile and hence unnecessary.

[With respect to the plaintiff] Here, plaintiff alleges that defendants were unjustly enriched as the result of the Board's breach of fiduciary duty. At this stage of the pleadings, the Court concludes that because plaintiff has sufficiently pled facts of breach of fiduciary duty, it is "axiomatic" that plaintiff has also sufficiently pled a claim for unjust enrichment.

Questions

(1) The Dodd-Frank Act states that a shareholder's vote is neither binding on the board of directors' decision concerning executive compensation nor does a board decision against the shareholder vote constitute a violation of the business judgment rule. Do you

agree with the decision in this case, notwithstanding the act's provisions?

(2) Under what circumstances may a court determine that the board's decision to ignore the shareholder's vote did violate their fiduciary duties as board members?

It may be argued that the Neca case is an isolated case reflecting a particular federal court's view. For example, in *Assad v. Hart*[21] and *Dennis v.* Hurt,[22] the court determined that the business judgment rule was not violated by the board's adverse decision to that of the shareholder's vote. Nevertheless, corporate boardrooms need to confront the issue of whether the grant of extraordinary pay packages and severance payments may be considered to be an abuse of discretion notwithstanding the statutory defense that (1) such grants are within their independent business judgment; (2) are often based on recommendations of outside compensation consultants; and (3) that the say-on-pay statutory provision is nonbinding.

A number of derivative lawsuits have already begun post Dodd-Frank that allege that bonuses and other monetary incentives are based on a "pay-for-performance" theory. Thus, inasmuch as the company experienced a downturn, the senior executives received unmerited additional financial compensation that the shareholders voted against by its say-on-pay vote that was ignored by the board of directors contrary to the interests of the shareholders. The lawsuits claim that a demand on the board to act otherwise would be futile and that the board violated its fiduciary duty, duty of loyalty, and failed to make proper and accurate disclosures in the annual proxy statements. Whether courts will sustain derivative lawsuits making such claims may depend on the extent of the alleged abuse of discretion by the board of directors.[23]

Say on Golden Parachutes

One of the most abused areas of executive compensation was the grant of "golden parachutes" to senior executives, particularly when there was a possibility of a hostile merger. A "golden parachute" generally is an agreement between a board of directors and senior management that provides additional compensation, often extraordinary monetary benefits, in the event of termination of employment. The additional compensation may be in the form of severance pay, stock options, and/or other forms of compensation. As usual, there are arguments for and countervailing arguments against the use of golden parachutes. Proponents argue that a golden parachute enables a company to secure outstanding leaders who require monetary security to effectively perform their duties, while critics have argued that it is simply a device to ward off potential hostile takeovers that add corporate costs to already extremely well-paid executives.

Dodd-Frank thus provides that in any proxy or consent in which shareholders are asked to approve an acquisition, merger, consolidation, or disposition of all or substantially all the assets of an issuer, there must be a disclosure of any

agreements or understandings in simple form between the person making the solicitation and the senior officers of the target company. The disclosure is to include the aggregate total of all such compensation that may be paid or become payable to or on behalf of such executive officer, whether it be present, deferred, or contingent compensation with respect to the said merger. The proxy, consent, or authorization shall contain a separate resolution subject to shareholder vote to approve such agreements or understandings.

The shareholder vote, however, is *not* binding on the issuer or board of directors, albeit the board may be reluctant to ignore a negative vote concerning the grant of golden parachutes. The act makes clear that such vote may not be construed as overriding a decision by the issuer or board, or to create or imply any change in the fiduciary duties of board members or the issuer, or to restrict or limit shareholders from making proposals to include in proxy materials related to executive compensation. An institutional investment manager must report at least annually how it voted concerning such resolution unless otherwise compelled to report such vote in public documents. The SEC is given the power to issue regulations concerning golden parachutes as well as providing for exemptions that would disproportionately burden small issuers.

On January 25, 2011, the SEC did issue a final rule concerning "Shareholder Approval of Executive Compensation and Golden Parachute Compensation" effective April 4, 2011. In essence, it recited the somewhat detailed provisions of the statute and provided that issuers are to make appropriate disclosures on required forms filed with the SEC. There were exemptions for a small issuer or entity, defined as a company with total assets of $5 million or less on the last day of its fiscal year. An investment company is deemed to be a small entity if it has less than $50 million in assets at the close of its fiscal year. The SEC adopted a two-year exemption for smaller reporting companies so that these issuers will not be required to conduct either a shareholder advisory vote on executive compensation or a shareholder advisory vote on the frequency of say-on-pay votes until the first annual or other meeting of shareholders occurring on or after January 21, 2013. Smaller companies are not permanently exempted from the say-on-pay vote, frequency of say-on-pay votes, and golden parachute disclosure.

Compensation Committee and Consultant Advisers Independence

Section 952 of Dodd-Frank discusses independence of decision making on the part of board compensation committees and consultants thereof. The SEC is directed by the act to require each member of the compensation committee of a board of directors to be a member of the board and be independent. Factors determining independence include (1) the source of compensation of a member of the board of the issuer including consulting, advisory, or other forms of compensation; and (2) whether a member of the board of directors of an issuer is affiliated with the issuer, its subsidiary, or its affiliate.

The SEC is required to compel national securities exchanges and associations to prohibit the listing of any equity security of an issuer, with certain exceptions, that does not comply with its requirements concerning the independence

of the compensation committee. The SEC may grant exceptions to the exchanges by taking under consideration the size of an issuer and other relevant factors. Similarly, the compensation committee of an issuer may only select a compensation consultant, legal counsel, or other adviser to the committee after considering factors that affect their independence as set forth by the SEC. The factors include whether the said persons are employed by the issuer to perform other services; the amount of fees received from the issuer as a percentage of its total revenue; policies and procedures in place to avoid conflicts of interest; and any stock of the issuer owned by the said consultant or adviser. The compensation committee of an issuer may, in its sole discretion, retain or obtain the advice of a compensation consultant and shall directly be responsible for its appointment, compensation, and oversight. Funding for the consultants is to be made reasonably available by the issuer.

Executive Disclosure

Section 953 of the Dodd-Frank Act mandates the SEC, by rule, to require each issuer to disclose in any proxy or consent solicitation material for an annual meeting of the shareholders of the issuer a clear description of any compensation required to be disclosed by the issuer:

- Information that shows the relationship between executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the shares of stock and dividends of the issuer and any distributions
- The information may include a graphic representation of the information required to be disclosed
- The median of the annual total compensation of all employees of the issuer, except the CEO or equivalent of the issuer
- The annual total compensation of the CEO or equivalent of the issuer
- The ratio between the medium of the annual total compensation of all employees, except the CEO and the annual total compensation of the CEO

Compensation Clawbacks

There have a number of reported instances when senior officers received incentive-based compensation for earnings that were often exaggerated due to accounting manipulations, sales of corporate assets, and other bases. Often, at a later date, the earnings statement were restated to reflect a substantial diminution of reported earnings but the executives were not required to reimburse the company for the receipt of moneys based on the earlier statement of earnings.

Section 954 of the Dodd-Frank Act contains a provision requiring an issuer to develop and implement a policy of disclosure concerning incentive-based compensation that is grounded on financial information required to be reported under the securities laws. In the event that the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, the issuer is compelled

to recover from any current or former executive officer of the issuer who received incentive-based compensation during the prior three-year reporting period based on the said erroneous data. Included are stock options awarded as compensation. The sum to be recovered is the amount in excess of what would have been paid to the executive officer under the accounting restatement had it been properly recorded.

Hedging

Hedging is the practice of taking an offsetting position with respect to an investment in order to protect against potential losses. Dodd-Frank Act §955, "Disclosure Regarding Employee and Director Hedging," amends the Exchange Act of 1934 to require boards of directors of issuers to disclose in proxy documents whether any employees or directors have entered into hedging transactions such as prepaid variable forward contracts, equity swaps, collars, and exchange funds that are designed to hedge or offset any decrease in the market value of equity securities granted to the employee or member of the issuer's board of directors directly or indirectly.

Reporting of Enhanced Compensation Structure

Section 956 states that covered financial institutions are to disclose to federal regulators the structures of all incentive-based compensation arrangements offered by them sufficient to determine whether the compensation structure provides an executive officer, employee, director, or its principal shareholder with excessive compensation, fees, or benefits; or could lead to material financial loss to the covered financial institution. No disclosure is necessary if the financial institution does not have incentive-based pay arrangements.

Prohibited Compensation Arrangements

An incentive-based payment arrangement that regulators determine creates "inappropriate risks" by the covered financial institution is prohibited. Examples of such arrangements include excessive compensation fees or benefits, or compensation that could lead to material financial loss by the covered institution. Standards to be considered are comparable to those established under the Federal Deposit Insurance Act.

Proxy Access

One of the most important changes in corporate governance brought about by the Dodd-Frank Act is proxy access. Section 971 of the Act (Proxy Access) amended the Exchange Act of 1934 to give the SEC the power to prescribe rules and regulations that include (1) a proxy, as well as a consent, or authorization by an issuer to also include a nominee submitted by a shareholder to serve on its board of directors; and (2) a requirement that the issuer follow certain specified procedures with respect to the proxy being solicited by the issuer. The SEC is given the power to issue rules that permit the use by a shareholder of

proxy solicitation materials supplied by the issuer for the purpose of nominating individuals to its board of directors. The SEC may exempt an issuer from this obligation if the requirement disproportionately burdens small issuers.

In accordance with §971 of Dodd-Frank, the SEC adopted Rule 14a-11, which are applicable only when state law or a company's governing documents do not prohibit shareholders from nominating a candidate for election as a director. Smaller companies were given a three-year delay for implementation. The conditions for the application of the rule were that the nominating shareholder, either individually or collectively, (1) had to satisfy a 3 percent threshold of voting power of the company's securities entitled to be voting upon at the shareholders' annual meeting; (2) had to have held the said minimum amount of shares for at least three years; and (3) had to state that it was not seeking control of the board.[24]

The SEC also adopted changes to Rule 14a-8(i)(8), which allowed a company to exclude from its proxy statement a shareholder proposal that relates to a nomination or an election for membership on the company's board of directors or a procedure for such nomination or election. The amendment to the rule now allows shareholders the right to place certain of its proposals in a company's proxy materials to be voted upon at the shareholders' annual meeting subject to certain exclusions. Shareholders would be able to present proposals to amend the corporate documents concerning director nomination procedures and provide proxy access standards. In order to propose such amendments, the shareholders must meet eligibility requirements under the rule, which include that the shareholder own at least $2,000 market value of shares or 1 percent whichever is less for at least one year. Shareholders who wish to submit a proposal must do so no later than 120 days before the anniversary of the date on which the company's proxy statement for the prior year's annual meeting was released to shareholders. A company may exclude a shareholder proposal if such proposal:

- Would disqualify a nominee who is standing for election
- Would remove a director from office before his or her term expired
- Questions the competence, business judgment, or character of one or more nominees or directors
- Nominate a specific individual for election to the board of directors, other than pursuant to Rule 14a-11, an applicable state law provision, or a company's governing documents
- Otherwise could affect the outcome of the upcoming election of directors.

The result of the new rule is to give shareholders a more active voice in the selection of board members and to influence proxy access standards (private ordering). The rule became effective September 14, 2011.

Rule 14a-11, however, was vacated by the U.S. Court of Appeals in the following case but Rule 14a-8(i)(8) continues to be enforceable inasmuch as the court did not make a determination concerning its validity. The SEC decided not to appeal the court's ruling but rather indicated it would revisit the rule to

conform to the court's objections to the SEC's interpretation of the congressional mandate. No date has been given for a new Rule 14a-11.

Business Roundtable v. SEC

647 F3d 144 (C.A. D.C. 2011)

FACTS: The Business Roundtable and the Chamber of Commerce of the United States, each of which has corporate members that issue publicly traded securities, petitioned for review of Exchange Act Rule 14a-11. The rule requires public companies to provide shareholders with information about and their ability to vote for shareholder-nominated candidates for the board of directors. The petitioners argue the SEC (commission) acted arbitrarily and capriciously because it neglected its statutory responsibility to determine the likely economic consequences of Rule 14a-11 and to connect those consequences to efficiency, competition, and capital formation. They also maintain the commission's decision to apply Rule 14a-11 to investment companies is arbitrary and capricious.

ISSUES:(1) Whether the SEC acted arbitrarily and capriciously in issuing rule 14a-11 in failing to determine the likely economic consequences of the rule?

(2) Whether the SEC acted arbitrarily and capriciously in applying the rule to investment companies?

DECISION: As to both issues, the court of appeals determined that the SEC's determination acted arbitrarily and capriciously in issuing the proposed Rule 14a-11.

REASONING (Ginsburg J*): We agree with the petitioners and hold the commission acted arbitrarily and capriciously for having failed . . . adequately to assess the economic effects of a new rule. Here the Commission inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters.

The proxy process is the principal means by which shareholders of a publicly traded corporation elect the company's board of directors. Typically, incumbent directors nominate a candidate for each vacancy prior to the election, which is held at the company's annual meeting. Before the meeting the company puts information about each nominee in the set of "proxy materials"—usually comprising a proxy voting card and a proxy statement—it distributes to all shareholders. The proxy statement concerns voting procedures and background information about the board's

*Judge Douglas H. Ginsburg—no relation to U.S. Supreme Court Justice Ruth Bader Ginsburg.

nominee(s); the proxy card enables shareholders to vote for or against the nominee(s) without attending the meeting. A shareholder who wishes to nominate a different candidate may separately file his own proxy statement and solicit votes from shareholders, thereby initiating a "proxy contest."

Rule 14a-11 provides shareholders an alternative path for nominating and electing directors . . . . The rule requires a company subject to the Exchange Act proxy rules, including an investment company (such as a mutual fund) registered under the Investment Company Act of 1940 (ICA), to include in its proxy materials "the name of a person or persons nominated by a [qualifying] shareholder or group of shareholders for election to the board of directors."

To use Rule 14a-11, a shareholder or group of shareholders must have continuously held "at least 3% of the voting power of the company's securities entitled to be voted" for at least three years prior to the date the nominating shareholder or group submits notice of its intent to use the rule, and must continue to own those securities through the date of the annual meeting. . . . The nominating shareholder or group must submit the notice, which may include a statement of up to 500 words in support of each of its nominees, to the commission and to the company.. . . A company that receives notice from an eligible shareholder or group must include the proffered information about the shareholder(s) and his nominee(s) in its proxy statement and include the nominee(s) on the proxy voting card . . . .

The Commission did place certain limitations upon the application of Rule 14a-11. The rule does not apply if applicable state law or a company's governing documents "prohibit shareholders from nominating a candidate for election as a director . . . . " Nor may a shareholder use Rule 14a-11 if he is holding the company's securities with the intent of effecting a change of control of the company . . . . The company is not required to include in its proxy materials more than one shareholder nominee or the number of nominees, if more than one, equal to 25 percent of the number of directors on the board . . . . The Commission concluded that Rule 14a-11 could create "potential benefits of improved board and company performance and shareholder value" sufficient to "justify [its] potential costs . . . " The agency rejected proposals to let each company's board or a majority of its shareholders decide whether to incorporate Rule 14a-11 in its bylaws, saying that "exclusive reliance on private ordering under State law would not be as effective and efficient" in facilitating shareholders' right to nominate and elect directors . . . . The Commission also rejected the suggestion it exclude investment companies from Rule 14a-11 . . . .

Consideration of Economic Consequences

In the Adopting Release, the commission predicted Rule 14a-11 would lead to "[d]irect cost savings" for shareholders in part due to "reduced

printing and postage costs" and reduced expenditures for advertising compared to those of a "traditional" proxy contest .... The commission also identified some intangible, or at least less readily quantifiable, benefits, principally that the rule "will mitigate collective action and free-rider concerns," which can discourage a shareholder from exercising his or her right to nominate a director in a traditional proxy contest, and "has the potential of creating the benefit of improved board performance and enhanced shareholder value."... The commission anticipated the rule would also impose costs upon companies and shareholders related to "the preparation of required disclosure, printing and mailing ..., and [to] additional solicitations," ... and could have "adverse effects on company and board performance," ... for example, by distracting management .... The commission, nonetheless, concluded the rule would promote the "efficiency of the economy on the whole," and the benefits of the rule would "justify the costs" of the rule ....

In the Adopting Release, the commission recognized "company boards may be motivated by the issues at stake to expend significant resources to challenge shareholder director nominees." .... Nonetheless, the commission believed a company's solicitation and campaign costs "may be limited by two factors": first, "to the extent that the directors' fiduciary duties prevent them from using corporate funds to resist shareholder director nominations for no good-faith corporate purpose," they may decide "simply [to] include the shareholder director nominees ... in the company's proxy materials"; and second, the "requisite ownership threshold and holding period" would "limit the number of shareholder director nominations that a board may receive, consider, and possibly contest." ...

We agree with the petitioners that the commission's prediction that directors might choose not to oppose shareholder nominees had no basis beyond mere speculation. Although it is possible that a board, consistent with its fiduciary duties, might forgo expending resources to oppose a shareholder nominee—for example, if it believes the cost of opposition would exceed the cost to the company of the board's preferred candidate losing the election, discounted by the probability of that happening—the commission has presented no evidence that such forbearance is ever seen in practice. To the contrary, the ABA Committee on Federal Regulation of Securities commented: "If the [shareholder] nominee is determined [by the board] not to be as appropriate a candidate as those to be nominated by the board's independent nominating committee ..., then the board will be compelled by its fiduciary duty to make an appropriate effort to oppose the nominee, as boards now do in traditional proxy contests."

The commission's second point, that the required minimum amount and duration of share ownership will limit the number of directors nominated under the new rule, is a reason to expect election contests to be infrequent; it says nothing about the amount a company will spend on solicitation

and campaign costs when there is a contested election. Although the commission acknowledged that companies may expend resources to oppose shareholder nominees, . . . it did nothing to estimate and quantify the costs it expected companies to incur; nor did it claim estimating those costs was not possible, for empirical evidence about expenditures in traditional proxy contests was readily available. Because the agency failed to "make tough choices about which of the competing estimates is most plausible, [or] to hazard a guess as to which is correct," . . . we believe it neglected its statutory obligation to assess the economic consequences of its rule . . . .

[Shareholders with Special Interests]. The petitioners next argue the commission acted arbitrarily and capriciously by "entirely fail[ing] to consider an important aspect of the problem," . . . to wit, how union and state pension funds might use Rule 14a-11. Commenters expressed concern that these employee benefit funds would impose costs upon companies by using Rule 14a-11 as leverage to gain concessions, such as additional benefits for unionized employees, unrelated to shareholder value. The commission insists it did consider this problem, albeit not *in haec verba,* along the way to its conclusion that "the totality of the evidence and economic theory" both indicate the rule "has the potential of creating the benefit of improved board performance and enhanced shareholder value . . . . " Specifically, the commission recognized "companies could be negatively affected if shareholders use the new rules to promote their narrow interests at the expense of other shareholders," . . . but reasoned these potential costs "may be limited" because the ownership and holding requirements would "allow the use of the rule by only holders who demonstrated a significant, long-term commitment to the company," . . . and who would therefore be less likely to act in a way that would diminish shareholder value. The commission also noted costs may be limited because other shareholders may be alerted, through the disclosure requirements, "to the narrow interests of the nominating shareholder."

The petitioners also contend the commission failed to respond to the costs companies would incur even when a shareholder nominee is not ultimately elected. These costs may be incurred either by a board succumbing to the demands, unrelated to increasing value, of a special interest shareholder threatening to nominate a director, or by opposing and defeating such nominee(s). The commission did not completely ignore these potential costs, but neither did it adequately address them.

Notwithstanding the ownership and holding requirements, there is good reason to believe institutional investors with special interests will be able to use the rule and, as more than one commenter noted, "public and union pension funds" are the institutional investors "most likely to make use of proxy access . . . " Nonetheless, the commission failed to respond to comments arguing that investors with a special interest, such as unions and state and local governments whose interests in jobs may well be greater than their interest in share value, can be expected to pursue self-interested

objectives rather than the goal of maximizing shareholder value, and will likely cause companies to incur costs even when their nominee is unlikely to be elected . . . .

[Investment Advisers] Because the rule is arbitrary and capricious on its face, it is assuredly invalid as applied specifically to investment companies . . . . Investment companies, such as mutual funds, pool investors' assets to purchase securities and other financial instruments. They are subject to different requirements, providing protections for shareholders not applicable to publicly traded stock companies . . . . One "investment adviser" typically manages a family of mutual funds, known as a "complex." The boards of the funds in a complex are generally organized in one of two ways: Either there is a "unitary board," comprising one group of directors who sit as the board of every fund in the complex or there are "cluster boards," comprising two or more groups of directors, with each group overseeing a different set of funds within the complex. A recent survey showed 81 percent of responding complexes have a unitary board and 15 percent a cluster structure. In either case, boards typically address the business of multiple funds in a single meeting.

We agree . . . that the commission failed adequately to address whether the regulatory requirements of the ICA reduce the need for, and hence the benefit to be had from, proxy access for shareholders of investment companies, and whether the rule would impose greater costs upon investment companies by disrupting the structure of their governance. Although the commission acknowledged the significant degree of "regulatory protection" provided by the ICA, it did almost nothing to explain why the rule would, nonetheless, yield the same benefits for shareholders of investment companies as it would for shareholders of operating companies. For example, the commission justified applying Rule 14a-11 to investment companies in part on the ground that "investment company boards . . . have significant responsibilities in protecting shareholder interests, such as the approval of advisory contracts," . . . but did not consider that the ICA already requires shareholder approval of advisory contracts . . . .

The commission also failed to deal with the concern that Rule 14a-11 will impose greater costs upon investment companies by disrupting the unitary and cluster board structures with the introduction of shareholder-nominated directors who sit on the board of a single fund, thereby requiring multiple, separate board meetings and making governance less efficient . . . . The commission acknowledged "the election of a shareholder director nominee may . . . increase costs and potentially decrease the efficiency of the boards . . . . " Nonetheless, it did not consider these as incremental costs of the rule because it erroneously attributed them to "the State law right to nominate and elect directors," perhaps a necessary but not a sufficient cause, and dismissed them with the conclusory assertion that the "policy goals and the benefits of the rule justify these costs."

Questions

(1) Assuming the SEC does assess the economic effects of a new rule, how does it make the assessment? What are the factors that underlie such an assessment?
(2) What effects would cause the rule to be nullified?

NYSE Rule 452 Concerning Proxy Vote on Executive Compensation

NYSE Rule 452, "Giving Proxies by Member Organizations," places new restrictions on broker discretionary voting on uninstructed shares. The rule permits brokers to exercise their discretion to vote on "routine" proposals when the beneficial owner fails to provide specific voting instructions within 10 days of the scheduled meeting, and prohibits brokers from voting those uninstructed shares on "non-routine" matters such as proposals to amend the certificate of incorporation or bylaws to implement corporate governance changes. Examples of restrictions include votes to de-stagger the board of directors; implement; implement majority voting in the election of directors; eliminate supermajority voting requirements; and other non-routine matters.

The permission is allowed provided the organization has no knowledge of any contest to the action taken, is adequately disclosed to the shareholders, and does not include authorization for a merger, consolidation, or and other substantial right of such stock.

The Dodd-Frank Act requires stock exchanges to prevent brokers from voting on executive compensation unless instructions are given by the beneficial owner to the broker. A commentary to the rule states that a matter relating to executive compensation includes (1) an advisory vote to approve the compensation of executives; (2) a vote on whether to hold such an advisory vote every one, two, or three years; and (3) an advisory vote to approve any type of compensation, whether present, deferred, or contingent that is based on or relates to an acquisition, merger, consolidation, or sale, or disposition of all or substantially all of the assets of an issuer and the total amount to be paid to an executive officer.

The impact of the rule change is the increased influence of institutional investors because individual investors ordinarily do not give such instructions and, thus, their votes will not be counted. Institutional investors, who usually give instructions on director voting, will likely have increased voting power especially when they institute "vote no" campaigns against directors instituted by shareholder activists and special interest groups. Further impact of the rule change is the increased difficulty by the corporation in obtaining a quorum at annual shareholder meetings for nonroutine matters such as amendments to the articles of incorporation, increased difficulty in obtaining a majority vote, and increased costs in engaging proxy solicitation firms, proxy materials, and time delays.[25]

Chairman and CEO Structures

Section 972 of the Dodd-Frank Act amended the Exchange Act of 1934 to provide that the SEC is to issue rules requiring an issuer to disclose in the annual proxy sent to investors the reasons why the issuer has chosen the same person to act as both chairman of the board of directors and CEO or the equivalent thereof or different individuals for the said positions. It appears that the obvious purpose of the section is to question how a board may supervise the actions of its CEO when the same person is acting in both positions. Nevertheless, the practice of one person acting in both capacities continues almost unabated. An example is James Dimon, who again, in 2012, was voted by the board of directors to act in both capacities at JPMorgan Chase & Co., notwithstanding a well-publicized loss of $6.2 billion in questionable trades, albeit the chief investment officer lost her position and the bank overall has gained significant profits for the time frame. The issue, however, likely will be brought to the forefront as institutional investors, commentators, and other interested persons call for the separation of the two positions.

Whistle-blowing Additions and Amendments under the Dodd-Frank Act

As stated in the discussion on SOX above, seeking relief through the office of the Secretary of Labor was virtually to no avail. In a private action, relief consisted mainly of reinstatement with back pay, costs, and attorneys' fees. The Dodd-Frank Act, however, adds significantly to the relief that may be sought by an aggrieved whistle-blower. In addition to restricting the use of arbitration provisions in an employment agreement, the act permits a judicial proceeding before a jury. This right is extremely valuable to a litigant because it raises the scepter of a possible runaway jury verdict particularly when a corporation has acted in a highly inappropriate manner toward an employee to which many jury members can relate.

Section 922 amends the Securities Act of 1934 to provide a mandatory award to a whistle-blower if the SEC commences a judicial or administrative action that results in monetary sanctions of over $1 million. The information from the whistle-blower must be derived from the independent knowledge of the whistle-blower or his or her analysis that was not previously known to the SEC from any source other than the whistle-blower and not derived from a judicial or administrative hearing, governmental report, hearing, audit, or investigations or from the news media. In such case, the whistle-blower would be entitled to an award of not less than 10 percent of the amount collected as monetary sanctions and not more than 30 percent in total of what has been collected in making the award. The SEC is to consider the significance of the information provided by the whistle-blower; the degree of assistance by the whistle-blower or his or her representative; and the deterrent effect of the violations.

An award will be denied to a whistle-blower who acquired the original information while a member, officer, or employee of a governmental regulatory agency,

a self-regulatory organization, the PCAOB, a law enforcement organization, or was convicted of a crime relating to the information given. The information may be made anonymously through a representative of the whistle-blower but disclosure of the whistle-blower's identity is to be made prior to issuance of the award. There are additional provisions that prohibit retaliation with liability provisions comparable to those under SOX. There are special provisions relating to employees of nationally recognized statistical rating organizations.

It should be noted that whereas SOX applied whistle-blowing provisions to those companies that were public or required to file reports with the SEC, the Dodd-Frank Act provisions apply to all companies including small, nonpublic companies. Whether the act will bring about greater enforcement by governmental authorities, which is a requirement for an award to be based on, remains to be seen. In any event, the provision likely will have a salient effect on corporate management officials who may fear exposure of egregious wrongdoing.

We will discuss Dodd-Frank Act additions and amendments to existing rules and regulations in subsequent chapters as they relate to the particular topics covered therein.

State Statutes Affecting Shareholder Activist Movements

As the reader is aware, there are 50 states in the United States, each of which is a sovereign state able to pass its own laws that reflect the mores and values of its citizens so long as the laws and regulations enacted do not conflict with federal law and the U.S. and state constitutions. Corporate law is almost entirely within the purview of the individual states. Although most business law statutes, particularly those concerning corporate law, are similar to each other, nevertheless, there are significant differences in particular states. For many decades there has been a movement to harmonize the laws of the 50 states led by the National Conference of Commissioners on Uniform State Laws and by the ABA. With respect to corporate law, it was the ABA's Business Law Section that prepared for adoption by the several states an MBCA, which today has been modified and is known as the Revised Model Business Corporation Act (RMBCA). The suggested act has been adopted by 32 states.[26]

The major states whose laws are most attractive to corporations are Delaware, wherein more than half of the corporations on the New York State Exchange are incorporated, and New York, which is also deemed favorable for incorporation. The advantages of a larger corporation to become a Delaware corporation include (1) the high level of sophistication of its judiciary whose Chancery Court is composed of specialists in corporate law; (2) its greater protection that is offered to directors and officers of the corporation; and (3) less protection to shareholders thereby giving corporate officers and directors greater independence.

Delaware law allows a provision in the corporation's certificate of incorporation to shield directors from personal liability for alleged breach of fiduciary duty, although a breach of loyalty or intentional misconduct may override the

provision. Officers and directors may contractually agree with the corporation to be indemnified against lawsuits by shareholders and they may be indemnified by directors and officers insurance policies paid for by the corporation. There are also additional provisions protecting corporations to a greater degree from shareholders lawsuits and derivative lawsuits. California's corporate law provisions may be the most onerous in the country whose laws favor shareholders to a far greater extent.[27] Corporate parties that enter into contracts ordinarily specify the jurisdiction and law that governs the contract in the event that a dispute arises between the contractual parties. Merger agreements favor Delaware law to govern the contract while New York law and jurisdiction is favored for all other business contracts.[28]

Litigation: Books and Records

Shareholders have become more aggressive in making their views attended to by the board of directors and management. There are multiple reasons for the sudden rise of shareholder activism that include large institutional holdings of pension plans and the like; abuses by the board and management, especially concerning extraordinary executive compensation packages; the publicity surrounding corporate scandals of recent years; the downturn of the economy and its attendant stagnant behavior of the stock market; and other factors. Thus, shareholders, who have been content to keep the status quo as long as their holdings were on an upward spiral, began to examine corporate behavior more closely. They questioned whether the board and management were acting in their best interests or were self-serving. With federal statutes having undergone significant changes, attention was now focused on state rules and regulations affecting shareholder rights and the responsibilities of a board of directors and the management of the enterprise.

Inasmuch as most major publicly owned corporations are Delaware corporations, we will discuss significant developments with respect to corporations therein. State statutes give shareholders the right to access corporate books and records when there are allegations that there is wrongdoing on the part of the board of directors and/or senior managers of the corporation or if their actions are contrary to the interests of the shareholders. Delaware statute, 8 Del. C. §220, governs the right of shareholders to inspect books and records. A shareholder, under the said statutory provision, has the right to inspect books and records of the corporation, including that of its subsidiary, provided the parent corporation has access or can obtain access to the said books and records. In order for a shareholder to make demand, however, he or she or it must demonstrate a proper purpose for the inspection. A "proper purpose" is defined in §220(b) as a "purpose reasonably related to such person's interest as a stockholder." A person seeking inspection of books and records, as distinguished from the stock ledger or list of stockholders of the corporation, has the burden of establishing a proper purpose.[29]

In the litigation in the State of Delaware below, the issue before the court is whether a shareholder may demand the production of books and records

pursuant to the above statute. Recall that Congress had enacted legislation called the Private Securities Litigation Reform Act (PSLRA) of 1995, which made the commencement of a lawsuit based on fraud against a company far more difficult to commence and proceed. Congress followed it up three years later with the Securities Litigation Uniform Standards Act (SLUSA) to prevent litigants from using state courts to accomplish the same purpose as a federal lawsuit now precluded by PSLRA. The same reasons applied to SLUSA as to the PSLRA, namely, that a number of law firms specialized in commencing lawsuits based on flimsy grounds but through a process of discovery were able to harass companies to settle cases thereby gaining large legal fees often with minimal benefits to clients on whose behalf the actions were commenced.

In the following case, the plaintiff was unable to establish a claim in the federal action that would enable him to proceed with pretrial depositions including the inspection of books and records of the defendant. The plaintiff then sought to gain access to the books and records through the Delaware Court.

Beiser v. PMC-Sierra, Inc.

C.A. No. 3893-VCL (Del. Ct. Ch. February 26, 2009)

FACTS: Beiser sought the production of certain books and records under Section 20 of the Delaware statute. The plaintiff in this case was also the lead plaintiff in a related federal lawsuit in which discovery was stayed pursuant to the PSLRA of 1995. The federal lawsuit was based on alleged improper stock option backdating by PMC. The federal district court in its order of May 8, 2008, noted that discovery would not be allowed until Beiser filed a complaint that met the applicable pleading standards. The federal court also denied Beiser's motions to compel the defendant to produce certain documents. On June 25, 2008, PMC moved to dismiss that complaint for failure to plead demand futility, among other things. The federal Court then stayed those proceedings to allow Beiser to pursue this action [in Delaware].

Previously, on April 15, 2008, . . . Beiser sent a letter to PMC's counsel requesting the opportunity to inspect the company's books and records. PMC responded that it would not allow the requested inspection. On May 8, 2008, in its order granting . . . the federal court noted that "[w]hatever rights plaintiffs may have under Delaware law to seek corporate records are matters that plaintiffs must pursue, if at all, in the Delaware Courts." Beiser filed his complaint in this action on July 15, 2008, seeking the inspection of certain of PMC's books and records pursuant to 8 *Del. C.* §220. PMC has moved to dismiss the complaint claiming, inter alia, that Beiser does not have the requisite "proper purpose" to inspect the company's books and records.

ISSUE: Whether the plaintiff had a "proper purpose" under Delaware law when the only end use for the requested documents is to assist in

the prosecution of a federal action where discovery is stayed under the PSLRA?

DECISION: The court determined that the basis for the request was not a proper purpose and dismissed the lawsuit to compel production of the records.

REASONING (Lamb, J.): Section 220 requires that the plaintiff have a proper purpose for his books and records request. According to the statute, a "proper purpose" is "a purpose reasonably related to [the plaintiff's] interest as a stockholder." Ultimately, at trial the plaintiff must prove by a preponderance of the evidence "that his primary purpose as to each category of the [d]emand is proper."

Beiser claims that he seeks PMC's books and records for the purposes of (i) investigating possible mismanagement and breaches of fiduciary duties; (ii) investigating violations of law by the officers and directors of [PMC] in connection with [PMC's] stock option granting practices and procedures and internal controls; and (iii) determining whether [PMC's] officers and directors are independent and/or disinterested and whether they have acted in good faith.

Delaware Courts have often held that investigating possible wrongdoing by a company's officers and directors is a "proper purpose" under Section 220. At the pleading stage, however, a plaintiff must do more than merely "state, in a conclusory manner, a generally accepted proper purpose. [A plaintiff] must state a reason for the purpose, i.e., what it will do with the information, or an end to which that investigation may lead." Here, Beiser has failed to plead any proper end to the purposes he sets forth, nor has the Court been able to infer any proper purpose from the pleadings.

Generally, the end, in cases such as this, is to determine whether sufficient evidence exists to support the filing of a derivative lawsuit. The Delaware Courts have consistently encouraged plaintiffs to utilize Section 220 *before* filing a derivative action. Doing so may prevent "expensive and time-consuming procedural machinations that too often occur in derivative litigation." Here, Beiser could have filed his Section 220 action before August 29, 2006, the date he filed his initial federal complaint. Instead Beiser waited over 20 months, until April 15, 2008, by which time PMC had already expended considerable resources in defense of the Federal Action. Though the dilatory nature of Beiser's filing of the Section 220 action is not, in and of itself, fatal to his case, the timing does make it more difficult for Beiser to plead a proper purpose because the most obvious end use (to aid in filing a subsequent action) is no longer available.

Where no proper end is evident, to satisfy the "proper purpose" requirement the plaintiff must clearly plead how he might use the evidence. Here, the only reasonable use for the evidence is to aid Beiser in the Federal Action through discovery that has been foreclosed by the PSLRA. As discussed below, this is not a proper purpose under Section 220.

The PSLRA was enacted in an effort to reduce abusive litigation practices in certain federal lawsuits and automatically stays discovery upon the defendant's filing of a motion to dismiss. The Securities Litigation Uniform Standards Act of 1998 (the "SLUSA"), enacted by Congress three years after the PSLRA to prevent plaintiffs from fleeing to state Court to obtain discovery, allows a federal Court to "stay discovery proceedings in any private action in a State Court as necessary in aid of its jurisdiction, or to protect or effectuate its judgments, in an action subject to a stay of discovery pursuant to [the PSLRA]." . . . .

Both federal and Delaware courts have held that Congress did not intend to preempt Section 220 actions through the enactment of the PSLRA and the SLUSA. Delaware courts have, however, anticipated that Section 220 actions might be used to circumvent the PSLRA and allowed the Section 220 action to proceed, in the face of a PSLRA-mandated stay of discovery, only where (1) the plaintiff was not currently involved in the federal action, (2) the plaintiff's counsel was not currently involved in the federal action, and (3) the plaintiff agreed to enter a confidentiality agreement preventing him from sharing the information obtained with the plaintiff or counsel in the federal action . . . .

In this case Beiser is the lead plaintiff in the related Federal Action and is represented by the same counsel as in this action. Additionally, Beiser and his counsel have failed to stipulate that documents gathered in the Section 220 action would not be used in the Federal Action. Quite the contrary, it is evident that the purpose of the Section 220 action is to obtain documents for use in the Federal Action . . . . Here, Beiser's only purpose appears to circumvent the mandates of the PSLRA. Attempting to obtain discovery for use in a case where such discovery is clearly prevented by federal law, without more, will not satisfy the "proper purpose" requirement of Section 220.

Questions

1. Was the SLUSA constitutional inasmuch as it prevents states from permitting such lawsuits coupled with the use of liberal discovery provisions?
2. Discuss the jurisdictional limits of federal and state courts with respect to such lawsuits.

In *City of Westland Police & Fire Retirement System v. Axcelis Technologies, Inc.*,[30] the lawsuit concerned the action by the defendant company, which refused to accept the resignations of three directors who had failed to receive a majority of the shareholder vote when they stood for reelection. The company had adopted a policy whereby a director, standing for reelection who received less than a majority of the stockholder vote, had to submit his or her resignation to the board of

directors. The board would then decide whether to accept the director's resignation. In the lawsuit, the plaintiff alleged that the failure to receive a majority vote was a sign of wrongdoing especially when coupled with the board's refusal to accept an acquisition offer from a competitor to whom it later sold the company's principal assert for much less than the initial offer. The plaintiff Retirement Fund then sought to inspect the company's books and records.

The court stated that the plaintiff, in order to meet the "proper purpose" requirement of the Delaware statute, had to go beyond alleging a suspicion of improper wrongdoing but rather must present "some evidence to suggest a credible basis from which [this court] can infer that mismanagement waste, or wrongdoing may have occurred."[31] The court stated that the plaintiff failed to demonstrate any credible basis for the inspection of books and records; that the three directors were properly reelected under Delaware's corporate law's plurality voting provisions; and that the record demonstrated that the retention of the three directors were based on their experience and knowledge concerning the defendant's management. Obtaining internal, confidential information in order to put pressure on a board in an ongoing proxy fight is not a proper purpose.[32]

The opposite result took place in *Jana Master Fund, Ltd. V. CNET Networks, Inc*.[33] In *Jana,* the plaintiff was successful in obtaining court approval for inspection of books and records of the defendant corporation. Plaintiff, Jana, is an investment fund that owns approximately 11 percent of the outstanding shares of the defendant CNET. The defendant had a staggered, eight-member board of directors with two of the members up for election in the year in question. Jana sought to replace the said two members and to expand the board from 8 to 13 members and to nominate five individuals to fill the said vacancies. When it wrote to CNET of its intention to solicit proxies from other CNET shareholders, the defendant refused to provide the requested stocklist materials claiming that the plaintiff did not have a proper purpose in so demanding. It further stated that the company's bylaws required a shareholder to nominate candidates for director election or to seek other corporate business at an annual meeting to have beneficially owned at least $1,000 of company stock *for at least one year*. Jana owned its shares for only eight months but premised its demand claiming that the bylaw only applies to nominations and proposals under Rule 14–8 of the federal securities laws, which refer to nominations and proposals a shareholder wishes to have included in the management's form of proxy.

Inasmuch as Jana intended to independently finance its own proxy materials it alleged that the bylaw was inapplicable. The court agreed with the plaintiff's contention that the bylaw did not apply to the plaintiff and, thus, ruled in favor of the plaintiff with respect to its demand for inspection of the defendant's books and records. Other permissible purposes stated by the court would include seeking of information to determine the value of a shareholder's interest in the company.

Breach of Fiduciary Duty and the Business Judgment Rule

A "fiduciary duty" is a special duty of trust between two or more persons that is more than merely not acting carelessly. It is the highest standard of care owed by

the fiduciary who may be, for example, the agent in a principal-agent relationship, a partner in a partnership, an executor of a will, or attorney in an attorney-client relationship. Such duty of care generally requires that the person owing the duty avoid a conflict of interest situation, not personally profit from the relationship other than receiving the agreed-upon fees or commissions, account fully to the fiduciary, keep the fiduciary fully informed, and act in the best interests of the fiduciary.

In the context of corporations, the directors of a corporation have a fiduciary relationship with the company's shareholders. The following case, decided by the Supreme Court of Delaware, discusses basic principles of corporate governance and the said relationship of directors to shareholders. In it, there is an excellent discussion of the "business judgment rule" that was cited extensively in later cases.

Unocal Corp. V. Mesa Petroleum Co.

493 A.2d 946 (Sup. Ct. Del., 1985)

FACTS: On April 8, 1985, Mesa, the owner of approximately 13 percent of Unocal's stock, commenced a two-tier "front-loaded" cash tender offer for 64 million shares, or approximately 37 percent, of Unocal's outstanding stock at a price of $54 per share. The "back-end" was designed to eliminate the remaining publicly held shares by an exchange of securities purportedly worth $54 per share. It was disclosed, however, to Unocal's stockholders that the securities offered in the second-step merger would be highly subordinated to what was later referred to as "junk bonds."

Unocal's board consists of eight independent outside directors and six insider directors. It met on April 13, 1985, to consider the Mesa tender offer. Detailed presentations were made by legal counsel regarding the board's obligations under both Delaware corporate law and the federal securities laws. The board then received a presentation from Peter Sachs on behalf of Goldman Sachs & Co. (Goldman Sachs) and Dillon, Read & Co. (Dillon Read) discussing the bases for their opinions that the Mesa proposal was wholly inadequate. Mr. Sachs opined that the minimum cash value that could be expected from a sale or orderly liquidation for 100 percent of Unocal's stock was in excess of $60 per share and, thus, Mesa's tender offer price was inadequate.

Mr. Sachs also presented various defensive strategies available to the board if it concluded that Mesa's two-step tender offer was inadequate and should be opposed. One of the devices outlined was a self-tender by Unocal for its own stock with a reasonable price range of $70–75 per share. The cost of such a proposal would cause the company to incur $6.1–6.5 billion of additional debt. The eight outside directors, comprising a clear majority of the thirteen members present, then met separately with Unocal's financial advisors and attorneys. Thereafter, they unanimously agreed to advise the board that it should reject Mesa's tender offer as inadequate, and that Unocal should pursue a self-tender to provide the stockholders with a fairly

priced alternative to the Mesa proposal. The board then reconvened and unanimously adopted a resolution rejecting as grossly inadequate Mesa's tender offer.

A price range between $70 and $80 per share was considered, and, ultimately, the directors agreed upon $72. The board was also advised about the debt securities that would be issued, and the necessity of placing restrictive covenants upon certain corporate activities until the obligations were paid. The board's decisions were made in reliance on the advice of its investment bankers, including the terms and conditions upon which the securities were to be issued. Based upon this advice, and the board's own deliberations, the directors unanimously approved the exchange offer. Their resolution provided that if Mesa acquired 64 million shares of Unocal stock through its own offer (the Mesa Purchase Condition), Unocal would buy the remaining 49 percent outstanding for an exchange of debt securities having an aggregate par value of $72 per share. Mesa was excluded from Unocal's exchange. Mesa challenged it by filing this suit in the Court of Chancery.

ISSUE: (1) Whether a corporation's self-tender for its own shares, which excludes from participation a stockholder making a hostile tender offer for the company's stock, is valid?

(2) Did the Unocal board have the power and duty to oppose a takeover threat it reasonably perceived to be harmful to the corporate enterprise, and if so, is its action here entitled to the protection of the business judgment rule?

DECISION: The Supreme Court of Delaware decided the action in favor of Unocal on both issues, reversing the decision of the Delaware Court of Chancery.

REASONING (Moore, J.): The board has a large reservoir of authority upon which to draw. Its duties and responsibilities proceed from the inherent powers conferred by 8 *Del.C.* §141(a), respecting management of the corporation's "business and affairs." Additionally, the powers here being exercised derive from 8 *Del.C.* §160(a), conferring broad authority upon a corporation to deal in its own stock. From this it is now well established that in the acquisition of its shares a Delaware corporation may deal selectively with its stockholders, provided the directors have not acted out of a sole or primary purpose to entrench themselves in office . . . . Finally, the board's power to act derives from its fundamental duty and obligation to protect the corporate enterprise, which includes stockholders, from harm reasonably perceived, irrespective of its source. Thus, we are satisfied that in the broad context of corporate governance, including issues of fundamental corporate change, a board of directors is not a passive instrumentality.

Given the foregoing principles, we turn to the standards by which director action is to be measured . . . . [We previously] held that the business judgment rule, including the standards by which director conduct is judged, is applicable in the context of a takeover . . . . The business

judgment rule is a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." . . . . A hallmark of the business judgment rule is that a Court will not substitute its judgment for that of the board if the latter's decision can be "attributed to any rational business purpose." . . . .

When a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders. In that respect a board's duty is no different from any other responsibility it shoulders, and its decisions should be no less entitled to the respect they otherwise would be accorded in the realm of business judgment . . . . There are, however, certain caveats to a proper exercise of this function. Because of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred.

This Court has long recognized that . . . [w]e must bear in mind the inherent danger in the purchase of shares with corporate funds to remove a threat to corporate policy when a threat to control is involved. The directors are of necessity confronted with a conflict of interest, and an objective decision is difficult . . . . In the face of this inherent conflict directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership . . . . However, they satisfy that burden "by showing good faith and reasonable investigation . . . . " Furthermore, such proof is materially enhanced, as here, by the approval of a board comprised of a majority of outside independent directors who have acted in accordance with the foregoing standards . . . .

In the board's exercise of corporate power to forestall a takeover bid our analysis begins with the basic principle that corporate directors have a fiduciary duty to act in the best interests of the corporation's stockholders . . . . As we have noted, their duty of care extends to protecting the corporation and its owners from perceived harm whether a threat originates from third parties or other shareholders. But such powers are not absolute. A corporation does not have unbridled discretion to defeat any perceived threat by any Draconian means available. The restriction placed upon a selective stock repurchase is that the directors may not have acted solely or primarily out of a desire to perpetuate themselves in office . . . .

A further aspect is the element of balance. If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed. This entails an analysis by the directors of the nature of the takeover bid and its effect on the corporate enterprise. Examples of such concerns may include: inadequacy of the price offered, nature and timing of the offer, questions of illegality,

the impact on "constituencies" other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of securities being offered in the exchange . . . . While not a controlling factor, it also seems to us that a board may reasonably consider the basic stockholder interests at stake, including those of short-term speculators, whose actions may have fueled the coercive aspect of the offer at the expense of the long-term investor. Here, the threat posed was viewed by the Unocal board as a grossly inadequate two-tier coercive tender offer coupled with the threat of greenmail.

Specifically, the Unocal directors had concluded that the value of Unocal was substantially above the $54 per share offered in cash at the front end. Furthermore, they determined that the subordinated securities to be exchanged in Mesa's announced squeezeout of the remaining shareholders in the "back-end" merger were "junk bonds" worth far less than $54. It is now well recognized that such offers are a classic coercive measure designed to stampede shareholders into tendering at the first tier, even if the price is inadequate, out of fear of what they will receive at the back end of the transaction. Wholly beyond the coercive aspect of an inadequate two-tier tender offer, the threat was posed by a corporate raider with a national reputation as a "greenmailer."[34] In adopting the selective exchange offer, the board stated that its objective was either to defeat the inadequate Mesa offer or, should the offer still succeed, provide the 49% of its stockholders, who would otherwise be forced to accept "junk bonds," with $72 worth of senior debt. We find that both purposes are valid.

However, such efforts would have been thwarted by Mesa's participation in the exchange offer. First, if Mesa could tender its shares, Unocal would effectively be subsidizing the former's continuing effort to buy Unocal stock at $54 per share. Second, Mesa could not, by definition, fit within the class of shareholders being protected from its own coercive and inadequate tender offer.

Thus, we are satisfied that the selective exchange offer is reasonably related to the threats posed. It is consistent with the principle that "the minority stockholder shall receive the substantial equivalent in value of what he had before." . . . This concept of fairness, while stated in the merger context, is also relevant in the area of tender offer law. Thus, the board's decision to offer what it determined to be the fair value of the corporation to the 49% of its shareholders, who would otherwise be forced to accept highly subordinated "junk bonds," is reasonable and consistent with the directors' duty to ensure that the minority stockholders receive equal value for their shares.

Thus, while the exchange offer is a form of selective treatment, given the nature of the threat posed here the response is neither unlawful nor unreasonable. If the board of directors is disinterested, has acted in good faith and with due care, its decision in the absence of an abuse of discretion will be upheld as a proper exercise of business judgment . . . .

Questions

(1) To what extent did the intended use of junk bonds for the second-step merger allow the directors to claim that it reasonably exercised its business judgment in thwarting the offer?
(2) Google "junk bonds," which was a favorite method of financing mergers in the 1970s. Discuss why their usage is almost nonexistent today.

The *Unocal* case was followed up by a number of cases wherein the business judgment rule and the relationship between a board and the shareholders was explored. Several cases concerned the sudden vote to expand the number of directors of a corporation when there is a hostile tender offer. In *MM Companies, Inc. v. Liquid Audio, Inc.*,[35] MM Companies sought an injunction against Liquid Audio, Inc., and certain directors of the corporation with respect to its action in expanding the number of board directors from five to seven members. MM had sought to acquire Liquid Audio, having made a tender offer on October 26, 2001, of $3 per share, which offer was rejected by the five-member board of Liquid Audio as allegedly inadequate. Liquid Audio's bylaws called for a staggered board of directors divided into three classes each of whose tenure would expire in successive years thereby requiring two years of voting to wrest control of the board by a dissident shareholder. In October 2001, MM requested Liquid Audio to call a special meeting of stockholders to consider filling the existing vacancies on the board. Liquid Audio declined to do so and on November 13, 2001, added two more members to the board.[36]

The court discussed basic corporate principles of corporate governance. Among them is the allocation of power between stockholders of a corporation and corporate directors. Stockholders have the right to vote on specific matters affecting the corporation, which includes the right to vote for board directors. The directors have the power to manage the corporate enterprise. The maintenance of the allocation of the said powers is the " 'ideological underpinning' upon which the legitimacy of the directors' managerial power rests."[37] With respect to the voting for board directors, the court emphasized that it would give careful scrutiny to an attempt to effectively frustrate and deny such right of the stockholders.

The court did not state it would per se prevent a board from naming additional directors even if it was for the purpose of preventing a change in the board when the latter did so to prevent the exercise of a shareholder's vote on a merger or takeover but would exercise "enhanced judicial scrutiny" so as to place a heavy burden on the existing board to demonstrate a compelling justification for its action. The defense of exercise of the business judgment rule is inappropriate when it is used primarily to subvert a shareholder's vote on a proposed merger or takeover.

The court, in its decision, placed heavy reliance on *Blasius Indus. Inc. v. Atlas Corp*.[38] In *Blasius*, there was an attempted takeover by Blasius Industries seeking

a restructuring of Atlas to enhance shareholder value. In May 1987, with Drexel Burnham serving as underwriter, the two shareholders caused Blasius to raise $60 million through the sale of junk bonds. A portion of these funds were used to acquire a 9 percent position in Atlas. Blasius' debt service obligations arising out of the sale of the junk bonds made it unable to service those obligations from its income from operations. After a meeting that concerned possible complex restructuring of Atlas, it was determined that the Blasius proposal should be denied. It appears that Atlas then added two more members to the board of directors thereby preventing a possible majority vote in favor of the Blasius proposal. The court ruled that the addition of directors to prevent a shareholder vote that would result in a change on the board to effectuate a restructuring of the company was wrongful notwithstanding the board members' belief it was in the best interests of the company. Good faith beliefs do not suffice to interfere with shareholders from making changes of personnel on the board.

In *Blasius*, the court addressed the issue of the application of the business judgment rule. It stated that the rule does not apply to situations where the board acts for the purpose of interfering with a shareholders' vote even if done advisedly and in good faith. The reason is the legitimacy of such interference. Shareholders have only two ways in which they may oppose perceived inadequate performance of a corporation. They may sell their shares in the company or they may vote to replace the existing board members. In essence, such interference with shareholders' voting is unwarranted and may not be permitted in the absence of a *compelling justification*. Good faith does not suffice.

In *Mercier v. Intel (Del) Inc.*, 929 A2d 786 (Del. Ch. 2007), the directors of Inter-Tel sought to enter into an all cash merger with Mitel. In order to do so, the directors established a special committee to present the proposed merger to shareholders for a vote. When a number of shareholders expressed their opposition to the proposed merger, the directors determined that they did not have enough votes by shareholders to approve the measure. Accordingly, the special committee postponed the shareholder vote on the same day that the vote was to have taken place. The committee felt that by postponing the vote, shareholders would have more time to come to the understanding that the price being offered was meritorious given that Inter-Tel was performing badly. Also, the additional time before the vote may cause speculators and arbitrageurs time to buy up the stock and thus increase the vote in favor of the merger.

Certain shareholders sued for an injunction to stop the vote entirely rather than postpone the vote, which would allow a manipulation of the vote. The directors justified their action under the business judgment rule. Using the *Blasius* compelling justification test, the court ruled that there was compelling justification for the postponement of the vote by the directors. The justifications included (1) the rejection of a merger that the directors thought was in the best interests of the company; (2) that there was information which the shareholders had not considered adequately or information that had not yet been disclosed; (3) the bid would be irretrievably lost if the shareholders noted against the merger.

The court, using the Blasius compelling justification test and the *Unocal* reasonable standard, determined that the directors had met the test and standard for the reason that they had served with an "honesty of purpose" inasmuch as they would have lost their positions as directors if the merger had been successful. There was no possibility that they had breached their duty loyalty, which often takes place when directors act selfishly in order to retain their positions as directors. The *Unocal* standard is one that requires directors to identify a legitimate corporate objective that was proper and not selfish and that their action was reasonable in relation to the legitimate objective and was not done to preclude shareholders from exercising their right to vote or to coerce them into voting a particular way.

Whether or not the trend toward greater shareholder participation and governance will continue remains to be seen in the future. With the substantial changes in communication today it appears that boards and managers must pay much greater attention to their responsibilities. Shareholder revolt and corporate embarrassment by actual or imagined wrongdoings appear to foreshadow a new era of corporate governance. In Chapter 3, we will discuss corporate governance in other countries, which often contrasts sharply with that of the United States.

CHAPTER 3

International Corporate Governance

In Chapter 2, we discussed corporate governance in theory and in practice in the United States. In essence, the shareholder approach is utilized in most corporate settings, that is, the belief in most boardrooms that the major, if not exclusive, duty of a corporation is to maximize the profits for its shareholders. We have seen that the theory is undergoing fundamental changes due to recent legislative enactments, especially the Dodd-Frank Act, and the rise in influence of large institutional investors. In this chapter, we will review types of stakeholder models that are applied in non-U.S. corporate settings.

The Stakeholder Model

The stakeholder model reflects the model most utilized in the non-Anglo-Saxon major industrial nations. There are a variety of subsets of the model but its focus varies widely from that of the shareholder model. The stakeholder model emphasizes the corporation's social responsibilities to various stakeholders and to society itself. In one subset found in Japan, but presently undergoing major change, the key feature was corporate assurance of lifetime employment for the employees of the corporation. Employees therein had a greater incentive to develop and supply firm-specific human capital, to practice significant loyalty to the firm, to facilitate team effort, and to be willing to make concessions in times of distress. Management's emphases are on the long-term health of the corporation, the benefit the employees, and a return of the profit to the shareholders. Since the primary holders of corporate indebtedness were banks, there was less need and incentive for immediate profit gains and, therefore, more for long-term profitable outlook. Japanese corporate structure is one that is insular and conservative. It protects management from the external pressures of the market and from shareholders. Banks often dominate the board because corporate capital is raised from bank loans rather than from the public sale of securities.

The Two-Tier Stakeholder Model of Corporate Governance

Germany's Model of Corporate Governance

There are other types of stakeholder models including that of Germany and, to some extent, of France. The German securities market is essentially

underdeveloped. Of two million companies in Germany, about 4,600 are stock companies. Only about 825 of the 4,600 companies are truly publicly traded. The result is that unfriendly takeovers are relatively rare events. The few German shareholders consist mainly of holders of large blocks of shares with long-term interests. Shares are also owned by large financial institutions that provide funding for the corporations. There are two major types of corporate entities that limit liability to the value of the corporate assets, namely, the *limited liability company* consisting of privately owned corporate shares that cannot be publicly sold (*Gesellschaft mit beschränkter Haftung*) and the *publicly owned stock corporation* (*Aktiengesellschaft*). Public corporations are subject to various disclosure and reporting requirements and have to file prospectuses with the relevant securities commission before offering shares to the general public. The latter corporations are the large entities that have substantial capital needs and are listed on stock exchanges such as the Frankfurt Stock Exchange.

The German corporation is a classic stakeholder model. It consists of two corporate boards, namely, the supervisory board and the management board. The supervisory board (*Aufsichtsrat*) comprises a minimum of 3 members with multiples of 3 but no more than 21 members. In firms of over 2,000 employees, the shareholders may elect half and the employees the other half of the board members. German supervisory boards must have a minimum of one-third employee membership on the board. The board's primary duty is to appoint and remove members of the management board (*Vorstand*). The Vorstand is responsible for the day-to-day operations of the corporation. It is not subject to the dictates of the general meeting of shareholders; rather, shareholder demands are to be made to the supervisory board, which then makes adjustments and demands upon the management board. The management board must take into consideration the various stakeholders including the shareholders, the welfare of the employees, and the community at large. The profit motive is not the paramount principle governing the corporation's operations.[1]

Members of the management board are prohibited from engaging in any transaction that competes with the corporation except with the permission of the supervisory board. The management board's duties include providing information to the supervisory board with respect to the corporation's business, condition, policy, and other factors impacting upon the corporation. Management is subject to the strict control and influence by banks, which often own large blocks of shares. Such ownership was prohibited in the United States under the Glass-Steagall Act of 1933 but has undergone a major evolution under the Gramm-Leach-Bliley Act of 1999.[2]

The principal advantage of the German model is management accountability. Banks demand significant control over management. Both the management and the board seek the firm's long-term health and profitability. Banks receive added information to enhance their reaction to technology-driven and rapidly changing markets. They, therefore, add their expertise to the

decision-making process. The cost of capital acquisition is less because banks are more amenable to grant new loans or restructure existing loan agreements. Lower dividend payout ratios result because of money retained for conservative research and development for factory improvements, equipment, and employee training.

It appears that the German system is less efficient and flexible than the U.S. system. Companies are not subject to diverse shareholder input. Businesses are not vulnerable to takeovers; inefficient firms, therefore, may continue their poor performance. Significant bank influence tends to cause management to invest in safe operations and impede investments in new ventures that may have significant risks. In the crisis of the past half decade, however, German corporations were seemingly less affected than other Western European counterparts. German employees have enjoyed substantially greater benefits than American workers in the form of wages, benefits including much longer paid vacations, protection against dismissal, and other benefits.

Public corporations are subject to the German Corporate Governance Code enacted in 2001 and in force in 2002.[3] The aim of the code is to attract investors globally and to strengthen confidence in German corporate management. The focus is on overcoming the criticisms leveled against German corporate governance:

- Inadequate focus on shareholder interests
- The two-tier system of executive board and supervisory board
- Inadequate transparency of German corporate governance
- Inadequate independence of German supervisory boards
- Limited independence of financial statement auditors

There have been other perceived disadvantages of the German and other stakeholder models. Corporations following the models now are rethinking their effectiveness in the emerging global marketplace. Due to conservative banking financing, there is an inherent bias against startups, ground-breaking research and development, and human-capital industries. By way of comparison, the average age for a listed firm on the New York Stock Exchange in the United States is 14 years; the average age for a company on the German stock exchange is 55 years. There is a tendency toward overinvestment in capacity, excessive risk avoidance, and insufficient attention to the creation of shareholder wealth. There is less creativity, initiative and adaptiveness. The cost of attending to constituencies other than shareholders is illustrated by the fact that the cost of labor in the United States is substantially less than in Germany and Japan. Also, legal standards with respect to disclosure of information to shareholders tend to vary greatly in the U.S. and U.K. models as opposed to that of Japan and Germany.[4]

Each of these criticisms is addressed in the provisions and stipulations of the code, which also takes into consideration the legal framework from which it is derived. The Government Commission on the German Corporate Governance

Code will continue to monitor once the code has been fully adopted including the observance of corporate governance in legislation and practice. It will review the code at least once a year for possible adaptation.[5] In addition to Germany, Austria also has a two-tier corporate governance model.

Corporate Governance in China

Doing Business in China

The remarkable transformation of the People's Republic of China ("China" as distinguished from Taiwan) from an insular communist rule before the late 1970s, which was one of the poorest economies in the world, to a market economy led by Deng Xiaoping and his successors after the death of Mao Zedong that is second only to that of the United States, has brought significant rewards to its population. The country also required the need to strengthen its corporate governance structure. There are a number of ways which a foreign entity can do business in China. The earliest and exclusive form when the Chinese economy was opened to the world was by a *representative office*, which form continues today. The office, though not considered to be a legal entity in China, is able to engage in procurement, conduct market research, enter into contracts, advise foreign companies of opportunities and regulatory requirements, and other related services. It may not open bank accounts, hire employees, or engage in buying or selling of goods.

The second way of doing business in China is to open a *branch office*. It is a legal entity and can operate in the same manner as local business enterprises. The branch office and its parent company are deemed to be one legal entity and are taxed on income sourced in China. Both the branch office and its parent company are liable for any indebtedness arising from its activities within China. The third and common mode of business enterprise is the *corporation* created under the laws of China, generally as a subsidiary of the foreign enterprise. By using the said form, the foreign entity can have substantial control over the local corporation and limit its liability. These local enterprises may take the form of a Chinese-Foreign Equity Joint Venture, the Chinese-Foreign Contractual Joint Venture, or an Enterprise with Foreign Capital.[6]

Corporate Governance

Effective corporate governance has become an overriding concern both internally within the corporate entity and to the stakeholders of the entity. With the rise of large institutional investors, much attention has been paid to how a company is run, especially as to its transparency, quality of corporate executives, degree of oversight by board members, and compliance with increasingly complex regulations by governmental and nongovernmental securities regulatory authorities. Effective corporate governance leads to greater investor confidence, lower cost of capital, and the greater likelihood of corporate profit. Corporate governance in China has a long history dating back to major chartered companies of the

sixteenth and seventeenth centuries as exemplified by the East India Company and the Hudson's Bay Company.[7]

When an economy becomes advanced, the issue arises concerning how a corporate entity operating within China is to be governed. Corporate governance, in the light of the downturn of the economy from 2007 to 2009 and continuing to a lesser degree today, has become a major concern both to investors and other stakeholders and to governments within which the entity operates. Like the United States and other national entities, China has witnessed a number of corporate scandals and significant corruption, which has caused it to become concerned with corporate governance. As a result, the government has enacted both statutory and regulatory rules to remedy the lack of progressive corporate policies.

Newly emerging economies look for models on which to base their transition from models that no longer function well or are significantly outdated. In determining which model to emulate, these nations usually look at those economies that have been and continue to be successful. China had a number of choices from models, as previously stated, such as the *shareholder* U.S. model of corporate governance or the *stakeholder* model. Both models have many adherents as well as many versions on a continuum from extreme shareholder welfare to extreme stakeholder obligations, often to the detriment of profitability.

China noted that the German model provided for substantial employee input in decision making leading to a more harmonious relationship between management and employees, while the U.S. shareholder model deemphasized any employee input other than demands made by unions. For historical reasons, as provided for in the National Labor Relations Act of 1936, employees in the United States may not partake in management decisions due to statutory prohibitions emanating from earlier times when management sought to dominate unions for alleged cohesiveness between management and labor. Thus, given that China emerged from Marxist emphasis on workers' rights, it appeared that the choice between the shareholder and stakeholder models was obvious. The German model appeared to be more in keeping with its ideological emphasis. Thus, China has looked to Germany not only for corporate governance model but also for its criminal and other domestic statutes. German law as a model appears to China to have greater clarity than the common law emphasis of judicial precedent rather than reliance exclusively on statutory enactments.

Structure of China's Corporate Governance

China has undergone four stages in the development of corporate governance: (1) From 1949 to 1983 when state-owned enterprises dominated the economy; (2) 1984–1993 during which government intervention was separated from enterprise operations so as to permit the latter to become responsible for their own profits or losses; (3) 1994–2005 with experimentation of modern enterprise structure by implementation of the 1993 Company Law, which classified companies into two types, namely, limited liability companies and joint stock limited liability companies; and (4) 2006 to the present with significant revision of the

Company Law that mandated independent directors, lowering of the threshold for the public listing of companies, and other significant expansion of the private corporate enterprise.[8]

Publicly listed companies (joint stock listed companies) are required to have a two-tiered structure boards that appear at least superficially to resemble Germany's two-tier boards. Boards consist of a board of supervisors comprising at least three directors and a board of directors consisting of 5–19 directors who are to serve renewable three-year terms. At least one-third of the board of supervisors must comprise employee representatives. The functions of the board of supervisors include the following: monitor the directors and managers to ensure compliance with China's law and regulations; review the financial affairs of the company; attend meetings of the board of directors; nominate external auditors; and hold ad hoc meetings. The board of directors convenes shareholder meetings; appoints and determines the compensation of senior management; prepares and adopts strategic and investment plans; determines plans of profit distribution, mergers, acquisitions, and organizational setup of management, adoption of budgets; and carries out other important functions.[9]

Although Chinese board structures resemble that of Germany, scholars have noted dissimilarities and perhaps greater resemblance to U.S. corporate governance structures. Financial disclosure is weak particularly with regard to accounting and auditing of financial information. Independent directors have limited say in influencing overall corporate strategy while supervisory boards tend to rubber-stamp decisions of the boards of directors. There is duplication and overlap of functions by the two boards, which thus creates inefficiency and redundancy.[10]

The problem in China today, albeit they are being addressed by the government, which is relatively inexperienced concerning the machinations in financial markets, is the lack of transparency concerning information disclosure of listed companies. There are four basic layers of the information disclosure system:

- *Basic laws* enacted by the National People's Congress or its Standing Committee—example is the "Securities Law" discussed in Chapter 5
- *Administrative regulations* enacted by the State Council—an example is the "Provisional Regulations on the Administration of Share Issuance and Trading"
- *Institutional rules and canonical documents*—an example is China Securities Regulatory Commission's rules concerning "Content and Format of Information Disclosure regarding Companies Issuing Securities to the Public"
- *Market criteria*—an example is the *Rules Governing the Listing of Securities* on the Shanghai and Shenzhen stock exchanges.

Problems that exist and that are gradually being addressed by the Chinese government include inaccurate or fabricated financial statements whereby publicly traded corporations manipulate earnings statements; disclosing information often

falsely in local newspapers and media rather than using mandatory communications channels; untimely information disclosures that often lead to insider trading; and price manipulation by persons having insider information.[11] Additional areas of concern include the concentration of state ownership generally by local and provincial governments with which the central government in Beijing is hesitant to intervene especially in cases of insider trading. There is an apparent lack of independence among board members. Although shareholders have the right to elect or remove board directors, the dominant owner of shares is often the government, which appoints board members who are subservient to the government. Also, China has an immature capital market as characterized by its banks, which give preferential treatment to state-owned enterprises. Other issues include the difficulty in issuing corporate bonds and the lack of preferred shares.

China appears to be addressing these issues gradually with the adoption of a variety of statutory and regulatory measures as discussed in this text.[12]

Alternate Two-Tier and One-Tier Stakeholder Model

French Corporate Governance

France recognizes either of two models within the stakeholder model for corporate governance: the two-tier model, similar to that of Germany, or the one-tier model like other Western states. In the two-tier model, the management of the *Societe anonyme* (SA) is divided into a management board known as the "Directorate" (Directoire) and the supervisory board (Conseil de Surveillance). The "President du directoire" represents the company in dealings with third parties. The supervisory board appoints members; exercises control over the management board; and may intervene to carry out the company's business. Its members are appointed at the general meeting of the company, usually for six-year terms but can be removed at any time at the said meeting. The management board may be required to obtain from the supervisory board consent for special transactions such as, for example, financial guarantees and the transfer of the entire assets of the corporation.[13]

In a one-tier model, the SA is somewhat similar to that of other one-tier models. The SA is managed by a board of directors (conseil d'administration) and headed by the President Directeur General (PDG) who is elected by the board. Each director must be a stockholder possessing a certain minimum of shares in the company. Directors are generally selected from the largest shareholders such as banks. Shareholders do vote for the board members but, like in the United States, they almost always act to ratify the selection. The board does exercise significant control over the managers especially inasmuch as they represent the largest shareholders. Director liability, albeit rare, is joint and several in civil actions and there is exposure to criminal liability.

In France, the Paris capital market is the fourth largest in the world. Stock holdings tend to be concentrated. The French Stock Exchange (Paris Bourse (Bourse de Paris)), institutional investors, companies, foreign investors, and

friendly shareholders (30–50 percent of shares) hold most of the shares. As in Germany, French banks dominate shareholders with significant power over boards and corporate policies. Bank controls prevent many hostile takeovers. Nonbank shareholders do have rights under French law. A shareholder possessing 5 percent or more of the corporation's capital, for example, may request the appointment of a management expert by a judicial court whose report is given to the shareholders and to the Commission des Operations de Bourse. Shareholders are required to appoint an auditor whose role is to control the financial statements of the corporation and assess the legality of the corporation's operations. French corporations are stakeholder entities accountable to a variety of stakeholders beyond that of the shareholders.[14]

In 2001, the French Assembly passed a law that required annual social and environmental impact reports from businesses. The law requires *premier marche* (literally, the "first market" on the French stock exchange) corporations to issue reports based on designated social indicators encompassing human resources, community, and labor standards. In addition, mandatory reporting is required concerning the implementation of management systems for health, safety, and the environment including consumption of energy, water and raw materials, and other requirements.[15]

One-Tier Stakeholder Models

Japan's Model of Corporate Governance

Most countries globally have a one-tier model such as that of the United States. Japan, for much of its history, was both insular and conservative in its approach to governance. Major families, such as the Mitsubishi, Mitsui, and the Sumitomo families, dominate banks and industrial output even to the present day, although the country's Anti-Monopoly Law of 1948, imposed by American occupation forces, continues to be a part of its legal landscape. In Japan, many Japanese firms have been part of a *keiretsu.* Competing corporations thereby became united in protecting each other with competing companies owning large block of shares in each other's firms and being represented on their respective boards. Thus, when a firm had financial difficulties, the result was often the entry into "friendly" mergers. For several decades Japanese firms prospered causing companies in other countries, including the United States, to rethink its corporate governance. In the United States it was and is illegal under its antitrust laws for competing firms to sit on each other's boards or to engage in cooperative agreements that include price fixing and other unlawful purposes.

According to most economists, however, Japanese companies that were uncompetitive should have been permitted to expire rather than protected. The eventual collapse of the Japanese market left only companies with multinational entities and independently operated entities to survive. Japan also had to rethink its mode of corporate governance. Financial structures of Japanese corporations are derived primarily from banks, trust banks, insurance companies, independent

institutions, and government sources. Banks, as an integral part of corporate business, have a stake in ensuring that the corporations to which they provide finance perform well and have the necessary resources. They are pro-business and are not impartial regulators of domestic industry.

The Japanese corporate structure of the largest stock corporations (*kabushiki kaisha*) is similar appearance to that of their U.S. counterpart. Thus, shareholders elect a board of directors that sets the overall policy and direction of the business entity and, in turn, select and monitor the performance of the corporation's day-to-day managers who are responsible for the implementation of the board's agenda. Similarly, as in the United States, the shareholders have little power unless they are dominant shareholders who are also board members. On October 1, 1982, statutory amendments were added to the Commercial Code concerning corporate governance whose purposes were to compel greater accountability of management, create greater dispersion of share ownership, and have greater shareholder participation in corporate decision making.

Board members, historically, were named by the chief executive officer (CEO) and the CEO's operating committee often in consultation with the largest shareholders. Although three directors are mandatory, most corporations have 10–20 executives who serve two-year terms and who usually are divided into working groups dominated by the most senior member. The reality is that board members serve the corporation and its employees, with shareholders having a lesser status. The shareholders rubber-stamp the decisions of the chief executives, especially that of the president of the company. There are few, if any, outside directors. The chairman of the board is usually a retired senior executive or government official. On the other hand, directors do interact closely with senior managers in monthly meetings and are generally well versed concerning the domestic and foreign trends. The priority is long-term health of the business rather than profit maximization. The emphasis is on company growth in order to maintain job security for the employees, increase opportunities for promotion of company executives, provide capital gains for shareholders, add tax revenues to the government, and overall benefit the community at large. Thus, it exemplifies the stakeholder form of corporate governance.

Corporate ownership is not widely disbursed but is possessed most often by a few individuals. Only 20–30 percent of a company's shares are typically available in general circulation. Outside shareholders are thus passive, although, as of 1981, corporate executives must attend annual meetings and answer questions from shareholders. There are large institutional "safe" shareholders that include banks, members of the *keiretsu*, board directors, employees, business customers, and associates. They form the "President's Club" and operate akin to a second board overseeing a company's operations. Shareholders appoint two auditors who report to the directors and are empowered to commence legal action if wrongdoings are uncovered. Due to the manner of corporate ownership and control, foreign takeovers have been rare to date as exemplified by the well-publicized failure of the American T. Boone Pickens to gain a seat on the board of the Japanese firm Koito.

Corporate executives, particularly the president and the president's operating committee, control the corporation. They set the agenda of long- and short-term goals for the corporation and are generally free from shareholder accountability other than as previously stated. Unlike in the U.S. model, the president's first loyalty is to employees who have historically been assured of lifetime employment. Companies unable to financially afford the current number of employees are able to transfer them to other members of the *keiretsu*. Presidents, though subject to age limits, are rarely forced out of office but may resign especially if the company fails to meet expectations. Executive compensation is not tied to profits but the latter may determine the degree of semiannual bonuses.

There are many positive and negative consequences to Japanese-style corporate governance. Its stakeholder emphasis of employee protection also causes a high degree of worker loyalty. Bank financing, rather than reliance on capital markets for financing, makes the company less susceptible to corporate takeovers, ensuring needed capital. There is continuous corporate monitoring by major stakeholders and there are high levels of productivity and quality of workmanship. On the other hand, management is insulated from outside pressures and is accountable only to banks and leading shareholders. The interlocking directorship and loyalty to employees created significant inefficiencies. The web of insular ownership and decision making creates a scenario that made it subject to systemwide collapse as became evident toward the end of the prior century and continuing into the new century.

As a result of the downturn of the Japanese economy, there has been a series of legislative initiatives to reform corporate governance. Japan enacted legislation beginning in 2002 that permitted companies to adopt a U.S.-style method of corporate management. By March 31, 2004, some 71 firms had adopted these changes with many more Japanese companies following thereafter, most of which were very large firms. The prior auditing system was amended to compel large companies to have three auditors, one of whom is an outside auditor—by 2005, half of the auditors were outside auditors. Companies, such as SONY, added outside directors and created the informal position of executive officer who is now separate from board members. Capital requirements moved away from bank reliance to external capital market or internal earnings.

The May 22, 2002, legislative reform instituted by the Japanese Diet now permitted domestic companies, commencing April 1, 2002, to adopt the U.S. corporate governance approach provided they are capitalized at 500 million yen or more or with debt of 20 billion yen. If they adopt the U.S.-style approach, then they must have at least three committees of at least three members each, a majority of whom are outside directors: (1) a nomination committee; (2) an audit committee that replaces the statutory audit; and (3) a compensation committee. The adopting firm must have at least one "representative officer" with authority to act for the firm. The board monitors the business of the company.

Also illustrating the changes that took place after the downturn of the economy is the recommendations made by the Japan Corporate Governance Committee of the Japan Corporate Governance Forum. On October 26, 2001,

it adopted the "Revised Corporate Governance Principles," which are stated at the end of the chapter as Appendix A.[16]

Notwithstanding the changes that have gradually taken place, the Japanese model continues to adhere to a stakeholder model while evolving in the direction of the U.S. shareholder model. Thus, it remains dominated by major families rather than a disbursed ownership of shares. Though there have been more appointments of "independent directors," they, in fact, tend to lack independence and are not valued as sources of constructive criticism. Japanese corporate audit and compensation committees are not independent unlike most U.S. counterparts; lifetime employment remains a dominant part of the Japanese corporate mentality.[17] As globalization continues unabatedly, there will be a greater convergence of corporate models.

A Third Way? The United Kingdom's "Enlightened Shareholder Model"?

Like the United States, the United Kingdom has experienced its share of corporate scandals. Its major concern has been about corporate governance. As a result it convened five major committees to evaluate different aspects of corporate governance.

- The *Cadbury Committee,* which convened in 1991 after the well-publicized collapse of Robert Maxwell's financial empire and that of Polly Peck, issued recommendations that were incorporated into a Code of Best Practices for preserving auditor independence and enhancing the supervisory role of the nonexecutive members of the board of directors. Its recommendations were incorporated into the London Stock Exchange (LSE) Listing Rules (Yellow Book).
- The *Greenbury Committee*, which issued the *Greenbury Report* that addressed director pay. The report issued a Code of Best Practices aimed at improving accountability in executive pay by stressing the role of nonexecutive directors in setting executive compensation and stating its disapproval of American-style stock options and "payment for failure" (allowing executives with long contracts to be paid early to leave). The report suggested that top executives and directors' annual pay increases be related to the pay increases that employees were receiving. It emphasized the importance of shareholder participation and full transparency concerning the remuneration.
- The *Hampel Committee* was created to review the *Code of Best Practices*. It issued its *Hampel Report* of June 1998, which resulted in the *Combined Code.* The code was amended in 2003. It combined the recommendations of the three committees and was incorporated into the LSE's Yellow Book. It emphasized risk management and encouraged shareholder democracy. This led to British pension fund participation in matters of financial performance, corporate governance, and social and environmental concerns. The emphasis is on more engagement by outside groups in corporate governance

matters. The LSE also required companies to describe their corporate governance arrangements in their annual reports to all shareholders to determine whether the company's actions are in conformity with the Principles of Good Governance and to explain why it deviated from the said code if not in conformity.

- The *Turnbull Committee*, which issued its *Turnbull Report* of September 1999, reviewed companies' approach to internal controls. It broadened corporate governance by explicit recognition that an effective internal control system must address a wide range of risks, including legal, health, safety, and environmental, reputation, and business probity issues.

Company Law Review

The Company Law Review (CLR) is an ongoing process begun in March 1998, whose goal is to protect the interests of those involved with a company, including shareholders, creditors, and employees. The review seeks to find a middle ground between the pluralist, stakeholder model and the narrow U.S. model of shareholder accountability. It assumes that the primary corporate focus is making profits for shareholders but goes beyond it to assert that a corporation's relationships with employees, customers, NGOs, creditors, and communities also affect profitability. It advocates an "enlightened" shareholder model, one that holds that long-term shareholder value is best achieved by reducing a company's future social and environmental risks and enhancing its reputation by caring for the needs of other parties beyond shareholders.

It proposed a requirement that directors take into account short- and long-term consequences and give recognition to other stakeholders and their effect on shareholders. It recommended a revised Operating and Financial Review (OFR), which is an annual report incorporating best practices as suggested by the Institute of Chartered Accountants. The OFR is an analysis of the company's business, strategic objectives, and financial results and includes relationships with employees, suppliers and customers, environmental and community impact, corporate governance, and management of risks.

The British government has reacted favorably to most of the CLR proposals but emphasized that disclosure is a matter of directors' informed judgment, which could vary from company to company. It recommended that information of a company's products, markets, acquisitions, disposals, purpose, strategy, and principal business always be included in its OFR. It further stated that the information concerning its policy on social, ethical, environmental, and community relationships be included when the directors in good faith judge them "material."

The CLR's Working Group's Consultation Document on Materiality sought to give guidance on what is material. The starting point of materiality is that the primary role of directors is to benefit shareholders but that their duty is to encompass long- and short-term issues, which are to include a wide range of social and ethical, environmental, and economic impacts. Materiality includes the high-level objective of enabling users to assess the strategies adopted by the business

and the potential for successfully achieving them, information that would influence shareholders' assessment of the company. In addition, there should be an understanding of the particular company's purposes and values and the need to take a broad view of the approaches and perspectives of users of the OFR by members and other key stakeholders. The OFR regulations would dovetail the EU's modernization directive, so that the OFR requirements would not require separate reports but would meet EU requirements and also provide for greater detailed reports.

Some of the areas that directors would have to consider and possibly add to the reports include an explanation of risk management approaches by companies using significant volumes of hazardous or toxic substances that may affect workers; how a company uses natural resources; the impact of climate changes; future compliance concerning discharge to air, land, or water; and an explanation of risk management in assessing the operational impact on biodiversity where failure would cause additional risk. Key performance indicators concern environmental, social, and employee matters to provide an understanding of the company's strategic development, performance, current position, and future risks and uncertainties. Thus, these emphases would be rather significant variations from the U.S. shareholder model.

Additional Statutory Measures Affecting Corporate Governance

Other major laws governing U.K. corporations are the City Code on Takeovers and Mergers, the rules applicable to mergers adopted by the Takeover Panel, the Financial Services Authority's Code of Market Conduct, and the Combined Code on Corporate Governance. They apply to all listed companies in the United Kingdom and those companies listed on the LSE. Compliance is voluntary but, if not complying, they must disclose the noncompliance in their annual reports and state the reasons for the noncompliance.

The Companies Act

The Companies Act applies to almost all companies in the United Kingdom. The act distinguishes private companies from public limited companies. Almost all companies are private companies but they cannot have their equity traded on a stock exchange. Private companies become listed companies by admittance to the official list maintained by the stock exchange. A listed company is obliged to comply with the Listing Rules of the London Stock Exchange (Yellow Book). The Yellow Book regulates the conduct of key transactions and imposes substantial disclosure obligations on listed companies. If a listed company breaches the Yellow Book, its infraction may be publicized and trading may be suspended.

The Combined Code

The Combined Code requires that nonexecutive directors comprise at least one-half of the directors. A majority of these nonexecutive directors should also be free from any relationship with the company or management that would

interfere with the exercise of their independent professional judgment. The code requires shareholder approval of any long-term incentive plans and approval is also required for the compensation report rendered to shareholders. Institutional investors have great influence inasmuch as their pension funds often hold a large percentage of a company's stock. They also issue their own corporate governance guidelines and will vote the stock they hold in accordance with the governance principles set forth in their guidelines. It is expected that their influence will increase in future years.

The Institute of Internal Auditors

The institute has recommended that corporate governance be more rules-based. The roles of the chairman and the CEO have been separated for many years. The United States is gradually following the U.K. lead in this regard. Typically, senior full-time executives sit on the board with outside or nonexecutive directors. Outside directors are to provide full-time executives with support and assistance as they carry out their managerial tasks and to monitor executive decision making to ensure that executives meet their legal and regulatory duties and ethical responsibilities. Directors are to act in the company's best interests, avoid conflicts of interest, and perform their duties with care, skill, and diligence. Directors are subject to some 200 punishable offenses as well as sanctions for other misdeeds under the Insolvency Act of 1986 and for environmental protection violations.

Comparison with U.S. Corporate Governance

Factors that resemble U.K. and U.S. corporate governance are the following:

- Strong equity market: Almost all of the largest U.S. and U.K. corporations are listed on the stock market (the United States had 30 listed companies per million population in 1996, the United Kingdom, 36; France, 8; Germany, 5)
- Market capitalization: U.S. stock markets (total market value of all of the listed shares for trading) was 95 percent of GDP; U.K. markets, 135 percent; other major European markets, 35 percent or less
- Diffused share ownership: large shareholders are uncommon in the United States and the United Kingdom; institutional investors (pension funds, insurance companies, mutual funds) play a major role in ownership (the United States, 50 percent; the United Kingdom, 60–70 percent)
- The United Kingdom and the United States have "outside" or "arm's-length" system: share ownership is widely disbursed and shareholders rarely intervene in running the corporation, unlike other countries where a small number of families, banks, or other firms play key roles
- Institutional investors usually do not play a key role in corporate governance because they invest in numerous companies and prefer to exit and sell their shares rather than try to reform the company

Implications for U.K. and U.S. Systems of Governance

Shareholders' passivity appears proper inasmuch as executives have the expertise and training to run the companies but the problem is that corporate executives may be tempted to use their control over corporate assets to further their own interests (agency costs). There are also issues concerning lavish spending, unnecessary travel, overgenerous salaries and bonuses, and other related issues.

Miscellaneous National Corporate Governance Regimes

Canada

Canada has a similar U.S.-based, rules-based structure that is prevalent in 11 of the 13 provincial governments—British Columbia and Alberta Provinces have principles-based regimes. The major stock exchange is the Toronto Stock Exchange that is regulated by the Ontario Securities Commission. The U.S.-based SRO, Financial Industry Regulatory Authority (FINRA), provides most of the testing requirements for persons to become securities brokers and dealers. The Toronto Stock Exchange has rules comparable to that of the New York Stock Exchange with governance standards concerning board supervision of management activities and the requirement that the audit committees of boards be financially literate. It also mandates that companies have outside directors and has Sarbanes-Oxley standards concerning CEO and chief financial officer (CFO) certification of corporate financial statements. Enforcement includes fines of $5 million or triple profits made and/or prison sentences of up to five years. There have been proposals for independent board members including the separation of management from board membership.

Mexico

All companies listed on the Bolsa Mexicana de Valores (stock exchange) must be organized as limited liability stock corporations. Mexico's corporate law is the Ley General de Sociedades Mercantiles (General Act of Commercial Companies) while its securities law is the Ley del Mercado de Valores (Law of Market Value). Although the board of directors oversees company management, the enterprise must have a comisario or statutory auditor (mostly from outside auditing firms) who examines the finances of the company and prepares an annual report. On June 9, 1999, a new Codigo de Mejores Pacticas Corporatives (Best Practices for Corporate Governance) was created. The Code was established by major financial organizations within Mexico and addresses issues concerning the structure and function of boards of directors, auditing of the firm, internal controls, transparency, and disclosures to shareholders. A major concern is the emphasis of protection of minority shareholders. Although compliance with the code is voluntary, companies must state which areas of the code with which they are not compliant with an explanation of the reasons for noncompliance. The Comision Nacional Bancaria y de Valores (National Banking and Securities Commission)

is the government agency that has oversight of the country's capital markets. The Mexican Securities Act is modeled on that of the United States including the requirement of independence of a majority of the audit committee.

India

India's model is based on the British model from which it gained independence in 1947. Banks were established but the postindependence socialist government under Prime Minister Jawaharlal Nehru imposed major barriers to industry both domestically and from foreign sources. There was much nationalization and promotion of small indigenous industries. High tariffs and strict controls over currencies kept imports at a minimum and the country became more impoverished. With examples of market-based economic prosperity in Asia, particularly in its border nation, China, India initiated reforms that have dramatically improved its economy and the lives of its inhabitants. Due to major securities scams in the early 1990s, corporate governance reforms were initiated. It adopted codes of good practice such as the Kumaramangalam Birla Code followed by the Benami Transactions Prohibition Act and the Prevention of Money Laundering Act, which has set forth statutory and ethical standards for business enterprises. Nevertheless, bribery of governmental officials from the lowest to the highest levels of government remains a major impediment to greater prosperity.

EU Common Law Action Plan (CLAP)

The EU commission proposed a plan to foster global efficiency and competitiveness of businesses in the EU by strengthening shareholders' rights and third-party protection. In its "Communication from the Commission to the Council and the European Parliament—Modernising Company Law and Enhancing Corporate Governance in the European Union—A Plan to Move Forward,"[18] as stated in the introductory remarks, the EU proposed the Common Law Action Plan (CLAP) in response to the U.S. Sarbanes-Oxley Act, which the commission believed created a series of problems due to its effect on EU companies and auditors. The commission reiterated that the EU shared the same broad objectives and principles as Sarbanes-Oxley but CLAP was initiated to add new initiatives and be Sarbanes-Oxley's equivalent. CLAP was thus designed to (a) facilitate freedom of establishment of companies: the harmonization of a number of minimum requirements makes it easier for companies to establish themselves in other member states where the regulatory framework is similar; and (b) guarantee legal certainty in intracommunity operations, where the presence of a number of common safeguards is key for the creation of trust in cross-border economic relationships.

CLAP focuses almost entirely on corporate governance. Specifically, although there is a recognition of the diverse cultural and legal views and systems among the EU states, the differences in the various state corporate governance arrangements may create uncertainty among issuers and investors. The commission

found that there was substantial convergence of company law and securities regulation. It therefore made a series of recommendations that, in part, are related to corporate governance and are set forth in Appendix B.

Convergence of Corporate Models of Governance

By "convergence" we refer to the utilization of diverse models to arrive at a common set of principles and objectives that countries may use to arrive at governance principles that are adaptable to a particular nation-state given its cultural and social norms. The idea is to ascertain the best standards from each of the models based on the experiences of the sources of the models. The sources from which the principles-based approach may be taken including the following: U.S. sources—the Sarbanes-Oxley Act of 2002, the Dodd-Frank Act of 2010, the New York Stock Exchange Report of the Accountability and Listing Standards Committees; U.K. sources—the Higgs Review of 2003 concerning the role and effectiveness of nonexecutive direction and the Smith Report of Audit Committees; France—the "Rapport Bouton" on promoting better corporate governance in listed companies and the Loi sur la securite Financiere of 2003; Germany—the German Code of Corporate Governance; Japan—the May 2002 law reforming the Japanese corporate governance system; and the EU—the 2002 consultative document of the High Level Group of Company Law Experts.

Convergence is due in large part to the globalization of capital markets, which created the need for a uniform standard that investors may look to rather than having as many diverse standards as there are numbers of nation-states. Leading the way is the International Organization of Securities Commissions (IOSCO) whose mission is to develop, implement, and promote international standards of regulation of securities through information exchange and cooperation in enforcement against misconduct and in the supervision of markets and market intermediaries.[19] The other common factors are mergers and acquisitions; listing standards of stock exchanges; the media; international organizations; political factors such as stability or lack thereof, degree of corruption, and taxation; access to capital; and governmental regulation. Larger corporations, although having a national base from which they operate; have become multinational without particular allegiance to any one country. When international trade was relatively small in scope there was no need for convergence of law and regulation. The present and future economy requires a degree of certainty concerning the legal and regulatory requirements of the countries in which they operate or in which they intend to expand.

There are limitations to convergence. The EU, by expanding to 27 countries, with additional applications pending, has been weakened by the diverse cultures, economies, and degree to which national entities seek to maintain control over their respective economies. Each country and the companies within them have their own views concerning capital formation and its disbursement. The shareholder/stakeholder mode of corporate governance is not easily converged. Japanese culture is much more responsive to employees and to the general

welfare of the nation while U.S. companies seek to maximize profits and believe, in the long run, that by doing so the benefits will inevitably trickle down to the citizenry. Nevertheless, as globalization continues on its cross-border ascendancy the need for uniformity of laws and regulations become paramount. The UN, through its International Law Commission (UNCITRAL), is one of many organizations seeking to unify laws and regulations that are needed to foster international trade. As less-developed countries attempt to industrialize, it is inevitable that they will copy the laws and regulations of successful states. China did not invent its post–Mao legal system but rather copied and adapted it mainly from German law. Inevitably, as countries perceive that it is in their best interests to create a more harmonious legal environment for the welfare of their populace, convergence will gradually take place.

Corporate Social Responsibility

The question arises whether a corporation owes any responsibility to society other than to produce products or services that are competitive with other entities engaged in the same or similar business. Corporate social responsibility (CSR) has been defined as "the continuing commitment by business to behave ethically and contribute to economic development while improving the quality of life of the workforce and their families as well as of the local community and society at large."[20] The EU defined CSR as "a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis."[21]

The United States appears to define CSR in the narrower sense of corporations acting in a philanthropic manner, that is, giving a share of profits to charitable causes supposedly without expectation of a return for the donations. In reality, such donations may also act as an aspect of marketing and for enhancing corporate image. Scholars have alleged that U.S. corporations have exemplified a lack of CSR unlike their counterparts in other areas of the globe. One scholar attributes the enactment of legal rules was due to the failure of companies to pay attention to environmental harm. An example is the release of cancer causing polychlorinated biphenyl (PCBs) and other chemical wastes into the Hudson River in New York by the General Electric Company, which later fought bitterly to prevent the government from compelling it to remove the toxins from the river. The lack of environmental and other social concerns led to the passage of laws that created the Environmental Protection Agency, the Consumer Product Safety Commission, and the Occupational Safety and Health Administration. The Clean Water Act, the Clean Air Act, and environmental statutes addressed specific environmental problems.[22]

As stated previously, Professor Milton Friedman's thesis opposes the concept and practice of social responsibility, holding that the sole obligation of a business is to maximize the profits of shareholders while adhering to legal restrictions imposed by government. Giving moneys or other resources to non–business-related activities constitutes theft of shareholder profits. Because companies

compete vigorously with each other, society benefits in the long run by having the best products and services available at the lowest cost. This is the nature of a free, open, and competitive economy. His theory and that of adherents to comparable analyses is the basis for the shareholder model prevalent in the United States. They would use as an example Japanese companies that felt a major responsibility toward their employees. Companies offered lifetime employment, which, in reverse, caused employees to devote their lives to the betterment of the enterprise. The problem, however, is that retaining more employees than were needed for the business, in part, led to inefficiencies and added costs to the manufacturing process.

On the other hand, most theorists today espouse the stakeholder concept that businesses have an obligation beyond that of maximizing profits, to wit, to employees, customers, suppliers, and other persons interacting with the business. The question, however, goes beyond that of stakeholder theory. Does a company have broad social obligations to society as a whole, both domestic and foreign? Europe and other areas of the globe, where social welfare and labor parties have historically been dominant forces in society, have traditionally emphasized the need for businesses to give back to society. They reflect a contrast with the United States wherein the rules-based, legal duty obligations are the mainstay of corporate obligation. Other nations, especially Japan and Western Europe, have espoused a principles-based, social duty responsibility approach that is much broader than legalistic obligation. The contrast may be found in the standards mandated by the International Organization for Standardization (ISO) 14000 and ISO 14001 that sets forth the criteria for an effective environmental management system. Thus, the standard is a general obligation for companies to improve their environmental performance while maintaining other ISO standards for quality and security with respect to the manufacture of products.[23]

Companies have now found it profitable to incorporate CSR as part of its business. Aside from the enormous possible costs of contamination of the environment, for example, EXXON in Alaska, British Petroleum in the Gulf of Mexico, companies from Wal-Mart, Apple, Proctor & Gamble, and many other companies have found it profitable to pay attention to environmental concerns. Wal-Mart has been able to sharply cut its utility costs by the adoption of efficient technological changes. Whole Foods has become a major food supermarket chain by its emphasis on organically sourced foods and environmentally friendly products.[24] The *Economist* Magazine also noted that CSR, which was once viewed as a do-good sideshow, is now seen as mainstream.[25]

The convergence of CSR is due to numerous factors. It is almost trite to say that we live in a global economy and society. The news and other channels of communication bring home to all peoples the daily events taking place worldwide from the tsunami in Japan to the horrors of child abuse including child labor. Stakeholders have raised their voices that were once placid and silent: employees, through organized labor, are now more vocal in their demands in less developed countries; companies suffer potential losses of reputation for practices that were once hidden from public view; and the critical downturn in the economies mainly

in Europe and in the United States has caused companies to address environmental and other risks. Shareholders, financial analysts, and companies are now compelled to integrate CSR issues due to increased vigilance by media and individuals whose technological capabilities of iPads, iPhones, and other devices now expose wrongdoing on a scale never before addressed.

The Union of South Africa (Republic of South Africa) was the poster country for apartheid throughout most of the twentieth century. The blatant discrimination ended on or about 1991 with the release of Nelson Mandela, who became president of the country after having served 27 years in prison. Although prior thereto the country was deeply divided between whites and blacks with the latter virtually enslaved and deprived of basic human rights, many companies did business with the country and flourished due to the abundance of resources therein. Rev. Leon H. Sullivan, a member of the board of directors of General Motors, proposed that companies should boycott countries that have apartheid governments. The following principles, later known as the Global Sullivan Principles of Social Responsibility, are among the most well-known guidance for companies to the present day. Numerous multinational companies and nation-states, but not all countries, have signed on to the principles, which endeavor to accord a level of dignity to all peoples, especially the employees therein.[26]

Global Sullivan Principles of Social Responsibility

As a company which endorses the Global Sullivan Principles we will respect the law, and as a responsible member of society we will apply these Principles with integrity consistent with the legitimate role of business. We will develop and implement company policies, procedures, training and internal reporting structures to ensure commitment to these Principles throughout our organization. We believe the application of these Principles will achieve greater tolerance and better understanding among peoples, and advance the culture of peace.

Accordingly, we will:

- Express our support for universal human rights and, particularly, those of our employees, the communities within which we operate, and parties with whom we do business.
- Promote equal opportunity for our employees at all levels of the company with respect to issues such as color, race, gender, age, ethnicity or religious beliefs, and operate without unacceptable worker treatment such as the exploitation of children, physical punishment, female abuse, involuntary servitude, or other forms of abuse.
- Respect our employees' voluntary freedom of association.
- Compensate our employees to enable them to meet at least their basic needs and provide the opportunity to improve their skill and capability in order to raise their social and economic opportunities.

- Provide a safe and healthy workplace; protect human health and the environment; and promote sustainable development.
- Promote fair competition including respect for intellectual and other property rights, and not offer, pay or accept bribes.
- Work with governments and communities in which we do business to improve the quality of life in those communities—their educational, cultural, economic and social well being—and seek to provide training and opportunities for workers from disadvantaged backgrounds.
- Promote the application of these Principles by those with whom we do business.

We will be transparent in our implementation of these Principles and provide information which demonstrates publicly our commitment to them.

Nonstate Actors and CSR

A variety of abuses, both perceived and actual, led to the rise of organizational and nonstate codes of conduct devoted to ending or lessening the violations of employees' rights, child labor, unhealthy working conditions, and environmental devastation. Part of the reason was the inability or unwillingness of developing economies to suppress these violations in the expectation of foreign investment. Although adhering to newly created codes of conduct added expenses to a company by compelling higher wages, and otherwise altering corporate culture, the benefits outweighed the liabilities by having a more productive, eager, and healthy workforce, access to cheaper capital, enhanced corporate image, avoidance of consumer boycotts, and lessening the prospect of governmental intervention.

United Nations Efforts

In addition to the Sullivan Principles, there were other quasi-governmental and nongovernmental organizations that proposed and enforced codes of conduct for companies doing business in developing countries. Highly instrumental in this regard is the United Nations. The International Labor Organization (ILO) is a tripartite organization consisting of representatives of governments, employers, and workers in an endeavor to guide multinational corporations (MNCs) and other stakeholders to develop policies directed toward social progress. MNCs are called upon to promote equal opportunity, security, and collective bargaining in employment, and policies that preclude arbitrary dismissal, strike breaking, and other unfair labor practices. MNCs are to obey local laws and regulations and to respect the UN Declaration of Human Rights, the International Covenant on Civil and Political Rights, the International Covenant on Economic, Social and Cultural Rights, the ILO's Constitution, and a multitude of other ILO conventions and recommendations. The problem is, however, that the ILO's

mandates are not legally binding and have generally not been effective in their mission.

The UN Economic and Social Council Commission on Human Rights adopted "the norms on the responsibilities of transnational corporations and other business enterprises with regard to human rights."[27] The main focus is on the rights of workers and is set forth in Appendix C.

There are a multitude of other codes that address conduct that MNCs and other entities are to follow. Among them are the 1999 UN Global Compact,[28] which is similar to the Sullivan Principles; Amnesty International's Human Rights Principles for Companies,[29] and the Workers' Rights Consortium's Model Code of Conduct.[30] There are codes of conduct specific to particular industries. For example, the 2002 Voluntary Principles on Security and Human Rights was developed by the governments of the United States and the United Kingdom together with companies in the extractive and energy sectors and NGOs having an interest in CSR and human rights. The Voluntary Principles are divided into three segments: (1) risk assessment—the ability to assess accurately the risks present in the company's operating environment taking into account security risks, potential for violence, human rights record, rule of law, conflict analysis, and equipment transfers; (2) interactions between companies and public security—need to consult with governments concerning security, ethical behavior policies, deployment of competent security forces, legal compliance with respect to equipment imports and exports, identification of forces that cause human rights abuses, have regular meetings with government officials, and respond to human rights violations; and (3) interactions between companies and private security—assure competent, high level of professionalism, particularly with respect to human rights.[31]

UN Global Compact's Ten Principles[32]

The UN Global Compact asks companies to embrace, support and enact, within their sphere of influence, a set of core values in the areas of human rights, labor standards, the environment and anticorruption:

Human Rights

- *Principle 1*: Businesses should support and respect the protection of internationally proclaimed human rights; and
- *Principle 2*: make sure that they are not complicit in human rights abuses.

Labour

- *Principle 3*: Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining;
- *Principle 4*: the elimination of all forms of forced and compulsory labour;
- *Principle 5*: the effective abolition of child labour; and

- *Principle 6*: the elimination of discrimination in respect of employment and occupation.

Environment

- *Principle 7*: Businesses should support a precautionary approach to environmental challenges;
- *Principle 8*: undertake initiatives to promote greater environmental responsibility; and
- *Principle 9*: encourage the development and diffusion of environmentally friendly technologies.

Anti-Corruption

- *Principle 10*: Businesses should work against corruption in all its forms, including extortion and bribery.

The European Union and CSR

European countries have already added substantial CSR requirements to corporate responsibility. France, Belgium, Germany, and the United Kingdom have passed laws mandating that pension funds disclose the extent to which they incorporate ethical, social, and environmental information in their environmental portfolios. Denmark, the Netherlands, Norway, and Sweden require companies to add substantial environmental information in their annual reports. France in its May 15, 2001, Nouvelles Regulations Economique (New Economic Regulations) requires a triple bottom line reporting that includes social and economic information for shares listed on its stock exchange.

In 2011, the EU issued a new policy with respect to CSR. The policy known as "A renewed EU strategy 2011–14 for Corporate Social Responsibility,"[33] noted that the number of EU enterprises that have signed up for the ten CSR principles of the UN Global Compact had risen from 600 in 2006 to over 1900 in 2011 with substantial increases also of organizations that are registered under the Environmental Management and Audit Scheme and with global or European workers' organization. It then gave a new definition of CSR: "The responsibility of enterprises for their impacts on society." The enterprises "should have in place a process to integrate social, environmental, ethical human rights and consumer concerns into their business operations and core strategy in close collaboration with their shareholders." The aim of the E.U. is to enhance positive impacts and prevent negative impacts through innovation of new products and services that will be beneficial to society.

The 8-areas action agenda for 2011-2014 as set forth by the E.U. Commission is as follows:

- Enhancing the visibility of CSR and disseminating good practices: this includes the creation of a European award, and the establishment of

sector-based platforms for enterprises and stakeholders to make commitments and jointly monitor progress.
- Improving and tracking levels of trust in business: the Commission will launch a public debate on the role and potential of enterprises, and organise surveys on citizen trust in business.
- Improving self- and co-regulation processes: the Commission proposes to develop a short protocol to guide the development of future self- and co-regulation initiatives.
- Enhancing market reward for CSR: this means leveraging EU policies in the fields of consumption, investment and public procurement in order to promote market reward for responsible business conduct.
- Improving company disclosure of social and environmental information: the new policy confirms the Commission's intention to bring forward a new legislative proposal on this issue.
- Further integrating CSR into education, training and research: the Commission will provide further support for education and training in the field of CSR, and explore opportunities for funding more research.
- Emphasising the importance of national and sub-national CSR policies: the Commission invites EU Member States to present or update their own plans for the promotion of CSR by mid 2012.
- Better aligning European and global approaches to CSR: the Commission highlights the OECD Guidelines for Multinational Enterprises,
    - the 10 principles of the UN Global Compact,
    - the UN Guiding Principles on Business and Human Rights,
    - the ILO Tri-partite Declaration of Principles on Multinational Enterprises and Social Policy,
    - the ISO 26000 Guidance Standard on Social Responsibility.

Thus, the EU is taking an aggressive stance to incorporate CSR into corporate governance of companies doing business in the EU. Its aim clearly is to cause enterprises to incorporate CSR in order to build long-term employee, consumer and citizen trust as a basis for sustainable business models. As it stated, "higher levels of trust in turn help to create an environment in which enterprises can innovate and grow."

The Organization of Economic Cooperation and Development

The Organization of Economic Cooperation and Development (OECD) had its origins in 1947 as an outgrowth of the U.S. Marshall Plan (European Recovery Plan) whose purpose was to aid Europe to recover from its devastation as a result of World War II. A secondary and equally important purpose was to prevent the spread of communism to Western Europe. The moneys allocated by Congress were to be disbursed by a newly created organization, the Organization for European Economic Cooperation (OEEC), set up by the Paris

Convention in April 1948. Its mission was not only to run the program but also to bring about cooperation among the countries that had perpetually waged wars against each other. Originally, it had 18 members from Western Europe including Turkey, Western Germany, and Trieste. In September 1961 it was replaced by the OECD, which expanded to 34 countries including the United States, Japan, Canada, Israel, Poland, and South Korea. Many non-OECD members, nevertheless, have agreed to abide by its principles.

The OECD also places heavy emphasis on corporate governance and has accordingly adopted its Principles of Corporate Governance as set forth hereafter.

OECD Principles of Corporate Governance[34]

I. The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law, and clearly articulate the division of responsibilities among different supervisory, regulatory, and enforcement authorities.

II. The corporate governance framework should protect and facilitate the exercise of shareholders' rights.

III. The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

IV. The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

V. The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

VI. The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

Conclusion

Chapters 2 and 3 contain a summary of the various models of corporate governance that are utilized in the world today. The models, however, are not stagnant. Inevitably, countries that are faring less well than other countries, particularly, those in the same region, look to those nations that are economically successful. China, more than three decades ago, came to the realization that a market

economy leads to greater prosperity for citizens of a country than a planned economy. It didn't have to look far to see that Hong Kong, South Korea, and Singapore created much wealth while mainland China was in the throes of poverty. It thus transformed itself to a market economy, albeit "Chinese style" ostensibly maintaining a one-party communist rule. The question that arises is which model is best for the inhabitants of a particular country. From a purely economic viewpoint, the United States, with its shareholder mentality, appears to be the most successful. Yet China, with 1.3 billion inhabitants, has been able to become the second leading economic power in a relatively short time span with a German-like model that emphasizes stakeholder concerns. Which model or alternative models will prevail in the long run must be left to future generations to develop.

APPENDIX A

Japan Corporate Governance Principles

Chapter I. Mission and Role of the Board of Directors

Principle 1: Position and Purpose of the Board of Directors

1. The board of directors is positioned as the management supervision body of the company.
2. The board of directors should supervise the management of the company by the CEO. The supervisory role of the board is premised on the fact that the decisions of the management team centered on the CEO will be evaluated by the securities market with the equity share market at its core.

Principle 2: Function and Powers of the Board of Directors

1. The matters to be decided by the board of directors should be limited to management supervision matters, i.e. approval of high level strategic decisions, nomination of candidates for director and executive positions, appointment and removal of the CEO, review and setting of management salaries, general control of accounting and auditing, and other similar matters.
2. In addition to the matters prescribed by law to be decided by the board, in light of its role as a supervisory body, a requirement that the board approve certain decisions of the CEO may also be provided for.

Principle 3: Organization of the Board of Directors

1. The number of members in the board of directors should be set so as to allow for meaningful discussion, and accurate and prompt decision making.
2. The board of directors should be comprised of outside directors (directors who are not also executives or employees) and inside directors (directors who are also executives or employees).

3. The majority of the board of directors should be comprised of outside directors.

Principle 4: Outside Directors and their Independence

1. An outside director is someone who is not and has never been a full-time director, executive, or employee of the company or its parent company, subsidiaries or affiliates (collectively, the "Company etc.").
2. An independent director is someone who can make decisions completely independently from the managers of the Company etc., and therefore necessarily does not hold any interest with respect to the company.
3. If companies exchange directors (interdirectorships), those directors should be regarded as lacking independence.

Principle 5: The Role of the Leader of the Board of Directors

1. The leader of the board of directors should, as chairperson or leader of the meeting, which supervises the CEO and other executives, discharge his or her duties from the standpoint of good corporate governance.

Chapter II. Mission and Role of the Committees Established within the Board of Directors

Principle 6: Establishment and Composition of Committees

1. The board of directors should establish a nominating committee, compensation committee and audit committee within the board. The board may, if necessary, establish a litigation committee or any other committee for a specific purpose (a "special committee") (each referred to as a "Committee").
2. Each Committee should consist of 3 or more directors.
3. The majority of directors on the nominating committee and the compensation committee should be outside directors, and there should be one or more independent directors. The majority of audit committee members should be independent directors.
4. An outside director should be appointed as the chairperson of each Committee.

Principle 7: Role of each Committee

1. The nominating committee should:

    (1) decide on candidates for directorships who meet certain pre-set qualification criteria, and propose the removal of directors at shareholders' meetings; and
    (2) propose appointment, removal and related matters with respect to executives. The CEO may submit requests or opinions to

the nominating committee, or may attend meetings of the Committee to present the requests or opinions.

2. The compensation committee should review the executive compensation programs and of each director's and executive's compensation pursuant to pre-set compensation principles. The objective of the compensation programs is to motivate directors and executives to work diligently, and therefore the compensation committee should respectfully review the incentive plans, which should be designed in a fair and reasonable manner. If the CEO decides to adopt incentive plans to employees, the CEO should obtain the approval of the compensation committee.
3. The audit committee should organize the overall accounting and audit functions, assess the audits conducted by certified public accountants, appoint and discharge certified public accountants, evaluate and make improvements to internal audit procedures and controls, and the internal control environment, and be responsible for related tasks.
4. Special committees should be established to enable the company to deal with situations that may significantly affect the interests of shareholders, such as derivative lawsuits, takeover bids and other serious matters.

Chapter III. Leadership Responsibility of the CEO

Principle 8: The Role of the CEO

1. The CEO, while observing the law and the Articles of Incorporation and adjusting the interests of various stakeholders based on market principles, should loyally carry out his or her duties in order to meet the management goals of the company.
2. The CEO should, under the supervision of the board of directors, devise high level management strategies, employ creative thinking, and maximize the value of the company over the long term.
3. In addition to organizing a management team and achieving the above objectives, the CEO should present plans regarding his or her successor to the nominating committee on an annual basis.
4. The CEO should not be a member of the nominating, compensation or audit committees.
5. The CEO should be responsible for making explanations to the board of directors and each Committee.

Principle 9: Executive Management Committee

1. An executive management committee should be set up under the CEO.
2. The executive management committee should assist the CEO in conducting all aspects of the business of the company.

3. Each company needs to be creative in setting the structure, authority and responsibility of the executive management committee so as to facilitate efficient executive decision-making.

Chapter IV. Addressing Shareholder Derivative Litigation

Principle 10: Litigation Committee

1. The litigation committee should assess whether to commence litigation against directors or executives in respect of whom the company or the shareholders have made a claim, to hold them responsible for their conduct. When making this judgment, the committee should broadly consider whether the conduct of the director can be regarded as having been performed in the implementation of a decision made by the company as a whole, whether appropriate sanctions have already been taken against the director, and whether or not the shareholders' requests are fair.
2. The litigation committee can be a permanent committee or a temporary committee.
3. The majority of members of the litigation committee should be independent directors. None of the members of the committee should be in a relationship of interest with the directors or executives that are the subject of litigation.

Chapter V. Securing Fairness and Transparency for Executive Management

Principle 11: Internal Control

1. In addition to ensuring the effectiveness of the internal audit and control of the company through the board of directors, various committees, certified public accountants, and a management audit department and related bodies, the CEO should realize a proper governance system, which provides for adequate internal control.
2. The audit committee should evaluate the CEO's policies for strengthening internal audit and control.
3. The CEO should prepare an annual report on the state of internal audit and control, and include that report in the business report and the securities report, and it is desirable that the report be audited by a certified public accountant.

Principle 12: Disclosure

1. The CEO should endeavor to promptly disclose any information which will influence the company stock price so as to ensure that price reflects its fair value, and should immediately notify the securities exchange or make the information public by other appropriate means when such information becomes available. At such times,

measures should be taken so that important information is not selectively given to a particular party.

2. The CEO should disclose information regularly and whenever necessary in order to show shareholders, investors, employees, customers, and local communities, etc. that the corporation's business affairs have been efficient and fair.
3. The CEO should prepare and make public in-house administrative protocols for announcing important information and for preventing insider trading.

Chapter VI. Reporting to the Shareholders and Communicating with Investors

Principle 13: General Meeting of Shareholders

1. The general meeting of shareholders is important because it provides an opportunity for those people who have invested in the company's shares to participate in the decision-making process of the company to a certain extent, to take part in corporate governance, to obtain information about the current state of the company by asking questions of the executives and receiving their explanations, and to evaluate the qualifications and capabilities of the executives through questions and answers.
2. The general meeting of shareholders also provides an opportunity for the directors and executives to report to the shareholders on the company's achievements as the result of the performance of their respective duties. The executive manager's explanations to the shareholders, however, should not be limited to matters pertaining to corporate decisions and reports, but should be comprehensive and include all matters in general that are deemed relevant to the interests of shareholders.
3. If executives are unable to answer any question from an investor at the general meeting of shareholders, a full and accurate answer should be forthcoming on the company's web page within a fixed period of time.

Principle 14: Investor Relations

1. Executives should be enthusiastic in meeting with analysts and other people who provide information to investors and shareholders, and it is desirable that these analysts and other such people convey to the investors and shareholders their assessment of the qualifications, capabilities, and vision of the executives. As information can be posted simultaneously on the Internet, it is essential that measures are taken to avoid any inequality arising among the investors and shareholders.

APPENDIX B

European Union Common Action Plan

Annual Corporate Governance Statement

Listed companies should be required to include in their annual report and accounts a coherent and descriptive statement covering the key elements of their corporate governance structure and practices, which should at least include the following items:

a) the operation of the shareholder meeting and its key powers, and the description of shareholder rights and how they can be exercised;
b) the composition and operation of the board and its committees;
c) the shareholders holding major holdings, and their voting and control rights as well as key agreements;
d) the other direct and indirect relationships between these major shareholders and the company;
e) any material transactions with other related parties;
f) the existence and nature of a risk management system;
g) and a reference to a code on corporate governance, designated for use at national level, with which the company complies or in relation to which it explains deviations.

Institutional investors should be obliged:

a) to disclose their investment policy and their policy with respect to the exercise of voting rights in companies in which they invest;
b) to disclose to their beneficial holders at their request how these rights have been used in a particular case.

Strengthening Shareholder Rights

Access to information—Shareholders of listed companies should be provided with electronic facilities to access the relevant information in advance of General Meetings.

The home Member State shall allow issuers the use of electronic means for the purposes of conveying information to shareholders, provided such a decision is taken in a general meeting and meets a series of conditions, including the individual consent of the shareholder concerned.

A host Member State may require issuers: a) to publish regulated information on their Internet sites, and b) to alert any interested person, without delay and free of charge, to any new disclosure or any change to regulated information which has already been published.

Other Shareholder Rights

There is a need for enhancing the exercise of a series of shareholders' rights in listed companies (right to ask questions, to table resolutions,

to vote in absentia, to participate in general meetings via electronic means).

Shareholder Democracy

Strengthening shareholders' rights should be based essentially on a) the provision of comprehensive information on what the various existing rights are and how they can be exercised and b) the development of the facilities necessary to make sure that these existing rights can be effectively exercised. This approach is fully consistent with the OECD Principles of Corporate Governance stated above.

Modernizing the Board of Directors

In key areas where executive directors clearly have conflicts of interests (i.e. remuneration of directors, and supervision of the audit of the company's accounts), decisions in listed companies should be made exclusively by non-executive or supervisory directors who are in the majority independent. With respect to the nomination of directors for appointment by the body competent under national company law, the responsibility for identifying candidates to fill board vacancies should in principle be entrusted to a group composed mainly of executive directors, since executive directors can usefully bring their deep knowledge of the challenges facing the company and of the skills and experience of the human resources grown up within the company. Non-executive directors should, nonetheless, also be included and specific safeguards should be put in place to deal with conflicts of interests when they arise, for example when a decision has to be made on the reappointment of a director.

In developing the minimum standards applicable to the audit committee, appropriate attention will be paid to a) the access it must have to the relevant information (there might be a scope for specific consideration of the need for greater legal protection for whistle-blowers) and b) the extent to which transparency on its activities is desirable.

Directors' Remuneration

Shareholders should be able to appreciate fully the relation between the performance of the company and the level of remuneration of directors, both ex ante and ex post, and they should be able to make decisions on the remuneration items linked to the share price.

Directors' Responsibilities

With a view to enhancing directors' responsibilities, the collective responsibility of all board members for financial and key non-financial statements (including the annual corporate governance statement mentioned above) should be confirmed as a matter of EU law.

Coordinating Corporate Governance Efforts of Member States

The Commission shares the view of the High Level Group that the EU should actively co-ordinate the corporate governance efforts of Member States through their company laws, securities laws, listing rules, codes, or otherwise. In particular, each Member State should progress towards designating a code of corporate governance, designated for use at the national level, as the code with which listed companies subject to their jurisdiction are to comply or in relation to which they are to explain deviations. Co-ordination should not only extend to the making of these national codes, but also to the procedures Member States have in place to monitor and enforce compliance and disclosure. Member States should participate in the co-ordination process set by the EU, but the process itself should be voluntary and non-binding with a strong involvement of market participants.

APPENDIX C

UN ECOSOC Principles

A. General Obligations

1. States have the primary responsibility to promote, secure the fulfillment of, respect, ensure respect of and protect human rights recognized in international as well as national law, including ensuring that transnational corporations and other business enterprises respect human rights. Within their respective spheres of activity and influence, transnational corporations and other business enterprises have the obligation to promote, secure the fulfillment of, respect, ensure respect of and protect human rights recognized in international as well as national law, including the rights and interests of indigenous peoples and other vulnerable groups.

B. Right to Equal Opportunity and Non-Discriminatory Treatment

2. Transnational corporations and other business enterprises shall ensure equality of opportunity and treatment, as provided in the relevant international instruments and national legislation as well as international human rights law, for the purpose of eliminating discrimination based on race, colour, sex, language, religion, political opinion, national or social origin, social status, indigenous status, disability, age—except for children, who may be given greater protection—or other status of the individual unrelated to the inherent requirements to perform the job, or of complying with special

measures designed to overcome past discrimination against certain groups.

C. Right to Security of Persons

3. Transnational corporations and other business enterprises shall not engage in nor benefit from war crimes, crimes against humanity, genocide, torture, forced disappearance, forced or compulsory labour, hostage-taking, extrajudicial, summary or arbitrary executions, other violations of humanitarian law and other international crimes against the human person as defined by international law, in particular human rights and humanitarian law.
4. Security arrangements for transnational corporations and other business enterprises shall observe international human rights norms as well as the laws and professional standards of the country or countries in which they operate.

D. Rights of Workers

5. Transnational corporations and other business enterprises shall not use forced or compulsory labour as forbidden by the relevant international instruments and national legislation as well as international human rights and humanitarian law.
6. Transnational corporations and other business enterprises shall respect the rights of children to be protected from economic exploitation as forbidden by the relevant international instruments and national legislation as well as international human rights and humanitarian law.
7. Transnational corporations and other business enterprises shall provide a safe and healthy working environment as set forth in relevant international instruments and national legislation as well as international human rights and humanitarian law.
8. Transnational corporations and other business enterprises shall provide workers with remuneration that ensures an adequate standard of living for them and their families. Such remuneration shall take due account of their needs for adequate living conditions with a view towards progressive improvement.
9. Transnational corporations and other business enterprises shall ensure freedom of association and effective recognition of the right to collective bargaining by protecting the right to establish and, subject only to the rules of the organization concerned, to join organizations of their own choosing without distinction, previous authorization, or interference, for the protection of their employment interests and for other collective bargaining purposes as provided in national legislation and the relevant conventions of the International Labour Organization.

E. Respect for National Sovereignty and Human Rights

10. Transnational corporations and other business enterprises shall recognize and respect applicable norms of international law, national laws and regulations, as well as administrative practices, the rule of law, the public interest, development objectives, social, economic and cultural policies including transparency, accountability and prohibition of corruption, and authority of the countries in which the enterprises operate.
11. Transnational corporations and other business enterprises shall not offer, promise, give, accept, condone, knowingly benefit from, or demand a bribe or other improper advantage, nor shall they be solicited or expected to give a bribe or other improper advantage to any Government, public official, candidate for elective post, any member of the armed forces or security forces, or any other individual or organization. Transnational corporations and other business enterprises shall refrain from any activity which supports, solicits, or encourages States or any other entities to abuse human rights. They shall further seek to ensure that the goods and services they provide will not be used to abuse human rights.
12. Transnational corporations and other business enterprises shall respect economic, social and cultural rights as well as civil and political rights and contribute to their realization, in particular the rights to development, adequate food and drinking water, the highest attainable standard of physical and mental health, adequate housing, privacy, education, freedom of thought, conscience, and religion and freedom of opinion and expression, and shall refrain from actions which obstruct or impede the realization of those rights.

F. Obligations with Regard to Consumer Protection

13. Transnational corporations and other business enterprises shall act in accordance with fair business, marketing and advertising practices and shall take all necessary steps to ensure the safety and quality of the goods and services they provide, including observance of the precautionary principle. Nor shall they produce, distribute, market, or advertise harmful or potentially harmful products for use by consumers.

G. Obligations with Regard to Environmental Protection

14. Transnational corporations and other business enterprises shall carry out their activities in accordance with national laws, regulations, administrative practices and policies relating to the preservation of the environment of the countries in which they operate,

as well as in accordance with relevant international agreements, principles, objectives, responsibilities and standards with regard to the environment as well as human rights, public health and safety, bioethics and the precautionary principle, and shall generally conduct their activities in a manner contributing to the wider goal of sustainable development.

H. General Provisions of Implementation

15. As an initial step towards implementing these Norms, each transnational corporation or other business enterprise shall adopt, disseminate and implement internal rules of operation in compliance with the Norms. Further, they shall periodically report on and take other measures fully to implement the Norms and to provide at least for the prompt implementation of the protections set forth in the Norms. Each transnational corporation or other business enterprise shall apply and incorporate these Norms in their contracts or other arrangements and dealings with contractors, subcontractors, suppliers, licensees, distributors, or natural or other legal persons that enter into any agreement with the transnational corporation or business enterprise in order to ensure respect for and implementation of the Norms.
16. Transnational corporations and other business enterprises shall be subject to periodic monitoring and verification by United Nations, other international and national mechanisms already in existence or yet to be created, regarding application of the Norms. This monitoring shall be transparent and independent and take into account input from stakeholders (including non-governmental organizations) and as a result of complaints of violations of these Norms. Further, transnational corporations and other business enterprises shall conduct periodic evaluations concerning the impact of their own activities on human rights under these Norms.

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CHAPTER 4

Securities Regulation Part I: Securities Act of 1933

Overview of Major Statutes and Regulations Affecting Securities

There are a number of statutes that concern the regulation of the many facets of securities. We begin this chapter with a brief overview of the statutes, which will be followed by a more detailed review of the Securities Act of 1933 ('33 Act) in this chapter and the Securities Exchange Act of 1934 ("'34 Act") in Chapter 5. The Sarbanes-Oxley Act of 2002 and the Dodd-Frank Act of 2010 are discussed in this and subsequent chapters where relevant to the subjects under review.

Securities Act of 1933

The 1920s were a period of tremendous growth in the American economy, having succeeded Great Britain as the leading world economy. The stock market responded accordingly with major capital investments in newly innovative companies as well as companies that sought to expand nationally and globally. The ensuing explosive growth of the stock market was inevitably accompanied by significant fraud and misrepresentations. Securities were then regulated by state laws that were inadequate to govern the interstate activities of issuers and promoters. The first of the federal statutes regulating securities was the Securities Act of 1933.[1] The act, also called the "truth in securities" law, was promulgated as part of the then new administration of President Franklin Roosevelt.

The essence of the statute is to give investors important information concerning securities offered for public sale. The government does not warrant the safety, value, or future performance of a particular security but requires that the information provided by the issuer of a security be accurate and fully disclosed. If the issuer or persons associated with the security misrepresent or commit fraud in connection with a particular offering, such person is subject to civil and/or criminal liability. This is accomplished by the requirement, subject to a number of exceptions and exemptions, that the issuer file a registration statement with the Securities and Exchange Commission (SEC) that includes a prospectus that is to be given to the investor before or at the time of the initial transaction.

The information contained therein is very detailed and includes a description of the company's business and security, perceived risks associated with the security, audited statements of prior performance, persons associated with the security and background of such persons, and other valuable information.

Securities Exchange Act of 1934

Whereas the '33 Act regulated the initial offering of a security, the '34 Act[2] regulates the subsequent transfer of securities and stock exchanges in which such trades take place. The act also created the SEC,[3] which has the authority to register and regulate all persons in connection with securities including brokerage firms, transfer agents, stock exchanges, and self-regulatory organizations (SROs) that play a major role in assisting it to regulate the daily activities of such persons. The act requires annual, quarterly, and other reporting requirements by companies concerning public securities. The SEC has extensive powers to investigate and impose civil fines and other penalties on wrongdoers, as well as the power to refer perceived criminal violations to the Department of Justice. It has jurisdiction over proxy solicitations, tender offers, and enforces regulations against insider trading.

The Commodity Exchange Act of 1936

The Commodity Exchange Act[4] was enacted in 1936 to regulate trading facilities, clearing systems, market participants, and market professionals. Other purposes of the act include the deterrence and prevention of price manipulation, fraud, and abusive sales practices. In 1974, the act was amended to create the Commodities Futures Trading Commission (CFTC) to regulate the said practices in the financial marketplace and to foster open, competitive, and financially sound markets.

Trust Indenture Act of 1939

The Trust Indenture Act[5] was passed to protect bond holders and holders of related securities. It requires that all bond issues of over $5 million not be offered for sale unless there is a written agreement between the issuer of the bond and the bondholder irrespective of whether the bonds have been registered under the '33 Act. This trust indenture must fully disclose the particulars of the bond issue in compliance with the terms of the Trust Indenture Act. If the bond issuer becomes insolvent, the act has provisions that enable the appointed trustee to seize the assets of the bondholder and sell them to reimburse bondholders to the extent of moneys received from the said sale of assets.

Investment Company Act of 1940

The Investment Company Act[6] regulates investment companies by requiring them to register with the SEC unless otherwise exempted. An investment

company is defined as a company that is or holds itself out primarily as being in the business of (1) investing, reinvesting, or trading in securities that are offered to the general public; (2) issuing face-amount certificates of the installment type; or (3) investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 percent of the value of such issuer's total assets. The said companies must disclose their financial condition and investment policies when shares are initially sold and subsequent to the initial sale. They include mutual funds, which are the dominant type of investment companies.

Investment Advisers Act of 1940

The provisions of the Investment Advisers Act[7] provides in essence that persons who hold themselves as investment advisers must register with the SEC if assets under advisement are $100 million or more. If the assets under advisement are below the said sum, then the investment advisers are subject to state registration in the state in which they are located and with an SRO. The provisions now include the previously excluded hedge funds as provided for under the Dodd-Frank Act. They are subject to a panoply of rules and regulations that detail the many duties and obligations of advisers to their clients.

Securities Investor Protection Act of 1970

The Securities Investor Protection Act[8] establishes the creation of the Securities Investor Protection Corporation (SIPC), which protects investors against misappropriation of moneys and securities by brokers and dealers and losses due to bankruptcy and liquidation. It does not protect against losses due to market conditions. Investors are protected up to the sum of $500,000 when the brokerage firm is a member, including up to $100,000 for cash accounts. In addition, some firms add insurance coverage. After liquidation of a firm, the SIPC will attempt to deliver securities held by the firm to the customer, sell or transfer the debtor's business to other firms, and liquidate the bankrupt firm as quickly as possible to minimize harm to the clients of the firm. There are additional provisions amending other securities statutes concerning standards of conduct of brokers and dealers and penalties for transgressions.

Sarbanes-Oxley Act of 2002

After a series of highly publicized financial scandals that caused investors to question the authenticity of so-called audited statements that often concealed much more data than was revealed, the Sarbanes-Oxley Act[9] was passed to remedy manipulations, omissions, and misstatements in financial data given to the public and to shareholders. As stated previously, under an otherwise pro-business administration, the act was passed by Congress and signed by President George W. Bush that provided for stringent controls of corporate reporting requiring

senior officers to not only sign their names verifying the financial returns of their companies but also confirm that they have personally assured that systems were put in place to prevent concealment and misinformation concerning a company's annual statements and related data. Other important provisions include the creation of the Public Company Accounting Oversight Board (PCAOB) and whistle-blowing provisions. The application of the act will be spelled out in greater detail in the different contexts in subsequent chapters.

Dodd-Frank Act of 2010

The most far-reaching and extensive act concerning the financial industry ever passed by Congress and signed into law by President Barack Obama is the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.[10] The 848-page act [not 2,319 pages recited in most commentaries, albeit extraordinarily long when compared to other financial legislation],[11] which is elaborated upon throughout this text, is an all-encompassing statute covering numerous subjects of financial concern including securities regulation, banking, consumer protection, credit rating agencies, financial products, and many other areas.

Self-Regulatory Organizations

The SEC works closely with SROs, which carry out most of the mandates under the securities acts. An SRO is a private organization that is delegated authority by a federal agency. The most important SRO in the securities field is the Financial Industry Regulatory Authority (FINRA), which was formerly the National Association of Securities Dealers (NASD). NASD merged with the New York Stock Exchange (NYSE) in 2007 to form FINRA. Other SROs include the American Arbitration Association, which arbitrates many disputes between investors and dealers, and the Municipal Securities Rulemaking Board that governs matters involving municipal securities.

FINRA

FINRA is a private corporation performing quasi-governmental functions. It is the largest SRO for all securities firms doing business in the United States. Its mission is to protect the integrity of the marketplace and investors by ensuring that the securities industry, through effective and efficient regulation, performs its functions fairly and honestly. FINRA oversees nearly 4,420 brokerage firms, about 162,575 branch offices, and approximately 629,280 registered securities representatives. It has approximately 3,200 employees and operates from Washington, D.C., and New York City, with 20 regional offices around the country. In essence, the SEC delegates much authority to FINRA, which in turn conducts numerous licensing examinations both in the United States and in Canada. According to the FINRA website, in 2011, it barred 329 individuals, suspended 475 brokers from association with FINRA-regulated firms, levied

fines totaling more than $63 million, and ordered more than $19 million in restitution to harmed investors. It has also established the Office of Fraud Detection and Market Intelligence with a staff that has expertise in fraud detection and investigation to uncover potentially serious frauds. In addition, a major aspect of its mission is investor education, which it promotes with very detailed modules for instruction both in high schools and in colleges.[12]

FINRA is not without its critics. The crisis of 2007–2009 illustrated the shortcomings of FINRA's investigative and enforcement authority. It failed to discover and cease the Bernard Madoff Ponzi scheme, possibly due to the Madoff family connections to FINRA, and the $7 billion Allen Stanford scheme. Critics complain that inasmuch as FINRA is owned by broker-dealers, it has an inherent conflict of interest. On August 31, 2009, the SEC's Office of Inspector General (OIG) released a report titled "Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme," which was highly critical of FINRA's failures in the scheme.[13] Nevertheless, FINRA appears to have become more aggressive in exercising its investigative and enforcement authority in recent years. A perusal of its website reveals substantial enforcement under the current leadership of FINRA.

Securities Act of 1933

Securities law is one of the areas of law that is dually regulated by the federal government and by the individual states. State laws regulating securities are known as "blue sky" laws so named because issuers of securities often had nothing backing the security except the blue sky. The term was apparently first used by U.S. Supreme Court Justice Joseph McKenna in *Hall v. Geiger-Jones Co.*,[14] in which he spoke of "speculative schemes which have no more basis than so many feet of 'blue sky.' "

Definition of a Security

The *Howey* case below is the most cited case in all textbooks and opinions concerning the definition of a security. In essence, the definition of a security is extremely broad. A security is (1) a contract, transaction, or scheme; (2) whereby a person invests his or her money in a common enterprise with the expectation of profits; (3) solely from the efforts of the promoter or a third party. Section 2(a)(1) of the Securities Act (SA) of 1933 defines a "security" as follows:

> The term "security" means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including

> any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

The definition, as amended by the Dodd-Frank Act, does exclude a security-based swap agreement and any registration of such agreement is void. We will discuss swaps in Chapter 6.

Securities and Exchange Commission v. Howey Co.

328 U.S. 293 (1946)

FACTS: The Howey Company owned large tracts of citrus acreage in Lake County, Florida. Over a period of several years, it planted about 500 acres annually, keeping one-half of the groves for itself and offering the other half to the public. Howey also had a separate service company that cultivated and developed many of the groves. Each prospective customer was offered both a land sales contract and a service contract, having been told that service arrangements were necessary for the cultivation, although the customers were free to make alternate arrangements with other service companies. The superiority of the Howey service company was stressed and 85 percent of the acreage sold during the three-year period ending May 31, 1943, was covered by service contracts with the Howey service company.

The land sales contract with the Howey Company provided for a uniform purchase price per acre or fraction thereof, varying in amount only in accordance with the number of years the particular plot has been planted with citrus trees. Upon full payment of the purchase price, the land was conveyed to the purchaser by warranty deed. The service contract, generally of a ten-year duration without option of cancellation, gave the Howey service company a leasehold interest and "full and complete" possession of the acreage. For a specified fee plus the cost of labor and materials, the company was given full discretion and authority over the cultivation of the groves and the harvest and marketing of the crops. The company was accountable only for an allocation of the net profits based upon a check made at the time of picking.

The purchasers, for the most part, were nonresidents of Florida and were predominantly business and professional people who lack the knowledge, skill, and equipment necessary for the care and cultivation of citrus trees. They were attracted by the expectation of substantial profits. It was represented that profits during the 1943–1944 season amounted to 20 percent, and that even greater profits might be expected during the 1944–1945

season, although only a 10 percent annual return was to be expected over a ten-year period. The mails and instrumentalities of interstate commerce were used in the sale of the land and service contracts and no registration statement or letter of notification has ever been filed with the SEC.

ISSUE: Whether, under the circumstances, the land sales contract, the warranty deed, and the service contract together constitute an "investment contract" within the meaning of §2(1)?

DECISION: The court determined that they did constitute an "investment contract" within the meaning of the act.

REASONING (Murphy, J.): The term "investment contract" is undefined by the Securities Act or by relevant legislative reports. But the term was common in many state "blue sky" laws in existence prior to the adoption of the federal statute, and, although the term was also undefined by the state laws, it had been broadly construed by state courts so as to afford the investing public a full measure of protection. Form was disregarded for substance, and emphasis was placed upon economic reality. An investment contract thus came to mean a contract or scheme for "the placing of capital or laying out of money in a way intended to secure income or profit from its employment . . . . "

In other words, an investment contract, for purposes of the Securities Act, means a contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.

The transactions in this case clearly involve investment contracts, as so defined. The respondent companies are offering something more than fee simple interests in land, something different from a farm or orchard coupled with management services. They are offering an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise managed and partly owned by respondents. They are offering this opportunity to persons who reside in distant localities and who lack the equipment and experience requisite to the cultivation, harvesting, and marketing of the citrus products. Such persons have no desire to occupy the land, or to develop it themselves; they are attracted solely by the prospects of a return on their investment. Indeed, individual development of the plots of land that are offered and sold would seldom be economically feasible, due to their small size. Such tracts gain utility as citrus groves only when cultivated and developed as component parts of a larger area. A common enterprise managed by respondents or third parties with adequate personnel and equipment is therefore essential if the investors are to achieve their paramount aim of a return on their investments. Their respective shares in this enterprise are evidenced by land sales contracts and warranty deeds, which serve as a convenient method of determining the investors'

allocable shares of the profits. The resulting transfer of rights in land is purely incidental.

Thus, all the elements of a profit-seeking business venture are present here. The investors provide the capital and share in the earnings and profits; the promoters manage, control, and operate the enterprise. It follows that the arrangements whereby the investors' interests are made manifest involve investment contracts, regardless of the legal terminology in which such contracts are clothed. The investment contracts in this instance take the form of land sales contracts, warranty deeds, and service contracts which respondents offer to prospective investors. And respondents' failure to abide by the statutory and administrative rules in making such offerings, even though the failure result from a bona fide mistake as to the law, cannot be sanctioned under the Act.

Questions

1. The court's interpretation of what constitutes a "security" is extraordinarily broad. Would the court render as broad a definition had the case been presented today?
2. Would Florida's securities law be applicable?

Registration Requirements

The most important feature of the '33 Act is the requirement of registration of securities by issuers. Section 5(a) of the act makes it unlawful for any person to use the facilities of interstate commerce to sell a security through the use of a prospectus or other means, deliver such security after the sale, or sell or deliver a security or prospectus unless a registration has been filed and accepted by the SEC. Acceptance by the SEC is not a guaranty against losses; rather, the acceptance merely signifies that the applicant issuer has met the filing requirements of the SEC by having filed the proper registration form and prospectus. A recent exception created by the Jumpstart Our Business Startups Act (JOBS Act),[15] discussed below, does permit an emerging growth company or any person authorized to act on behalf of an emerging growth company to engage in oral or written communications with potential investors that are qualified institutional buyers or institutions that are accredited investors.

The Registration Process

The purpose for registration is to compel an issuer of a security to disclose accurate information so as to enable prospective investors to determine whether or not to purchase the security. Included in the detailed registration is a copy of the prospectus that must be given to the investor prior to or at the time of purchase of the security. There are many types of forms required by the SEC under the act, dependent on the nature of the transaction. For example, there are registration statements for Canadian issuers, for shares evidenced by American Depositary Receipts (ADRs), securities of certain foreign private issuers, and other forms. For

purposes of an issuer in the United States the registration form is Form S-1, which is divided into two parts, the first of which is the information to be included in the prospectus and the second part, information not required in the prospectus, as well as exhibits annexed thereto.

The information to be included is detailed in Regulation S-K. The prospectus is rather lengthy and specific as to what must be included. For example, the cover of the prospectus must have the name of the registrant; the title and amount of securities; and the offering price of the securities. Other items in the prospectus include risk factors, ratio of earnings to fixed charges, use of proceeds, determination of the offering price, management, audited financials for the past two years, and many other details. A perusal of the data by a potential investor would reveal the experience or lack thereof of the promoters and management of the issuer. Unfortunately, few unsophisticated investors read the prospectus before purchasing the security. Had they read it, they may not have bought it after reading about the risks associated with the security (usually near the beginning of the prospectus) and/or the lack of managerial experience of the intended directors and officers of the new entity.

Section 5(a) prohibits the sale of a security until the registration process has been completed. Section 5(b) prohibits the transmission of a prospectus until the registration is complete, and Section 5(c) prohibits the offer to sell or purchase a security required to be registered during the said pending period. The meaning of an "offer" to sell or purchase has been interpreted by the SEC to mean anything that conditions the market, that is, efforts by the issuer to condition the public mind or arouse public interest in a security prior to its registration. The goal is to prevent a speculative frenzy such as that exemplified by the publicity given to the Facebook initial public offering (IPO) in 2012. Factors to consider are whether comments by issuers condition the public minds to include the motivation of the communication, the type of information distributed, the breadth of the distribution, the form of the communication.

In the following action, the SEC clarified whether an offer to sell includes an offer where there is no monetary consideration.

In re universalscience.com, Inc. and Rene Perez[16]

Administrative Proceeding, File No. 3–10266 (August 8, 2000)

In its Order Instituting Public Administrative Proceedings, the SEC made the following allegations:

Although Universalscience was not officially incorporated until November of 1999, Perez created a Universalscience website which initially appeared on the Internet on May 2, 1999. Universalscience represented on its website that the company would give away 100 shares of "free" stock to each of the first 10,000 applicants who signed up to be Universalscience "members." Additionally, each of these applicants would then be eligible to purchase an additional 1,000 shares at $1.00 per share.

The Universalscience website further stated that these new "members" would have the right of first refusal for shares in a future initial public offering of Universalscience. Eventually, over 4,000 individuals signed up for the "free" stock offering. Universalscience received no proceeds from its $1.00 per share offering.

Universalscience has not registered any of these securities with the commission, nor has it filed a Form D claiming an exemption from registration. In addition, Universalscience has not registered the securities in any state, nor has it delivered the requisite disclosure documents. Moreover, Universalscience did not limit its stock offerings to only accredited investors.

The SEC discussed Securities Act §§5(a)–(c) in connection with an offer of securities for no monetary consideration. Section 5(a) of the Securities Act prohibits the sale of securities or the delivery of securities after a sale through jurisdictional means unless a registration statement is in effect as to the securities or the transactions are exempt from registration. Section 5(c) of the Securities Act, in part, prohibits the use of jurisdictional means to offer to sell securities unless a registration statement has been filed.

Section 2(a)(3) of the Securities Act defines "sale" or "sell" to "include every contract of sale or disposition of a security or interest in a security, for value." The lack of monetary consideration for the shares does not mean that there was not a sale or offer for sale for purposes of §5.

Thus, a gift of stock is a "sale" within the meaning of the Securities Act when the purpose of the "gift" is to advance the donor's economic objectives rather than to make a gift for simple reasons of generosity. Universalscience and Perez benefited from the "free" stock distribution because it attracted additional people to the website. The "free" stock distribution also enhanced Perez's objectives of increasing traffic to the Universalscience website in order to increase potential advertising revenues. In addition to publicizing the Universalscience "program," the "free" stock give away generated interest in the planned direct public offering; such increased interest obviously would benefit Universalscience and Perez.

In addition, the Universalscience offer of shares at $1 per share also violated the Securities Act. Although Perez testified that Universalscience received no monetary consideration from the sale of Universalscience shares, Universalscience was offering to sell shares over the Internet, an instrument of interstate commerce, without a registration statement having been filed. Such an offer of unregistered shares over the Internet clearly constituted a violation of §5(c) of the Securities Act.

There is no exemption from the registration requirements of §5 available to Universalscience. Because Universalscience offered stock over the Internet, Universalscience engaged in a general solicitation and §4(2) and the exemptions under Rules 505 and 506 of Regulation D are inapplicable. Nor is Rule 504 available, which exempts certain offerings that do not exceed an aggregate annual amount of $1 million. Rule 504

limits the circumstances where general solicitation is permitted to transactions (1) registered under state law requiring public filing and delivery of a disclosure document to investors before sale, or (2) exempted under state law permitting general solicitation and advertising so long as sales are made only to accredited investors. Universalscience has not satisfied either of these criteria. It offered and sold securities nationwide over the Internet without making any of the requisite state filings or disclosures and it did not limit sales to accredited investors. Moreover, the offering of 1,000 shares of stock to the first 10,000 applicants at one dollar per share exceeded the $1 million limit in Rule 504.

Accordingly, the respondents' offer and sale of these securities violate §5(a) and §5(c) of the Securities Act.

Filing Periods

There are three significant periods affecting the registration statement:

Prefiling Period

The first important date is the prefiling period, that is, before the registration statement has been filed. On June 29, 2005, the SEC adopted new rules expanding what may be communicated during the said period to avoid "gun-jumping." The rules created categories of issuers, namely, well-known seasoned issuers (WKSIs), seasoned issuers, unseasoned issuers, and nonreporting issuers. The new rules, according to the SEC, had the following effect:

- WKSIs are permitted to engage at any time in oral and written communications, including use at any time of a new type of written communication called a "free writing prospectus," subject to enumerated conditions (including, in some cases, filing with the SEC).
- All reporting issuers are, at any time, permitted to continue to publish regularly released factual business information and forward-looking information.
- Nonreporting issuers are, at any time, permitted to continue to publish factual business information that is regularly released and intended for use by persons other than in their capacity as investors or potential investors.
- Communications by issuers more than 30 days before filing a registration statement will be permitted so long as they do not reference a securities offering that is the subject of a registration statement.
- All issuers and other offering participants will be permitted to use a free writing prospectus after the filing of the registration statement, subject to enumerated conditions (including, in some cases, filing with the SEC). Offering participants, other than the issuer, will be liable for a free writing prospectus only if they use, refer to, or participate in the planning and use of the free writing prospectus by another offering participant who uses

it. Issuers will have liability for any issuer information contained in any other offering participant's free writing prospectus as well as any free writing prospectus they prepare, use, or refer to.
- The exclusions from the definition of prospectus are expanded to allow a broader category of routine communications regarding issuers, offerings, and procedural matters, such as communications about the schedule for an offering or about account-opening procedures.[17]

Thus, the issuer can make known to the public general information about the proposed security offering provided there is no attempt to sell the security. Rule 169 provides a safe harbor about information that may be released to the public prior to completion of the registration process. They may communicate factual information about the issuer, its business or financial developments, or other aspects of its business; and post advertisements of, or other information about, the issuer's products or services. However, a communication containing information about the registered offering or released or disseminated as part of the offering activities in the registered offering may not be disseminated.

Waiting Period (Quiet Period)
All companies subject to the '33 Act, foreign and domestic, are required to file registration statements, periodic reports, and other forms electronically through the Electronic Data-Gathering, Analysis, and Retrieval system (EDGAR). After the registration statement has been filed, the SEC has 20 days to review the registration statement and prospectus. During the period between the day of filing and the 20-day review period, written offers may be made by radio or television limited to a "statutory prospectus" that conforms to §10 of the Securities Act.

Posteffective Period
Section 8(a) of the '33 Act states that the effective date of the registration statement is the 20th day after the filing date or such earlier time period as the SEC may determine. If any amendment is filed prior to the effective date, the registration statement shall be deemed to have been filed when the amendment was made unless the SEC consents to it being a part of the registration statement. The issuer is now free to make offers and sell the securities that have been registered subject, of course, to the antifraud provisions of the Securities acts. Section 5(b)(2) of the '33 Act requires that a prospectus be given at the time of the initial sale of the registered securities unless the sales were made by a person who is not an issuer, underwriter, or dealer. A dealer is also exempt under §4(a)(12) from the prospectus requirement with certain exceptions for transactions that take place prior to 40 days after the effective date of the registration.

Exempt Securities

Not all securities come within the purview of SEC registration requirements. There are *exempt securities* and *exempt transactions* under the act. The following

securities are exempted under §3 of the act, usually because they are regulated under other statutory provisions and governmental agencies:

- Government-backed securities including those issued or guaranteed by the federal government, any state, or territory of the United States
- Any security issued or guaranteed by any U.S. bank or one that is a direct obligation of a Federal Reserve bank including savings and loan associations, building and loan associations, and comparable institutions
- Insurance company contracts and annuity plans (usually under supervision of a state insurance department)
- Short-term commercial paper of up to nine months with certain exceptions
- Common carriers (formerly under Interstate Commerce Commission, which was abolished in 1995; now under the Surface Transportation Board)
- Any security issued by a nonprofit organization such as those exclusively for religious, educational, benevolent, fraternal, or other charitable, or reformatory purposes
- Certificates issued by a receiver or by a trustee in bankruptcy, with the approval of the court
- Additional exempt securities under Article 3 include purely intrastate securities; securities otherwise exempted by the SEC of up to $5 million; and any equity security issued in connection with the acquisition by a holding company of a bank a savings association

Note that although the securities and securities transactions may be exempt from registration requirements under the act, they are still subject to the antifraud provisions of the securities acts.

Exempt Transactions

In addition to securities that are exempt from SEC registration requirements under the act, there are also exempt transactions that need not comply although they may come within state registration requirements. They include the following transactions under Article 4 and the SEC's regulations pursuant to the act:

- Transactions by any person other than an issuer, underwriter, or dealer
- Transactions by an issuer not involving any public offering
- Transactions by a dealer except (A) transactions that took place prior to the expiration of 40 days after the first date the security was offered to the public by the issuer or through an underwriter; (B) transactions in a security in which a registration was filed that took place prior to the expiration of 40 days in which a registration was filed; and (C) transactions as to securities that were part of an unsold allotment to or subscription by the dealer that participated in the distribution of the said securities
- Brokers' transactions executed upon customers' orders that were not solicited by the said brokers

The following exempt transactions that were stated under the act but set forth in greater detail and are best known under the SEC's Rules are the following:

Intrastate Offering Exemption
Section 3(a)(11) of the Act of 1933 exempts purely intrastate offerings by an issuer. The purpose of the exemption is to facilitate the financing of local business operations. In order to qualify for the exemption the following requirements must be met:

- The security may only be offered and/or sold to persons residing within the state or territory
- The issuer must be incorporated in the state where the securities are offered
- The issuer must conduct at least 80 percent of its business within the state, that is, at least 80 percent of its gross revenues must be derived from business within the state
- The issuer must have at least 80 percent of its assets within the state
- The issuer intends to use and uses at least 80 percent of the net proceeds to the issuer from sales made with the operation of a business or of real property, the purchase of real property located in, or the rendering of services within such state
- The issuer takes affirmative steps to prevent the resale of the sold securities to nonresidents within nine months after the initial sale such as by placing a legend on the security stating the prohibition

The SEC's Rule 147(b)(2) does provide for a "safe harbor" for the exemption. The rule states that any offerings made within a six-month period before or after the intrastate offering exemption will not be integrated into the intrastate offering provided such offerings are not of the same class as the intrastate offerings. The SEC's Release No. 33–4434 set forth the factors to be considered in determining whether two or more offerings may be integrated: They are whether (i) the offerings part of a single plan of financing; (ii) the offerings involve issuance of the same class of securities; (iii) the offerings made at or about the same time; (iv) the same type of consideration to be received; and (v) the offerings made for the same general purpose.[18]

The following summary of a case concerns whether the securities were exempt as an intrastate offering.

Busch v. Carpenter

827 F.2d 653 (10th Cir. 987)

In *Busch v. Carpenter*, the plaintiffs sought to recover the purchase price paid for stock in its lawsuit against Sonic Petroleum, Inc., and three individual defendant officers of Sonic. They alleged that the issuance of the securities purchased violated the registration provisions of the Act of '33 by

not registering the securities, having relied on the intrastate offering exemption. Sonic was incorporated in Utah on October 2, 1980, to acquire, extract, and market natural resources and during the latter part of 1980 offered and sold shares in the company to Utah residents. Sonic failed to undertake the activity in Utah or in any other state. In early 1981, Carpenter, an officer of Sonic, was contacted by Mason, an Illinois oil and gas promoter, concerning a proposed merger of their operations, which culminated in a merger in which Mason received a majority share of stock in Sonic and acquired an Illinois drilling corporation owned by Mason. Shortly after Mason Oil was formed, William Mason drew $351,126 from the remainder of the $435,000 net proceeds of the original Sonic offering and deposited it in Illinois. This money was not used in Utah. In May 1981, Mason and Carpenter set up Norbil Investments, a brokerage account in Utah, so that Mason and his friends could buy shares of the company's stock. Plaintiffs, who are California residents, bought their stock through Norbil. Plaintiffs also presented evidence of purchases through Norbil of stock by other nonresidents between May and August 1981.

The court of appeals stated that the evidence fails to suggest that any of Sonic's publicly offered shares were issued under questionable circumstances. Carpenter and Mason did not know each other until their initial conversation in the spring of 1981. Mason's subsequent acquisition of control over Sonic was accomplished strictly by means of recapitalization, not via a tender of shares from the company's public offering. Moreover, the interstate purchases by Mason and others of freely trading shares several months after the completion of the intrastate offering do not, without more, impugn the investment intent of the original buyers or otherwise imply an effort to evade the federal securities laws. Norbil served as a conduit for over-the-counter purchases made by Olsen & Company on behalf of Mason and various acquaintances. Although Carpenter did collect from buyers, pay Olsen, and transfer the stock certificates to their new owners, there is simply no indication that those who sold through Norbil had not originally purchased their stock for investment purposes. The court, however, sent the case back to the district court, which had ruled in favor of the defendants based on a motion for summary judgment, for a full trial of the claims made.

Private Offering Exemption

Section 4(a)(2) of the Securities Act exempts from registration "transactions by an issuer not involving any public offering." Rule 506 of Regulation D states that in order to qualify for the exemption, the requirements of Rules 501 and 502 must be complied with. In essence, the purchasers of the securities must be "accredited investors," that is, they must have enough knowledge and experience in finance and business matters to evaluate the risks and merits of the investment

or be able to bear the investment's economic risk; they must have access to the type of information normally provided in a prospectus; and agree not to resell or distribute the securities to the public. No form of *public* solicitation or general advertising may be made in connection with the offering.

An "accredited investor," according to Rule 501(a), includes:

- a bank, insurance company, registered investment company, business development company, or small business investment company;
- an employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of $5 million;
- a charitable organization, corporation, or partnership with assets exceeding $5 million;
- a director, executive officer, or general partner of the company selling the securities;
- a business in which all the equity owners are accredited investors;
- a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds $1 million at the time of the purchase, excluding the value of the primary residence of such person;
- a natural person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year; or
- a trust with assets in excess of $5 million, not formed to acquire the securities offered, whose purchases a sophisticated person makes.

In the following case, the issue arose concerning the meaning of the exemption under the securities laws of a private offering of a security.

Securities and Exchange Commission v. Ralston Purina Co.

346 U.S. 119 (1953)

The issue before the U.S. Supreme Court was whether Ralston Purina's offerings of treasury stock to its key employees came within the exemption of "transactions by an issuer not involving any public offering" and thus exempt from registration. The company, which manufactured feed and cereal products, encouraged employees to purchase stock in the company and had authorized unissued available common shares to some of the employees. Between 1947 and 1951, Ralston Purina sold nearly $2,000,000 of stock to numerous employees, including the bakeshop foreman, chow loading foreman, clerical assistant, copywriter, electrician, stock clerk, production trainee, stenographer, and other employees.

The court agreed with the SEC in holding that the securities did not come within the exemption. The fact that there were numerous employees

who purchased the stock, rather than a few key employees, caused the issuance thereof to constitute a public offering. Exemption from the registration requirements of the Securities Act is the question to be addressed. The design of the statute is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions. Since exempt transactions are those as to which "there is no practical need for [the bill's] application," the applicability of §4 (1) should turn on whether the particular class of persons affected needs the protection of the act. An offering to those who are shown to be able to fend for themselves is a transaction "not involving any public offering." Employees are just as much a part of the public as nonemployees. The focus of inquiry should be on the need of the offerees for the protections afforded by registration. The employees here were not shown to have access to the kind of information that registration would disclose. The obvious opportunities for pressure and imposition make it advisable that they be entitled to compliance with §5 registration requirements.

Small Issues—Regulation A

Section 3(b) grants the authority to the SEC to exempt "small issues" up to $5 million in any 12-month period provided it finds that registration is not necessary in the public interest and for the protection of investors. Even if an exemption is granted, the issuer must file an offering statement that consists of a notification, offering circular to be given to prospective investors, and exhibits for the SEC for review. Whereas the registration statement is quite detailed and requires audited financial statements, the small issues exemption permits a much simpler filing and eliminates the need for audited financial statements. Nevertheless, Regulation A is quite detailed including the signatures on the offering statement of the chief executive officer (CEO), chief financial officer (CFO), a majority of the board of directors, and each selling security holder. Of course, all offerings must comply with the antifraud provisions of the securities laws. Companies may test the waters by use of a general solicitation and advertising to determine whether there is interest in the securities being offered prior to filing the offering statement but no solicitation may be made or money accepted. Generally, up to $1.5 million of securities may be sold under Regulation A, albeit the higher sum may be exempted by the SEC.

Regulation D

Under Regulation D, there are three exemptions from registration requirements. They are Rules 504, 505, and 506.

Rule 504. Under subsection (2) of the rule, an exemption is permitted for an offering of securities up to $1 million. The aggregate offering price for such securities under Rule 504 may not exceed $1,000,000 in a 12-month period. Public solicitation or advertising is not permitted. Purchasers of the shares will receive restricted certificates that may not be further transferred unless the securities have

been registered or come within an exemption. A public offering of the securities and transfer of freely tradable securities may be exchanged under certain circumstances. They are (1) the offering is made exclusively in one or more states that require a publicly filed registration statement and delivery of a substantive disclosure document to investors; (2) the securities are registered and sold in a state that requires registration and disclosure delivery and also sell in a state without those requirements provided the disclosure documents are delivered as mandated by the state in which the registration takes place; or (3) the securities are sold exclusively according to state law exemptions that permit general solicitation and advertising, solely to "accredited investors." As with the other exemptions, the antifraud provisions of the Securities Acts apply to the offerings.

Rule 505. The rule provides an exemption from registration where the aggregate offering price for an offering of securities does not exceed $5,000,000 for all securities sold within a 12-month period. The said securities may be sold to an unlimited number of "accredited investors" and up to 35 unaccredited investors who either alone or with a purchaser representative are sophisticated, that is, they must have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment. The issued securities are "restricted," that is, they may not be resold for at least a year without registering the transaction. No general solicitation or advertising to sell the securities is permitted. Material information concerning the securities must be given to the nonaccredited investors. There should be reasonable steps taken to ensure that the said securities are not resold during the one-year period.

Rule 506. The third exemption under Regulation D is when there are no more than 35 nonaccredited purchasers of securities from the issuer in any offering under this section. The rule is a "safe harbor" for the private offering exemption. An unlimited amount of capital may be raised under this rule from an unlimited number of accredited investors and up to 35 nonaccredited sophisticated investors as stated in Rule 505. No general solicitation or advertising to market the securities may be made. Again, the antifraud provisions of the Securities Acts apply. Financial statements are required to be given to the nonaccredited investors. The securities are "restricted", that is, may not be resold for at least one year.

As of this writing, the SEC on August 29, 2012, in conformity with the Jobs Act, discussed below, proposed amendments to Rule 506 of Regulation D and to Rule 144A, which would remove the "no general solicitation or advertising prohibition" provided that all purchasers of the securities are accredited investors. In addition, the proposed rule that is likely to be adopted would require the issuer to take reasonable steps to verify that the purchasers of the securities are in fact accredited investors. The proposed amendment to Rule 144A would provide that securities may be offered pursuant to Rule 144A to persons other than qualified institutional buyers, so long as the securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are qualified institutional buyers.

The SEC noted that in 2011 the estimated amount of capital (including both equity and debt) raised in Rule 506 offerings and Rule 144A offerings was $895 billion and $168 billion, respectively, when compared to $984 billion raised in registered offerings. In 2010, it was estimated that the amount of capital raised in Rule 506 offerings and Rule 144A offerings was $902 billion and $233 billion, respectively, compared to $1.07 trillion raised in registered offerings. Thus, the said numbers illustrate the importance of the exemptions under both rules for issuers seeking access to U.S. capital markets. The proposed rule has met some opposition which has delayed implementation.[19]

Jobs Act Exemption

The Jumpstart Our Business Startups (JOBS) Act was signed into law on April 5, 2012. The purpose of the law is reflected in its title: "To increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies." An "emerging growth company" is defined as an issuer that had total annual gross revenues of less than $1 million during its past fiscal year. In order to do so, a new "crowdfunding exemption" was created under the Act, for which the SEC is required to adopt rules to implement the new exemption. Crowdfunding is the networking and pooling of capital in order to enhance the creation of industries accompanied by the employment of workers therein.

To accomplish crowdfunding, §4(6) of the Securities Act was amended so as to exempt from registration requirements the offer or sale of securities by an issuer where:

- (A) The aggregate amount sold to all investors by the issuer during the 12-month period preceding the date of such transaction is not more than $1,000,000
- (B) The aggregate amount sold to any investor by an issuer during the 12-month period preceding the date of such transaction, does not exceed:
  - (i) The greater of $2,000 or 5 percent of the annual income or net worth of such investor, as applicable, if either the annual income or the net worth of the investor is less than $100,000; and
  - (ii) 10 percent of the annual income or net worth of such investor, as applicable, not to exceed a maximum aggregate amount sold of $100,000, if either the annual income or net worth of the investor is equal to or more than $100,000;
- (C) The transaction is conducted through a broker or funding portal registered with the SEC that complies with the requirements of §4A(a); and
- (D) The issuer complies with the requirements of the Act.

The intermediary person must register with the SEC as a broker or funding portal, register with an SRO (generally, FINRA), and provide disclosures as to

risk and other investor education materials as the SEC may determine. The said broker or funding portal has additional extensive obligations:

- Ensure that each investor reviews the education materials
- Affirm that the investor understands that he or she may suffer a loss of part or all of the investment and answers questions demonstrating an understanding of the risk taken, and the risk of illiquidity
- Take measures to reduce the risk of fraud by obtaining background information concerning each officer, director, and person holding more than 20 percent of the outstanding equity in the company and make available to the SEC and to potential investors any information provided to the issuer at least 21 days prior to the sale of securities
- Ensure that all proceeds are made available to the issuer only when the aggregate capital raised is equal to or exceeds the target sum and allow investors to cancel their commitments
- Ensure privacy of information collected from the investors
- Meet such other requirements as the SEC may require

The issuer is required to file with the SEC and provide to investors and the relevant broker or portal detailed information concerning the particulars of the issuer including names of directors and officers and persons holding more than 20 percent of the shares; a description of the business and anticipated business plan; and the financial condition of the company with the required details dependent on whether the target offerings are $100,000 or less or between $100,000 and $500,000, and over $500,000. For amounts over $500,000, requirements include audited financial statements must be provided; target amounts sought; price of the securities offered; not advertise the terms of the offering; a description of the ownership and capital of the issuer; and not compensate any persons without full disclosure to the SEC concerning the details of their compensation.

The act affords private compensation for any untrue statement or omission of a material fact that the investor was unaware of. Securities issued under this exemption are restricted, that is, they may not be resold within one year of date of purchase unless made to the issuer, to an accredited investor, as part of an offering registered with the SEC, or to a family member at the discretion of the SEC.

Additional Issuer Exemptions

There are other less well-known exemptions that may be applicable. They include the "Accredited Investor Exemption" under §4(6) of the act, which exempts from registration offers and sales of securities to accredited investors when the total offering price is less than $5 million; the "California Limited Offering Exemption"—Rule 1001, which provides an exemption from registration requirements of the Securities Act for offers and sales of securities in amounts of up to $5 million, which satisfy the conditions of §25102(n) of the California Corporations Code; and the "Exemption for Sales of Securities

Through Employee Benefit Plans" under Rule 710, which exempts sales of securities if made to compensate employees.

Exempt Transactions for Nonissuers

In addition to the exempt transactions for issuers, the following exemptions from registration requirements concern nonissuers. Section 4(a)(1) of the '33 Act states that the registration provisions of the act shall not apply to transactions by any person other than an issuer, underwriter, or dealer. Section 4(a)(3) exempts most transactions by a dealer and Section 4(a)(4) exempts brokers' transactions executed upon orders from the customer on any exchange or on an over-the-counter market except when the broker solicited the orders. An underwriter does not have the exemptions that apply to most brokers and dealers. Thus, if an underwriter is a party to a securities transaction, registration may be required.

Rule 144: Selling Restricted and Control Securities

The exempt transactions of issuers, discussed previously, usually contain restrictions on the resale of the securities for a one-year period. Rule 144 provides a means by which investors can resell privately placed or restricted securities. In the preliminary note to the rule concerning "persons deemed not to be engaged in a distribution and therefore not underwriters," it states that when a person sells a nonexempt security to any other person, the sale must be registered unless an exemption can be found for the transaction. Section 4(1) of the Securities Act provides an exemption for a transaction "by a person other than an issuer, underwriter, or dealer." Therefore, it is important to understand the meaning of who and what is an "underwriter" to determine whether or not the §4(1) exemption from registration is available for the sale of the securities.[20]

Underwriter

An "underwriter" is defined under §2(a)(11) of the Securities Act as:

> Any person who has purchased from an issuer *with a view to*, or offers or sells for an issuer in connection with, the *distribution* of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. As used in this paragraph the term "issuer" shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.
>
> (emphasis added)

As interpreted by the SEC, the emphasis is on the words "with a view to . . . distribution." Thus, an investment banking firm that arranges with an issuer for the public sale of its securities is an "underwriter." Individual investors, even though they may not be professionals in the securities business, may be "underwriters" if they act as links in a chain of transactions through which

securities move from an issuer to the public. The SEC found that there was some confusion concerning whether the purchaser of the securities acquired the securities with a view to distributing them. Thus, SEC adopted Rule 144 to clarify the meaning of the term with a "view to distribution." It created a "safe harbor" to differentiate certain activities or purposes from consideration as an "underwriter." It also distinguishes an "affiliate for an issuer" from nonaffiliates. An affiliate of an issuer is defined by the rule as "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer," such as controlling shareholders, directors, and executive officers.

A person who meets the conditions set forth in Rule 144 will not be deemed to be an underwriter and, thus, need not register the securities. The preliminary statement to the rule and guiding principles further state that if a sale of securities complies with all of the applicable conditions of Rule 144:

1. Any affiliate or other person who sells restricted securities will be deemed not to be engaged in a distribution and therefore not an underwriter for that transaction
2. Any person who sells restricted or other securities on behalf of an affiliate of the issuer will be deemed not to be engaged in a distribution and therefore not an underwriter for that transaction
3. The purchaser in such transaction will receive securities that are not restricted securities

Nonaffiliates may also be deemed not to be underwriters. A nonaffiliate who has not been an affiliate within the prior three months at the time of sale who sells restricted securities for his or her own account shall not be deemed to be an underwriter provided certain conditions under the rule have been met. Even if the requirements of the rule are not met, a person may seek an exemption under some other rule.

The SEC has provided a summary of the complex rule.[21]

- **Holding Period.** Rule 144(d)(1) distinguishes between an issuer who is subject to the filing requirements of the Exchange Act of 1934 from one who is not subject to its requirements. In the former case, the restricted securities must be held for a period of at least six months but the term is one year for an issuer that is not subject to the said filing requirements. The holding period begins when the actual acquisition or receipt of the security takes place.
- **Adequate Current Information**. Rule 144(c) states that adequate current information concerning the issuer must be made available to the investor. If the issuer is required to file reports with the SEC, such reports must be properly filed and posted.
- **Trading Volume Formula**. The number of shares that may be sold depends on whether the seller is or is not an affiliate. An affiliate may not sell more

than 1 percent of the restricted equity securities during any three-month period, or if the class is listed on a stock exchange or quoted on Nasdaq, the greater of 1 percent or the average reported weekly trading volume during the four weeks preceding the filing of a notice of sale on Form 144. Over-the-counter stocks can only be sold using the 1 percent measurement.

- **Ordinary Brokerage Transactions**. If you are an affiliate, the sales must be handled in all respects as routine trading transactions, and brokers may not receive more than a normal commission. Neither the seller nor the broker can solicit orders to buy the securities.
- **Filing a Notice of Proposed Sale With the SEC**. If you are an affiliate, you must file a notice with the SEC on Form 144 if the sale involves more than 5,000 shares or the aggregate dollar amount is greater than $50,000 in any three-month period. The sale must take place within three months of filing the form and, if the securities have not been sold, you must file an amended notice.

Thus, if there is compliance with the rule, the restricted securities may be resold within the limits provided therein. Note the proposed rule changes discussed in connection with Regulation 506 above.

Control Persons

Section 5 of the act does not provide for an exemption from registration of securities for control persons. The following criminal proceeding discusses the liability of such person.

United States v. Wolfson

405 F.2d 779 (2d Cir. 1968)

FACTS: There were 2,510,000 shares of Continental Enterprises, Inc., issued and outstanding. Of these shares, the defendant/appellant [person who appeals the case], Wolfson, himself with members of his immediate family and his right-hand man and first lieutenant, the defendant/appellant, Elkin B. Gerbert, owned 1,149,775 or in excess of 40 percent. The balance of the stock was in the hands of approximately 5,000 outside shareholders. The government's evidence at the trial was that between August 1, 1960, and January 31, 1962, Wolfson sold 404,150 shares of Continental through six brokerage houses; Gerbert sold 53,000 shares through three brokerage houses; and members of the Wolfson family, including Wolfson's wife, two brothers, a sister, the Wolfson Family Foundation, and four trusts for Wolfson's children, sold 176,675 shares through six brokerage houses. The evidence was undisputed that Wolfson, as the largest shareholder, had control over the officers and that no corporate policy was made without his knowledge and consent. No registration

statement was ever filed. The defendants/appellants alleged at the trial that they had no idea of the statutory requirements of registration nor were they advised either by their subordinates or by the brokerage firms. They further claimed they were not issuers, underwriters, or dealers under the act.

ISSUE: Whether the defendants/appellants were exempt under §5 of the act by their claim that they were not an issuer, underwriter, or dealer?

DECISION: The court of appeals stated they were not exempt under the act.

REASONING (Woodbury, J.): §5 of the Act, 15 U.S.C. §77e, in pertinent part provides:

> (a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—
>
> (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell or offer to buy such security through the use or medium of any prospectus or otherwise.***

However, §4 of the Act, 15 U.S.C. § 77d, exempts certain transactions from the provisions of §5 including "(1) Transactions by any person other than an issuer, underwriter, or dealer."

The appellants argue that they come within this exemption for they are not issuers, underwriters, or dealers. At first blush there would appear to be some merit in this argument. The immediate difficulty with it, however, is that §4(1) by its terms exempts only "transactions," not classes of persons, . . . and ignores §2(11) of the Act, which defines an "underwriter" to mean any person who has purchased from an issuer with a view to the distribution of any security, or participates directly or indirectly in such undertaking unless that person's participation is limited to the usual and customary seller's commission, and then goes on to provide:

> "As used in this paragraph the term 'issuer' shall include, in addition to an issuer, any person directly or indirectly *controlling* or controlled by *the issuer,* or any person under direct or indirect common control with the 'issuer.' "
>
> (Italics supplied)

In short, the brokers provided outlets for the stock of issuers and thus were underwriters . . . . Wherefore the stock was sold in "transactions by underwriters" which are not within the exemption of §4(1).

> But the appellants contend that the brokers in this case cannot be classified as underwriters because their part in the sales transactions came within §4(4), 15 U.S.C. §77d(4), which exempts "brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market but not the solicitation of such orders." The answer to this contention

> is that §4(4) was designed only to exempt the brokers' part in security transactions . . . . Control persons must find their own exemptions.

There is nothing inherently unreasonable for a broker to claim the exemption of §4(4), . . . when he is unaware that his customer's part in the transaction is not exempt. Indeed, this is indicated by the definition of "brokers' transaction" in 17 C.F.R. §230.154, commonly known as Rule 154, which provides:

> (a) The term "brokers' transaction" in §4(4) of the act shall be deemed to include transactions by a broker acting as agent for the account of any person controlling, controlled by, or under common control with, the issuer of the securities which are the subject of the transaction where:
>
> (4) The broker is *not aware* of circumstances indicating *** that the transactions are part of a distribution of securities on behalf of his principal.

And there can be no doubt that appellants' sale of over 633,000 shares (25% of the outstanding shares of Continental and more than 55% of their own holdings) was a distribution rather than an ordinary brokerage transaction. See Rule 154(6), which defines "distribution" for the purpose of paragraph (a) generally as "substantial" in relation to the number of shares outstanding and specifically as a sale of 1% of the stock within six months preceding the sale if the shares are traded on a stock exchange.

Certainly if the appellants' sales, which clearly amounted to a distribution under the above definitions, had been made through a broker or brokers with knowledge of the circumstances, the brokers would not be entitled to the exemption. It will hardly do for the appellants to say that because they kept the true facts from the brokers they can take advantage of the exemption the brokers gained thereby.

Questions

1. Should the case have been a civil rather than a criminal case? Did Wolfson have a legitimate argument that he did not willfully violate the statute because he was unaware that he fell into the category of an issuer, underwriter, or dealer?
2. Where a statute is as complex as the cited section of the statute, is the statement that "ignorance of the law is no excuse" valid under the circumstances?

Arbitration Agreements under the Act

A person opening a brokerage account will invariably be presented as part of the contract with the firm that any disputes with the firm are to be resolved by arbitration. Often, the investor is not aware that he or she has waived the right to

have a complaint heard at a trial in a court with or without a jury. When a claim is made and a lawsuit commenced, the brokerage firm will interpose a defense that the court does not possess the right to hear the case due to the waiver in favor of arbitration in the contract between the firm and its client. In a 1953 case, *Wilko v. Swan*,[22] the U.S. Supreme Court addressed the issue of whether, in an action brought by a customer against a securities brokerage firm to recover damages under the civil liabilities provisions of §12(2) of the Securities Act of 1933 for alleged misrepresentation in the sale of securities, the provision to arbitrate future controversies was void as contrary to §14 of the act. The court determined that an agreement for arbitration of any controversy arising in the future between the parties was void notwithstanding the provisions of the U.S. Arbitration Act.

Section 14 states that "any condition, stipulation, or provision binding any person acquiring any security to compliance with any provision of this title or of the rules and regulations of the Commission shall be void."

The Supreme Court in 1989 was called upon anew to determine whether a similar lawsuit instituted in the federal district court in another action made some 36 years later was barred by the arbitration provision in the agreement between the brokerage firm and the client.

De Quijas v. Shearson/American Express

490 U.S. 477 (1989)

FACTS: Petitioners are individuals who invested about $400,000 in securities. They signed a standard customer agreement with the broker, which included a clause stating that the parties agreed to settle any controversies "relating to [the] accounts" through binding arbitration that complies with specified procedures. The agreement to arbitrate these controversies is unqualified, unless it is found to be unenforceable under federal or state law. The investments turned sour, and petitioners eventually sued the respondent and its broker-agent in charge of the accounts, alleging that their money was lost in unauthorized and fraudulent transactions. In their complaint, they pleaded various violations of federal and state law, including claims under §12(2) of the Securities Act of 1933, and claims under three sections of the Securities Exchange Act of 1934.

ISSUE: Whether a predispute agreement to arbitrate claims under the Securities Act of 1933 is unenforceable, requiring resolution of the claims only in a judicial forum?

DECISION: The court decided that the arbitration agreement was valid and overruled its decision in *Wilko v. Swan.*

REASONING (Kennedy, J.): The *Wilko* case, decided in 1953, required the Court to determine whether an agreement to arbitrate future controversies constitutes a binding stipulation "to waive compliance with any provision" of the Securities Act, which is nullified by §14 of the Act. . . . The Court considered the language, purposes, and legislative history of the Securities Act and concluded that the agreement to arbitrate was void under

§14. But the decision was a difficult one in view of the competing legislative policy embodied in the Arbitration Act, which the Court described as "not easily reconcilable," and which strongly favors the enforcement of agreements to arbitrate as a means of securing "prompt, economical . . . and adequate solution of controversies . . . . " It has been recognized that *Wilko* was not obviously correct, for "the language prohibiting waiver of 'compliance with any provision of this title' could easily have been read to relate to substantive provisions of the Act, without including the remedy provisions . . . . "

To the extent that *Wilko* rested on suspicion of arbitration as a method of weakening the protections afforded in the substantive law to would-be complainants, it has fallen far out of step with our current strong endorsement of the federal statutes favoring this method of resolving disputes.

Once the outmoded presumption of disfavoring arbitration proceedings is set to one side, it becomes clear that the right to select the judicial forum and the wider choice of courts are not such essential features of the Securities Act that §14 is properly construed to bar any waiver of these provisions. There is no sound basis for construing the prohibition in §14 on waiving "compliance with any provision" of the Securities Act to apply to these procedural provisions. Although the first three measures do facilitate suits by buyers of securities, the grant of concurrent jurisdiction constitutes explicit authorization for complainants to waive those protections by filing suit in state court without possibility of removal to federal court. These measures, moreover, are present in other federal statutes which have not been interpreted to prohibit enforcement of predispute agreements to arbitrate. This avenue of relief is in harmony with the Securities Act's concern to protect buyers of securities by removing "the disadvantages under which buyers labor" in their dealings with sellers . . . .

"There is nothing in the record before us, nor in the facts of which we can take judicial notice, to indicate that the arbitral system . . . would not afford the plaintiff the rights to which he is entitled . . . . " Petitioners have not carried their burden of showing that arbitration agreements are not enforceable under the Securities Act. The language quoted above from §2 of the Arbitration Act also allows the courts to give relief where the party opposing arbitration presents "well-supported claims that the agreement to arbitrate resulted from the sort of fraud or overwhelming economic power that would provide grounds 'for the revocation of any contract.' "

Questions

1. Arbitrations were once disfavored by courts as usurping their power to try cases. How has the attitude toward arbitration changed over the decades? Can you give reasons for the change?
2. The court overruled its prior precedent. Given that fact, to what extent should precedents bind later rulings of the court?

Dodd-Frank Act and Arbitration

Section 921(a) of the Dodd-Frank Act added a new wrinkle to the issue of mandatory arbitration contracted for between the dealer and the customer. It states that §15 of the Exchange Act is amended to permit the SEC to enact a rule that "may prohibit, or impose conditions or limitations on the use of, agreements that require customers or clients of any broker, dealer, or municipal securities dealer to arbitrate any future dispute between them arising under the Federal securities laws, the rules and regulations thereunder, or the rules of a self-regulatory organization if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors." Thus, it will be left to future rule making of the SEC whether or not to follow the results of the *Swan* or *DeQuijas* decision.

Section 921(b) amends Section 205 the Advisers Act of 1940 by adding at the end thereof a new subsection (f), which gives the SEC authority to prohibit, restrict, or impose conditions on mandatory dispute arbitration "or limitations on the use of, agreements that require customers or clients of any investment adviser to arbitrate any future dispute between them arising under the Federal securities laws, the rules and regulations thereunder, or the rules of a self-regulatory organization if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors."

Civil Liability

Section 11. Civil Liability for False Statement Registration

Persons who violate the '33 Act may be subject to both civil and criminal liability. Section 11 of the act provides for civil liabilities for filing a registration statement that contains an untrue statement of a *material* fact or omits a *material* fact required to be stated therein or is necessary to make the statements therein not misleading. A person who acquires such security, unless it is shown that the person knew of the false fact or omission at the time of acquisition, may, either at law or in equity sue:

- Every person who signed the registration statement (§6 requires the registration statement to be signed by the issuer, CEO, CFO, comptroller, principal accounting officer, and majority of board of directors)
- Every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his or her liability is asserted
- Every person who, with his or her consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner
- Every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him or her, who has with his or her consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or

valuation that is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him or her
- Every underwriter with respect to such security.

If such person acquired the security after the issuer has made generally available to its security holders an earnings statement covering a period of at least 12 months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.

Reliance on the false statement or omission is presumed. Liability is joint and several, that is, each person may individually or collectively be found liable for damages to persons injured by the misrepresentation or omission. A person who sues must prove (1) purchase of the registered security; (2) material false information or omission; and (3) that he or she did not know of the falsity prior to purchase. There is no need to prove reliance on false statement or omission if purchased within one year of registration filing or causation, though the defendants can assert a defense that the loss was due to other factors.

Defenses to a Finding of Liability

Any of the above persons, *except the issuer*, may interpose one or more defenses to a civil action based on a claim of false representation or omission in the registration statement. They are as follows:

- Before the effective date of the registration statement, such person (a) had resigned or had taken steps to resign or ceased or refused to act in the capacity as stated in the registration statement; and (b) had advised the SEC and the issuer in writing of such action and that he or she would not be responsible to act in such capacity as set forth in the registration statement
- If the registration containing the false statement or omission became effective without his or her knowledge, then upon becoming aware of such fact, he or she immediately notified the SEC and gave reasonable public notice that such part of the registration statement had become effective without his knowledge
- *Due diligence defense*: He or she had reason to believe, after reasonable investigation, that the statements in the registration were true and that there were no omissions or were necessary to make the statements not misleading; more particularly if the statements were made by an expert
- Experts may present a defense that his or her statements or reports were not accurately represented on the registration statement and did believe that such statement or report was accurately presented on the registration statement

Damages

Persons injured by the false representation or omission may sue in a court of competent jurisdiction and may recover the following damages:

(1) The difference between the amount paid for the security (up to offering price) and the value thereof as of the time such suit was brought
(2) The price at which such security shall have been disposed of in the market before suit
(3) The price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought: Less damages not resulting from the false representation or omission

Note. The liability of an underwriter is limited to the public offering price of the security.

The following seminal case discusses the liability of the various parties for the filing of a registration statement that contained material false representations and, especially, the assertion of the defense of due diligence.

Escott v. Barchris Construction Corp.

283 F. Supp. 643 (S.D.N.Y. 1968)

FACTS: This is an action by purchasers of 5 ½ percent convertible subordinated fifteen-year debentures of BarChris Construction Corporation (BarChris) under §11 of the Securities Act of 1933. Plaintiffs allege that the registration statement with respect to these debentures filed with the SEC, which became effective on May 16, 1961, contained material false statements and material omissions. Defendants fall into three categories: (1) the persons who signed the registration statement; (2) the underwriters, consisting of eight investment banking firms, led by Drexel & Co. (Drexel); and (3) BarChris's auditors, Peat, Marwick, Mitchell & Co. (Peat, Marwick).

BarChris was in the business of constructing bowling alleys whose business expanded dramatically from 1956 to 1960. Parties purchasing the bowling alleys were permitted to defer payments for the construction over a period of years, which caused the company to require a large inflow of cash to continue its construction. In early 1961 it sold debentures [unsecured bonds] after filing the registration statement with the SEC. With the overbuilding of bowling alleys, the company suffered significant losses causing it to default in the payment of interest on the debentures and compelling it to file a Chapter 11 bankruptcy proceeding.

The registration statement was prepared and/or signed by the corporate parties, their attorneys, and attorneys for the underwriters, and the auditors. The court found that the earnings statement filed with the SEC contained figures that were overstated and liabilities that were understated.

ISSUES: (1) Did the registration statement contain false statements of fact, or did it omit to state facts that should have been stated in order to prevent it from being misleading?

(2) If so, were the facts which were falsely stated or omitted "material" within the meaning of the act?

(3) If so, have defendants established their affirmative defenses?

DECISION: The court determined: (1) there were false statements of fact, (2) which were material; and (3) the due diligence defenses were unavailing.

REASONING (McLean, J.): [The court recited the provisions of §11(b), which permit the due diligence defense of relying on expert parties after reasonable investigation. It found that the defendant senior officers of the corporation were clearly aware of the falsity of the numbers stated in the registration statement. Its financial officer was a CPA and knew or should have known the falsity of the financial data and thus could not claim due diligence. The attorney for the corporation, though a young attorney, was the secretary for the corporation and had to appreciate that the registration statement contained material errors].

[The court discussed the element of "materiality" as an element of civil liability for false representations.] It is a prerequisite to liability under §11 of the Act that the fact which is falsely stated in a registration statement, or the fact that is omitted when it should have been stated to avoid misleading, be "material." The regulations of the Securities and Exchange Commission pertaining to the registration of securities define the word as follows (17 C.F.R. § 230.405(*l*)):

> "The term 'material,' when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered."

What are "matters as to which an average prudent investor ought reasonably to be informed"? It seems obvious that they are matters which such an investor needs to know before he can make an intelligent, informed decision whether or not to buy the security.

Early in the history of the Act, a definition of materiality was given . . . . A material fact was there defined as:

> ***a fact which if it had been correctly stated or disclosed would have deterred or tended to deter the average prudent investor from purchasing the securities in question . . .

The average prudent investor is not concerned with minor inaccuracies or with errors as to matters which are of no interest to him. The facts which tend to deter him from purchasing a security are facts which have an important bearing upon the nature or condition of the issuing corporation or its business.

The "Due Diligence" Defenses

Section 11(b) of the act provides that:

> *** No person, other than the issuer, shall be liable *** who shall sustain the burden of proof—
>
> ***

(3) that (A) as regards any part of the registration statement not purporting to be made on the authority of an expert *** he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading; *** and (C) as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) *** he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading ***."

Section 11(c) defines "reasonable investigation" as follows:

> In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property.

Every defendant, except BarChris itself, to whom, as the issuer, these defenses are not available, and except Peat, Marwick, whose position rests on a different statutory provision, has pleaded these affirmative defenses. Each claims that (1) as to the part of the registration statement purporting to be made on the authority of an expert (which, for convenience, I shall refer to as the "expertised portion"), he had no reasonable ground to believe and did not believe that there were any untrue statements or material omissions, and (2) as to the other parts of the registration statement, he made a reasonable investigation, as a result of which he had reasonable ground to believe and did believe that the registration statement was true and that no material fact was omitted. As to each defendant, the question is whether he has sustained the burden of proving these defenses. Surprising enough,

there is little or no judicial authority on this question. No decisions directly in point under §11 have been found.

[Concerning the director of the corporation, the court said:] §11 imposes liability in the first instance upon a director, no matter how new he is. He is presumed to know his responsibility when he becomes a director. He can escape liability only by using that reasonable care to investigate the facts which a prudent man would employ in the management of his own property. In my opinion, a prudent man would not act in an important matter without any knowledge of the relevant facts, in sole reliance upon representations of persons who are comparative strangers and upon general information which does not purport to cover the particular case. To say that such minimal conduct measures up to the statutory standard would, to all intents and purposes, absolve new directors from responsibility merely because they are new. This is not a sensible construction of §11, when one bears in mind its fundamental purpose of requiring full and truthful disclosure for the protection of investors. [The court determined that the underwriters, except for one underwriter, made no investigation of the accuracy of the registration statement. With respect to the underwriters them, the court stated:]

The purpose of §11 is to protect investors. To that end the underwriters are made responsible for the truth of the prospectus. If they may escape that responsibility by taking at face value representations made to them by the company's management, then the inclusion of underwriters among those liable under §11 affords the investors no additional protection. To effectuate the statute's purpose, the phrase "reasonable investigation" must be construed to require more effort on the part of the underwriters than the mere accurate reporting in the prospectus of "data presented" to them by the company. It should make no difference that this data is elicited by questions addressed to the company officers by the underwriters, or that the underwriters at the time believe that the company's officers are truthful and reliable. In order to make the underwriters' participation in this enterprise of any value to the investors, the underwriters must make some reasonable attempt to verify the data submitted to them. They may not rely solely on the company's officers or on the company's counsel. A prudent man in the management of his own property would not rely on them.

It is impossible to lay down a rigid rule suitable for every case defining the extent to which such verification must go. It is a question of degree, a matter of judgment in each case. In the present case, the underwriters' counsel made almost no attempt to verify management's representations. I hold that that was insufficient.

On the evidence in this case, I find that the underwriters' counsel did not make a reasonable investigation of the truth of those portions of the prospectus which were not made on the authority of Peat, Marwick, as an expert. Drexel is bound by their failure. It is not a matter of relying upon

counsel for legal advice. Here the attorneys were dealing with matters of fact. Drexel delegated to them, as its agent, the business of examining the corporate minutes and contracts. It must bear the consequences of their failure to make an adequate examination.

[Concerning the accountants, Peat, Marwick, the Court said:]

Section 11(b) provides:

> Notwithstanding the provisions of subsection (a) no person . . . shall be liable as provided therein who shall sustain the burden of proof—
>
> ***
>
> (3) that . . . (B) as regards any part of the registration statement purporting to be made upon his authority as an expert . . . (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . .

This defines the due diligence defense for an expert. Peat, Marwick, has pleaded it.

The part of the registration statement purporting to be made upon the authority of Peat, Marwick, as an expert was, as we have seen, the 1960 figures. But because the statute requires the court to determine Peat, Marwick's belief, and the grounds thereof, "at the time such part of the registration statement became effective," for the purposes of this affirmative defense, the matter must be viewed as of May 16, 1961, and the question is whether at that time Peat, Marwick, after reasonable investigation, had reasonable ground to believe and did believe that the 1960 figures were true and that no material fact had been omitted from the registration statement which should have been included in order to make the 1960 figures not misleading. In deciding this issue, the court must consider not only what Peat, Marwick, did in its 1960 audit, but also what it did in its subsequent "S-1 review." The proper scope of that review must also be determined.

It may be noted that we are concerned at this point only with the question of Peat, Marwick's liability to plaintiffs. At the closing on May 24, 1961, Peat, Marwick, delivered a so-called comfort letter to the underwriters. This letter stated:

> It is understood that this letter is for the information of the underwriters and is not to be quoted or referred to, in whole or in part, in the Registration Statement or Prospectus or in any literature used in connection with the sale of securities.

Plaintiffs may not take advantage of any undertakings or representations in this letter. If they exceeded the normal scope of an S-1 review (a question

that I do not now decide) that is a matter that relates only to the cross claims that defendants have asserted against each other and that I have postponed for determination at a later date. [The court stated there were a number of material errors made by the firm's accountant concerning the audit.]

Thus, the court refused to grant a motion to dismiss the case based on the reasoning set forth above.

Questions

1. Should lawyer-officers held to a higher standard than nonlawyer-officers? Explain.
2. What steps should an individual take before agreeing to act as an officer of a corporation or to be a board member therein?

§ 12. Civil Liability in Connection with Prospectuses and Communications

Civil Liability under §12 extends to two situations: (1) a violation of §5 of the act, that is, failure to file a required registration statement and (2) offers or sells a security that includes a false statement of fact or omission in the prospectus or registration statement. The same due diligence defense applies for §11 liability and recovery is for the amount paid for the security plus interest upon tender of the security or damages less income received thereon if he or she no longer owns the security.

In the following case, the issues raised included whether a contract in a sale of stock in a private transaction can be considered as a prospectus under §12 of the act and whether the injured party can rescind the sale if there are misrepresentations.

Gustafson v. Alloyd

513 U.S. 561 (1995)

FACTS: Gustafson, McLean, and Butler in 1989 were the sole shareholders of Alloyd, Inc., a manufacturer of plastic packaging and automatic heat sealing equipment. Alloyd was formed, and its stock was issued, in 1961. In 1989, Gustafson decided to sell Alloyd and engaged KPMG Peat Marwick, to find a buyer. In response to information distributed by KPMG, Wind Point Partners II, L. P., agreed to buy substantially all of the issued and outstanding stock through Alloyd Holdings, Inc., a new corporation formed to effect the sale of Alloyd's stock. The shareholders of Alloyd Holdings were Wind Point and a number of individual investors.

In preparation for negotiating the contract with Gustafson, Wind Point undertook an extensive analysis of the company, relying in part on a formal business review prepared by KPMG. Alloyd's practice was to take inventory at year's end, so Wind Point and KPMG considered taking an

earlier inventory to use in determining the purchase price. In the end they did not do so, relying instead on certain estimates including provisions for adjustments after the transaction closed.

On December 20, 1989, Gustafson and Alloyd Holdings executed a contract of sale. Alloyd Holdings agreed to pay Gustafson and his coshareholders $18,709,000 for the sale of the stock plus a payment of $2,122,219, which reflected the estimated increase in Alloyd's net worth from the end of the previous year. Article IV of the purchase agreement, entitled "Representations and Warranties of the Sellers," included assurances that the company's financial statements "present fairly . . . the Company's financial condition" and that between the date of the latest balance sheet and the date the agreement was executed "there ha[d] been no material adverse change in . . . [Alloyd's] financial condition." The contract also provided that if the year-end audit and financial statements revealed a variance between estimated and actual increased value, the disappointed party would receive an adjustment.

The year-end audit of Alloyd revealed that Alloyd's actual earnings for 1989 were lower than the estimates relied upon by the parties in negotiating the adjustment amount of $2,122,219. Under the contract, the buyers had a right to recover an adjustment amount of $815,000 from the sellers. Nevertheless, on February 11, 1991, Alloyd Co. and Wind Point commenced a lawsuit seeking rescission of the contract under §12(2) of the Securities Act of 1933. Alloyd (the new company) claimed that statements made by Gustafson and his coshareholders regarding the financial data of their company were inaccurate, rendering untrue the representations and warranties contained in the contract. The buyers further alleged that the contract of sale was a "prospectus," so that any misstatements contained in the agreement gave rise to liability under §12(2) of the 1933 Act. Pursuant to the adjustment clause, the defendants remitted to the purchasers $815,000 plus interest, but the adjustment did not cause the purchasers to drop the lawsuit.

ISSUE: Whether this right of rescission extends to a private, secondary transaction, on the theory that recitations in the purchase agreement are part of a "prospectus"?

DECISION: The court held that the purchase agreement was not a prospectus and determined that there was no right of rescission under §12(2) of the Act of '33.

REASONING (Kennedy, J.) The rescission claim against Gustafson is based upon §12(2) of the 1933 Act, 48 Stat. 84, as amended, 15 U.S.C. §77*l* (2). In relevant part, the section provides that any person who

> offers or sells a security (whether or not exempted by the provisions of §77c of this title, other than paragraph (2) of subsection (a) of said §), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral

> communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,
>
> shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

§ 10. It provides, in relevant part:

> "Except to the extent otherwise permitted or required pursuant to this subsection or subsections (c), (d), or (e) of this section—
>
> "(1) a prospectus relating to a security other than a security issued by a foreign government or political subdivision thereof, shall contain the information contained in the registration statement . . . ;
>
> "(2) a prospectus relating to a security issued by a foreign government or political subdivision thereof shall contain the information contained in the registration statement . . . 15 U.S.C. § 77j(a).

Although §10 does not define what a prospectus is, it does instruct us what a prospectus cannot be if the Act is to be interpreted as a symmetrical and coherent regulatory scheme, one in which the operative words have a consistent meaning throughout. There is no dispute that the contract in this case was not required to contain the information contained in a registration statement and that no statutory exemption was required to take the document out of §10's coverage . . . . It follows that the contract is not a prospectus under §10. That does not mean that a document ceases to be a prospectus whenever it omits a required piece of information. It does mean that a document is not a prospectus within the meaning of that section if, absent an exemption, it need not comply with §10's requirements in the first place.

An examination of §10 reveals that, whatever else "prospectus" may mean, the term is confined to a document that, absent an overriding exemption, must include the "information contained in the registration statement." By and large, only public offerings by an issuer of a security, or by controlling shareholders of an issuer, require the preparation and filing of registration statements . . . . It follows, we conclude, that a prospectus under §10 is confined to documents related to public offerings by an issuer or its controlling shareholders . . . .

If the contract before us is not a prospectus for purposes of §10—as all must and do concede—it is not a prospectus for purposes of §12 either.

The relevant phrase in the definitional part of the statute must be read in its entirety, a reading which yields the interpretation that the term "prospectus" refers to a document soliciting the public to acquire securities. We find that definition controlling . . . .

When the 1933 Act was drawn and adopted, the term "prospectus" was well understood to refer to a document soliciting the public to acquire securities from the issuer . . . . In this respect, the word "prospectus" is a term of art, which accounts for congressional confidence in employing what might otherwise be regarded as a partial circularity in the formal, statutory definition . . . ("The term 'prospectus' means any prospectus . . . "). The use of the term "prospectus" to refer to public solicitations explains as well Congress' decision in §12(2) to grant buyers a right to rescind without proof of reliance . . . . ("The statements for which [liable persons] are responsible, although they may never actually have been seen by the prospective purchaser, because of their wide dissemination, determine the market price of the security . . . . ")

It is understandable that Congress would provide buyers with a right to rescind, without proof of fraud or reliance, as to misstatements contained in a document prepared with care, following well-established procedures relating to investigations with due diligence and in the context of a public offering by an issuer or its controlling shareholders. It is not plausible to infer that Congress created this extensive liability for every casual communication between buyer and seller in the secondary market. It is often difficult, if not altogether impractical, for those engaged in casual communications not to omit some fact that would, if included, qualify the accuracy of a statement . . . .

Nothing in the legislative history, moreover, suggests Congress intended to create two types of prospectuses, a formal prospectus required to comply with both §§10 and 12, and a second, less formal prospectus, to which only §12 would be applicable.

Questions

1. What other remedies, if any, are available given the circumstances of the case?
2. What if the sum claimed as an adjustment were a number of multiples of $815,000? Would it have made a difference in the result of the case?

§ 17. Civil Liability for Fraudulent Interstate Transactions

The act makes it unlawful to offer or sell securities or security-based swap agreements in interstate commerce to:

- Employ any device, scheme, or artifice to defraud
- Obtain money or property by means of an untrue statement of a material fact or omission to state a material fact necessary in order to make

the statements in light of the circumstances which they were made not misleading
- Engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser

It appears that there is no private right of action under this provision—only the SEC and an SRO may enforce.

Dodd-Frank Act added enforcement authority to the SEC. Although the SEC had the authority to commence action against an offending person for aiding and abetting a person committing a wrongful act under the Exchange Act of 1934, the Act expanded the scope of its authority to cover the '33 Act, the Investment Company Act of 1940, and the Investment Advisers Act. Under §§929M and 929N, the wording provides as follows: "Any person that knowingly *or recklessly* provides substantial assistance to another person in violation of a provision of this Act, or of any rule or regulation issued under this Act, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided [emphasis added]." Thus, the Dodd-Frank Act not only expands the coverage of the aiding and abetting prohibition but it also adds a much lower standard of proof by adding the words "or recklessly," which is much easier to prove than the previous "scienter" (knowledge) standard.

When issuing an order to cease and desist the offending action, the SEC may impose the following maximum monetary penalties:

- For a First Tier Offense: The maximum amount of a penalty or each act shall be $7,500 for a natural person or $75,000 for any other person.
- For a Second Tier Offense: The maximum amount of penalty for each such act or omission shall be $75,000 for a natural person or $375,000 for any other person, if the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement.
- For a Third Tier Offense: The maximum amount of penalty for each such act or omission shall be $150,000 for a natural person or $725,000 for any other person, if the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; and such act or omission directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons; or resulted in substantial pecuniary gain to the person who committed the act or omission. In determining which sums are to be imposed against the offending actor, the SEC may consider evidence submitted by the respondent of its ability to pay the fine, to continue in business, and its collectability.

Who May Bring an Action Under These Provisions?

May a private person bring a cause of action against the offending person under the act? The answer appears to be that there is no right of private enforcement under the provisions; only the SEC may bring an action.

Central Bank of Denver, N. A. *v.* First Interstate Bank of Denver, N.A.

511 U.S. 164 (1994)

FACTS: In 1986 and 1988, the Colorado Springs-Stetson Hills Public Building Authority (Authority) issued a total of $26 million in bonds to finance public improvements at Stetson Hills, a planned residential and commercial development in Colorado Springs. Petitioner, Central Bank of Denver, served as indenture trustee for the bond issues. The bonds were secured by landowner assessment liens, which covered about 250 acres for the 1986 bond issue and about 272 acres for the 1988 bond issue. The bond covenants required that the land subject to the liens be worth at least 160 percent of the bonds' outstanding principal and interest. The covenants required AmWest Development, the developer of Stetson Hills, to give Central Bank an annual report containing evidence that the 160 percent test was met. In January 1988, AmWest provided Central Bank with an updated appraisal of the land securing the 1986 bonds and of the land proposed to secure the 1988 bonds.

The 1988 appraisal showed land values almost unchanged from the 1986 appraisal. Soon afterward, Central Bank received a letter from the senior underwriter for the 1986 bonds. Noting that property values were declining in Colorado Springs and that Central Bank was operating on an appraisal over 16 months old, the underwriter expressed concern that the 160 percent test was not being met. Central Bank asked its in-house appraiser to review the updated 1988 appraisal. The in-house appraiser decided that the values listed in the appraisal appeared optimistic considering the local real estate market. He suggested that Central Bank retain an outside appraiser to conduct an independent review of the 1988 appraisal.

After an exchange of letters between Central Bank and AmWest in early 1988, Central Bank agreed to delay independent review of the appraisal until the end of the year, six months after the June 1988 closing on the bond issue. Before the independent review was complete, however, the authority defaulted on the 1988 bonds. Respondents First Interstate Bank of Denver and Jack K. Naber had purchased $2.1 million of the 1988 bonds. After the default, respondents sued the authority, the 1988 underwriter, a junior underwriter, an AmWest director, and Central Bank for violations of §10(b) of the Securities Exchange Act of 1934.

The complaint alleged that the authority, the underwriter defendants, and the AmWest director had violated §10(b). The complaint also alleged that Central Bank was "secondarily liable under §10(b) for its conduct in aiding and abetting the fraud." Central Bank retained an outside appraiser to conduct an independent review of the 1988 appraisal. After an exchange of letters between Central Bank and AmWest in early 1988, Central Bank agreed to delay an independent review of the appraisal until the end of

the year, six months after the June 1988 closing on the bond issue. Before the independent review was complete, however, the authority defaulted on the 1988 bonds. Respondents First Interstate Bank of Denver and Jack K. Naber had purchased $2.1 million of the 1988 bonds. After the default, respondents sued the authority, the 1988 underwriter, a junior underwriter, an AmWest director, and Central Bank for violations of §10(b) of the Securities Exchange Act of 1934. The complaint alleged that the authority, the underwriter defendants, and the AmWest director had violated §10(b). The complaint also alleged that Central Bank was "secondarily liable under §10(b) for its conduct in aiding and abetting the fraud."

ISSUE: Whether private civil liability under §10(b) extends as well to those who do not engage in the manipulative or deceptive practice, but who aid and abet the violation?

DECISION: The Supreme Court, in a 5-4 decision, determined that private liability did not extend under §120(b) to those who aid and abet the violation.

REASONING (Kennedy, J.): As we have interpreted it, §10(b) of the Securities Exchange Act of 1934 imposes private civil liability on those who commit a manipulative or deceptive act in connection with the purchase or sale of securities. In this case, we must answer a question reserved in two earlier decisions: whether private civil liability under §10(b) extends as well to those who do not engage in the manipulative or deceptive practice, but who aid and abet the violation . . . .

In the wake of the 1929 stock market crash and in response to reports of widespread abuses in the securities industry, the 73d Congress enacted two landmark pieces of securities legislation: the Securities Act of 1933 (1933 Act) and the Securities Exchange Act of 1934 (1934 Act) . . . . The 1933 Act regulates initial distributions of securities, and the 1934 Act for the most part regulates postdistribution trading . . . . Together, the Acts "embrace a fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of caveat emptor . . . . "

The 1933 and 1934 Acts create an extensive scheme of civil liability. The Securities and Exchange Commission (SEC) may bring administrative actions and injunctive proceedings to enforce a variety of statutory prohibitions. Private plaintiffs may sue under the express private rights of action contained in the Acts. They may also sue under private rights of action we have found to be implied by the terms of §§10(b) and 14(a) of the 1934 Act . . . . This case concerns the most familiar private cause of action: the one we have found to be implied by §10(b), the general antifraud provision of the 1934 Act. §10(b) states:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange

> "(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe . . . ."

Rule 10b-5, adopted by the SEC in 1942, casts the proscription in similar terms:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> "(a) To employ any device, scheme, or artifice to defraud,
>
> "(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> "(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> "in connection with the purchase or sale of any security . . . "

In our cases addressing §10(b) and Rule 10b-5, we have confronted two main issues. First, we have determined the scope of conduct prohibited by §10(b) . . . . Second, in cases where the defendant has committed a violation of §10(b), we have decided questions about the elements of the 10b-5 private liability scheme: for example, whether there is a right to contribution, what the statute of limitations is, whether there is a reliance requirement, and whether there is an in pari delicto defense . . . .

The latter issue, determining the elements of the 10b-5 private liability scheme, has posed difficulty because Congress did not create a private §10(b) cause of action and had no occasion to provide guidance about the elements of a private liability scheme. We thus have had "to infer how the 1934 Congress would have addressed the issue[s] had the 10b-5 action been included as an express provision in the 1934 Act . . . . "

With respect, however, to the first issue, the scope of conduct prohibited by §10(b), the text of the statute controls our decision. In §10(b), Congress prohibited manipulative or deceptive acts in connection with the purchase or sale of securities. It envisioned that the SEC would enforce the statutory prohibition through administrative and injunctive actions. Of course, a private plaintiff now may bring suit against violators of §10(b). But the private plaintiff may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of §10(b). With respect, however, to the first issue, the scope of conduct prohibited by §10(b), the text of the statute controls our decision. In §10(b), Congress prohibited manipulative or deceptive acts in connection with the purchase or sale of securities. It envisioned that

the SEC would enforce the statutory prohibition through administrative and injunctive actions. Of course, a private plaintiff now may bring suit against violators of §10(b). But the private plaintiff may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of §10(b) . . . .

Our consideration of statutory duties, especially in cases interpreting §10(b), establishes that the statutory text controls the definition of conduct covered by §10(b). That bodes ill for respondents, for "the language of §10(b) does not in terms mention aiding and abetting . . . . "

Congress has not enacted a general civil aiding and abetting statute either for suits by the Government (when the Government sues for civil penalties or injunctive relief) or for suits by private parties. Thus, when Congress enacts a statute under which a person may sue and recover damages from a private defendant for the defendant's violation of some statutory norm, there is no general presumption that the plaintiff may also sue aiders and abettors . . . .

In sum, it is not plausible to interpret the statutory silence as tantamount to an implicit congressional intent to impose §10(b) aiding and abetting liability . . . . Because the text of §10(b) does not prohibit aiding and abetting, we hold that a private plaintiff may not maintain an aiding and abetting suit under §10(b). The absence of §10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met . . . . In any complex securities fraud, moreover, there are likely to be multiple violators; in this case, for example, respondents named four defendants as primary violators.

Questions

1. If a court makes a decision based on a statute and not under the Constitution of the United States of which Congress disagrees, how may it change the result in future cases?
2. Did the Dodd-Frank Act change the result of this case for future cases?

In the above case decided before the adoption of the Dodd-Frank Act, the U.S. Supreme Court determined that a private party may not bring an action against persons who aid and abet the perpetrator of the forbidden act. Congressional legislation could have later provided for such lawsuit but failed to do so. Although the Dodd-Frank Act did not grant private relief, it did provide in §929Z that the Comptroller General of the United States conduct and report a study on the

impact of authorizing a private right of action against any person who aids or abets another person in violation of the securities laws. The study is to include (1) a review of the role of secondary actors in companies' issuance of securities; (2) the courts' interpretation of the scope of liability for secondary actors under federal securities laws after January 14, 2008; and (3) the types of lawsuits decided under the Private Securities Litigation Act of 1995.

Criminal Liability

Section 24 of the '33 Act has a criminal component that states that any person who willfully violates the provisions of the act or the rules and regulations promulgated by the SEC or any person or who willfully makes any untrue statement of material fact in a registration statement or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading may be criminally prosecuted and be subject to a fine of not more than $10,000 or imprisoned for up to five years, or both.

In the next chapter, we will examine the provisions of the second of the two major statutes that continue to be the bases for securities regulation, namely, the Securities Exchange Act of 1934 as well as a brief review of securities laws and regulations in the European Union and People's Republic of China.

CHAPTER 5

Securities Regulation Part II: Securities Exchange Act of 1934 and International Securities Regulation

Securities and Exchange Act of 1934

A year after the Securities Act of 1933 was enacted, Congress passed the Securities Exchange Act. Whereas the '33 Act was designed to govern and protect investors when there was a first issuance of a security, the purpose of the '34 Act was to regulate securities transactions on the secondary market. Inasmuch as these transactions occurred almost entirely on stock exchanges, the act provided for the registration of the exchanges under the auspices of the Securities and Exchange Commission (SEC) that was commenced by the act. Much of the actual regulation is conducted by self-regulatory organizations (SROs), such as the Financial Industry Regulatory Authority (FINRA) and securities' exchanges.

Securities and Exchange Commission

Section 4 of the '34 Act created the SEC that consists of five members appointed by the president subject to the advice and consent of the Senate. No more than three members may be of the same political party, each of whom serves for a period of five years, with staggered terms so that there is one expiration each year. The SEC is composed of the Divisions of Corporate Finance, Market Regulation, Enforcement, Investment Management, the Office of Compliance Inspections and Examinations, and many other sections. It employs numerous financial analysts and examiners, accountants, lawyers, economists, investigators, and other professionals to carry on its responsibilities. It is responsible for registering securities under the securities acts, and to regulate brokerage firms, transfer agents, clearing agencies, stock exchanges, and SROs. It possesses the power to enforce the statutes and regulations with wide-ranging disciplinary powers and to require publicly traded companies to file periodic reports.

The SEC also has an Office of the Investor Advocate whose functions are to assist retail investors in resolving disputes with it and with SROs; identify problems investors have with financial service providers and investment products;

analyze the impact of the SEC's and SROs' regulations and rules; and identify changes in regulations that the commission should adopt to promote the interests of investors. The Investor Advocate is required to appoint an ombudsman who has the responsibilities of acting as a liaison between the SEC and retail investors as well as making recommendations concerning compliance with the SEC's and SROs' rules and privacy matters.

Registration and Periodic Disclosure Requirements

The main thrust of the Exchange Act is to protect investors by compelling public companies to provide public disclosures of their finances that are made available through the SEC's EDGAR website. The disclosures therein assist investors in making competent decisions about whether or not to invest in a particular security, The act also provides for direct regulation over the stock exchanges wherein most secondary trades take place.

Registration

Subject to exemptions under the Act, §12(a) of the act makes it unlawful for any member, broker, or dealer to effect any transaction in any security on a national securities exchange unless the said security is registered. Although particular securities have to be registered under the '33 Act, the '34 Act requires all public companies to register with the SEC including the entire class of securities being issued. Under the '33 Act, registration is of the *units* of securities that are being sold for the particular transaction, for example, a specific number of shares to be sold. The '34 Act, however, provides for a one-time registration of the *class* of securities—for example, common stock, preferred stock. To sell additional units you must reregister under the '33 Act but there is no need to do so under the '34 Act if the issuer is selling additional shares of the same class of stock that was previously registered.

Section 12(b) of the act states that a security may be registered on a national securities exchange by filing an application with both the exchange and the SEC. The information, which is publicly available through EDGAR, includes the following details as to the issuer and controlling persons of the issuer:

- Organizational structure
- Terms, rights, and privileges of different classes of securities offered
- Names of officers, directors, underwriters, and persons holding more than 10 percent of any class of security
- Remuneration to others than directors and officers exceeding $20,000 per annum
- Bonus and profit-sharing arrangements
- Management and service contracts;
- Options existing or to be created in respect of their securities
- Material contracts not made in the ordinary course of business

- Balance sheets for not more than the three preceding years
- Profit and loss statements for not more than the three preceding fiscal years, certified if required by the SEC
- Other documents that the SEC may require

An issuer not registered with a national securities exchange but that transacts its shares in the over-the-counter market is subject to a continuous disclosure system under §12(g)(1), which requires the filing of a registration statement if, within 120 days after the last day of its first fiscal year, the issuer has total assets exceeding $10,000,000 and a class of equity security (other than an exempted security) held of record by either 2,000 persons, or 500 persons who are not accredited investors.

Disclosure

In addition to the information disclosed by the registration filing under the '34 Act, §13 is an extensive section requiring a mandatory disclosure system. Every issuer is required to file reports as required by the SEC. They include (1) annual reports (Form 10K) certified by independent public accountants; (2) quarterly reports (Form 10Q), and (3) other reports as required by the commission for important specified changes (Form 8-K). The annual reports are to be signed by the issuer and by its chief executive officer (CEO), chief financial officer (CFO), and accounting officers, as well as a majority of the board of directors with certifications by the CEO and CFO concerning financial information stated therein. Moreover, the Sarbanes-Oxley Act requires that the certification include their personal supervision that there are systems in place that would ensure the accuracy of the financial data.

There were a number of additional changes brought about by the Sarbanes-Oxley Act of 2002 that are reflected both in the act and in the regulations. The SEC is empowered to compel reports with details of balance sheets, earnings statements, valuation of assets and liabilities, and depreciation and depletion. Every issuer with registered securities under the act is required to file reports, make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer. Every issuer has to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that:

- Transactions are executed in accordance with management's general or specific authorization
- Transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements
- Maintain accountability for assets
- Access to assets is permitted only in accordance with management's general or specific authorization

- The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences

Criminal Liability

A CEO or the CFO, by certifying to the accuracy of the reports, verifies that the information stated therein is fairly presented in all material respects. They represent that the company adopted internal systems to ensure accurate reporting of financial data. Both of the said officers, or officers of equivalent status, are subject to extreme criminal penalties. If any such person knew that the report did not accurately reflect the true financial condition of the company, he or she is liable to imprisonment of ten years and/or a fine of $1 million. If the CEO or CFO willfully falsely certifies to the accuracy of the financial condition of the company in the said reports, such executive is liable to a fine of up to $5 million and/or imprisonment up to 20 years.

Disclosure of Foreign Holding

If an issuer, required to file reports under §12, holds 50 percent or less of the voting power of a domestic or foreign firm, then the issuer need only proceed in good faith to use its influence that is reasonable under the circumstances to cause the firm to devise and maintain a system of internal accounting controls, particularly if the firm is subject to foreign rules and regulations. The reasonableness of the firm's actions is determined by the standard of conduct that would satisfy reasonably prudent officials.

Acquisition of 5 Percent or More of Shares

Section 13(d)(1) of the '34 Act requires any person, who directly or indirectly acquires 5 percent or more of the beneficial ownership of any equity security of a §12 class of security (security covered by the '33 Act unless exempted) or any equity security of an insurance company, or swap, must report the acquisition within ten days to the SEC.

The report is to include the background, and identity, residence, citizenship of such person, and the source and amount of funds borrowed. If the purpose of the acquisition or any prospective acquisitions is to acquire control of the business of the issuer of the securities, then the acquirer must state the plans or proposals she or he may have to liquidate such issuer, to sell its assets to or merge it with any other persons, or to make any other major change in its business or corporate structure. In addition, the acquirer of 5 percent or more shares must state the number of shares of such security that are beneficially owned and the number of shares concerning which there is a right to acquire, directly or indirectly, by such person, and by each associate of such person, giving the background, identity, residence, and citizenship of each such associate. Information as to any contracts,

arrangements, or understandings with any person with respect to any securities of the issuer must also be stated.

Exceptions include any acquisition or offer by means of filing registration statement under the '33 Act; any acquisition of 2 percent or less; and any acquisition of an equity security by the issuer of the security.

Liability

Section 10b "Manipulative and Deceptive Devices"

Section 10b of the Exchange Act states that it shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

> b. To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in §206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the SEC may prescribe as necessary or appropriate in the public interest or for the protection of investors.

SEC Rule 10b-5. Employment of Manipulative and Deceptive Practices
Rule 10b-5 states as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a *material fact* [emphasis added] necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security

Elements of Proof Necessary to Establish a Private Cause of Action
In order for a private party or the SEC to bring an action under §10b and Rule 10b-5, it is necessary to prove the following elements: (1) there was a manipulation or deception; (2) that the said manipulation or deception was material; (3) that it was made in connection with the purchase or sale of securities; and (4) scienter (knowingly act or omit to do so). A private person may also have to establish that he or she or it has standing to bring a lawsuit by establishing personal harm; reliance on the manipulated or deceptive act or omission; and that the manipulation or deception caused the financial loss to the person commencing the lawsuit. We discuss below the meaning and application of the

said elements particularly that of manipulation or deception, materiality, scienter, and standing to sue.

Manipulation or Deception. Rule 10b-5 sets forth the meaning of manipulation or deception by making it unlawful to defraud, make untrue material statements, or to engage in practices that constitute a fraud or deceit. In the following U.S. Supreme Court case, the court determined at least one circumstance that does not constitute fraud or deception in the statute. In it, the court attempts to clarify its meaning.

Santa Fe Industries, Inc. v. Green

430 U.S. 462 (1977)

FACTS: In 1936, petitioner Santa Fe Industries, Inc. (Santa Fe), acquired control of 60 percent of the stock of Kirby Lumber Corp. (Kirby), a Delaware corporation. Through a series of purchases over the succeeding years, Santa Fe increased its control of Kirby's stock to 95 percent; the purchase prices during the period 1968–1973 ranged from $65 to $92.50 per share. In 1974, wishing to acquire 100 percent ownership of Kirby, Santa Fe availed itself of §253 of the Delaware Corporation Law, known as the "short-form merger" statute. Section 253 permits a parent corporation owning at least 90 percent of the stock of a subsidiary to merge with that subsidiary, upon approval by the parent's board of directors, and to make payment in cash for the shares of the minority stockholders. The statute does not require the consent of, or advance notice to, the minority stockholders. However, notice of the merger must be given within ten days after its effective date, and any stockholder who is dissatisfied with the terms of the merger may petition the Delaware Court of Chancery for a decree ordering the surviving corporation to pay him or her the fair value of their shares, as determined by a court-appointed appraiser subject to review by the court.

Santa Fe obtained independent appraisals of the physical assets of Kirby—land, timber, buildings, and machinery—and of Kirby's oil, gas, and mineral interests. These appraisals, together with other financial information, were submitted to Morgan Stanley & Co. (Morgan Stanley), an investment banking firm retained to appraise the fair market value of Kirby stock. Kirby's physical assets were appraised at $320 million (amounting to $640 for each of the 500,000 shares); Kirby's stock was valued by Morgan Stanley at $125 per share. Under the terms of the merger, minority stockholders were offered $150 per share.

The provisions of the short-form merger statute were fully complied with. The minority stockholders of Kirby were notified the day after the merger became effective and were advised of their right to obtain an appraisal in Delaware court if dissatisfied with the offer of $150 per share. They also received an information statement containing, in addition to the

relevant financial data about Kirby, the appraisals of the value of Kirby's assets and the Morgan Stanley appraisal concluding that the fair market value of the stock was $125 per share.

Respondents (plaintiffs), minority stockholders of Kirby, objected to the terms of the merger, but did not pursue their appraisal remedy in the Delaware Court of Chancery. Instead, they brought this action in federal court on behalf of the corporation and other minority stockholders, seeking to set aside the merger or to recover what they claimed to be the fair value of their shares. The amended complaint asserted that, based on the fair market value of Kirby's physical assets as revealed by the appraisal included in the information statement sent to minority shareholders, Kirby's stock was worth at least $772 per share. The complaint alleged further that the merger took place without prior notice to minority stockholders; that the purpose of the merger was to appropriate the difference between the "conceded pro rata value of the physical assets," and the offer of $150 per share—to "freez[e] out the minority stockholders at a wholly inadequate price," and that Santa Fe, knowing the appraised value of the physical assets, obtained a "fraudulent appraisal" of the stock from Morgan Stanley and offered $25 above that appraisal "in order to lull the minority stockholders into erroneously believing that [Santa Fe was] generous."

This course of conduct was alleged to be "a violation of Rule 10b-5 because defendants employed a 'device, scheme, or artifice to defraud' and engaged in an 'act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.' " Morgan Stanley assertedly participated in the fraud as an accessory by submitting its appraisal of $125 per share although knowing the appraised value of the physical assets.

ISSUE: Whether §10 (b) of the Securities Exchange Act of 1934 and Rule 10b-5 applies in the context of a Delaware short-form merger transaction used by the majority stockholder of a corporation to eliminate the minority interest?

DECISION: The court held that the statute did not apply under the facts stated above.

REASONING (White, J.): § 10 (b) of the 1934 Act makes it "unlawful for any person . . . to use or employ . . . any manipulative or deceptive device or contrivance in contravention of [Securities and Exchange Commission rules]"; Rule 10b-5, promulgated by the SEC under §10 (b), prohibits, in addition to nondisclosure and misrepresentation, any "artifice to defraud" or any act "which operates or would operate as a fraud or deceit . . . . "

Ernst & Ernst [discussed below] makes clear that in deciding whether a complaint states a cause of action for "fraud" under Rule 10b-5, "we turn first to the language of §10 (b), for '[t]he starting point in every case involving construction of a statute is the language itself . . . . ' " quoting *Blue Chip*

Stamps v. Manor Drug Stores, . . . In holding that a cause of action under Rule 10b-5 does not lie for mere negligence, the Court began with the principle that "[a]scertainment of congressional intent with respect to the standard of liability created by a particular section of the [1933 and 1934] Acts must . . . rest primarily on the language of that section, . . . " and then focused on the statutory language of §10 (b)—"[t]he words 'manipulative or deceptive' used in conjunction with 'device or contrivance . . . ' " The same language and the same principle apply to this case.

It is our judgment that the transaction, if carried out as alleged in the complaint, was neither deceptive nor manipulative and therefore did not violate either §10 (b) of the act or Rule 10b-5 . . . . The case comes to us on the premise that the complaint failed to allege a material misrepresentation or material failure to disclose. The finding of the District Court, undisturbed by the Court of Appeals, was that there was no "omission" or "misstatement" in the information statement accompanying the notice of merger. On the basis of the information provided, minority shareholders could either accept the price offered or reject it or seek an appraisal in the Delaware Court of Chancery. Their choice was fairly presented, and they were furnished with all relevant information on which to base their decision.

It is also readily apparent that the conduct alleged in the complaint was not "manipulative" within the meaning of the statute. "Manipulation" is "virtually a term of art when used in connection with securities markets." *Ernst & Ernst,* 425 U.S., at 199. The term refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity . . . . No doubt Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices. But we do not think it would have chosen this "term of art" if it had meant to bring within the scope of §10 (b) instances of corporate mismanagement such as this, in which the essence of the complaint is that shareholders were treated unfairly by a fiduciary . . . . .

Questions

1. The case was brought in federal court rather than the Delaware state court. On what basis did it do so?
2. When do federal securities laws trump that of state securities laws?

Materiality. The meaning of "material fact" was unclear thus leading to conflicting judicial interpretations. In the following case, the U.S. Supreme Court sought to clarify its meaning. In it, the court adopts the "fraud-on-the-market" theory that posits that the price of a company's stock is based on the available information about the business and the posted financial information. The decision is followed by additional cases that discuss its meaning.

Basic Inc. v. Levinson

485 U.S. 224 (1988)

FACTS: Combustion Engineering, Inc., an engineering company that produced alumina-based refractories [materials that maintain strength at high temperature], wanted to acquire Basic. Beginning in September 1976, Combustion representatives had meetings and telephone conversations with Basic's officers and directors concerning the possibility of a merger. During 1977 and 1978, Basic made three public statements denying that it was engaged in merger negotiations. Thereafter, Basic asked the New York Stock Exchange to suspend trading in its shares and issued a release stating that it had been "approached" by another company concerning a merger.

On December 19, Basic's board endorsed Combustion's offer of $46 per share for its common stock, and on the following day publicly announced its approval of Combustion's tender offer for all outstanding shares. The respondents, Levinson and others, were former Basic shareholders who sold their stock after Basic's first public statement of October 21, 1977, and before the suspension of trading in December 1978. They then brought a class action against Basic and its directors asserting that the defendants (petitioners on this appeal) issued three false or misleading public statements, and thereby were in violation of §10(b) of the 1934 Act and of Rule 10b-5. They alleged that they were injured by selling Basic shares at artificially depressed prices in a market affected by petitioners' misleading statements and in reliance thereon.

ISSUES: (1) What is the standard to be used concerning the application of the materiality requirement of §10(b) of the Exchange Act of 1934 and the SEC's Rule 10b-5 in the context of preliminary corporate merger discussions?

(2) Whether a person who traded a corporation's shares on a securities exchange after the issuance of a materially misleading statement by the corporation may invoke a rebuttable presumption that, in trading, he relied on the integrity of the price set by the market?

DECISION: (1) The court upheld the materiality standard that was set forth in the court's prior decision in the *TSC Industries* case stated below.

(2) The person may rely on the integrity of the market price based on a materially misleading statement by the corporation.

REASONING (Blackmun, J.): The 1934 Act was designed to protect investors against manipulation of stock prices . . . . Underlying the adoption of extensive disclosure requirements was a legislative philosophy: "There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy . . . . " This Court "repeatedly has described the *fundamental purpose of the Act as implementing a 'philosophy of full disclosure . . . '* "

Pursuant to its authority under §10(b) of the 1934 Act, . . . the Securities and Exchange Commission promulgated Rule 10b-5 . . . , legislative acquiescence, and the passage of time have removed any doubt that a private cause of action exists for a violation of §10(b) and Rule 10b-5, and constitutes an essential tool for enforcement of the 1934 Act's requirements.

The Court previously has addressed various positive and common law requirements for a violation of §10(b) or of Rule 10b-5 . . . . The Court also explicitly has defined a standard of materiality under the securities laws, see *TSC Industries, Inc. v. Northway, Inc.,* 426 U.S. 438 (1976), concluding in the proxy solicitation context that "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote . . . . " Acknowledging that certain information concerning corporate developments could well be of "dubious significance," . . . the Court was careful not to set too low a standard of materiality; it was concerned that a minimal standard might bring an overabundance of information within its reach, and lead management "simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decision making . . . " It further explained that, to fulfill the materiality requirement, "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 . . . . " We now expressly adopt the TSC Industries standard of materiality for the §10(b) and Rule 10b-5 context.

The application of this materiality standard to preliminary merger discussions is not self-evident. Where the impact of the corporate development on the target's fortune is certain and clear, the *TSC Industries* materiality definition admits straightforward application. Where, on the other hand, the event is contingent or speculative in nature, it is difficult to ascertain whether the "reasonable investor" would have considered the omitted information significant at the time. Merger negotiations, because of the ever-present possibility that the contemplated transaction will not be effectuated, fall into the latter category.

We . . . find no valid justification for artificially excluding from the definition of materiality information concerning merger discussions, which would otherwise be considered significant to the trading decision of a reasonable investor, merely because agreement-in-principle as to price and structure has not yet been reached by the parties or their representatives.

Whether merger discussions in any particular case are material therefore depends on the facts. Generally, in order to assess the probability that the event will occur, a fact finder will need to look to indicia of interest in the transaction at the highest corporate levels . . . . As we clarify today, materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information . . . . The fact-specific

inquiry we endorse here is consistent with the approach a number of courts have taken in assessing the materiality of merger negotiations . . . .

We turn to the question of reliance and the fraud-on-the-market theory. Succinctly put:

> The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business . . .. Misleading statements will therefore . . . defraud purchasers of stock even if the purchasers do not directly rely on the misstatements . . .. The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.. . .
>
> This case required resolution of several common questions of law and fact concerning the falsity or misleading nature of the three public statements made by Basic, the presence or absence of scienter, and the materiality of the misrepresentations, if any. In their amended complaint, the named plaintiffs alleged that, in reliance on Basic's statements, they sold their shares of Basic stock in the depressed market created by petitioners . . . .

We agree that reliance is an element of a Rule 10b-5 cause of action . . . . Reliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury . . . . There is, however, more than one way to demonstrate the causal connection . . . . The modern securities markets, literally involving millions of shares changing hands daily, differ from the face-to-face transactions contemplated by early fraud cases, . . . and our understanding of Rule 10b-5's reliance requirement must encompass these differences . . . .

> In face-to-face transactions, the inquiry into an investor's reliance upon information is into the subjective pricing of that information by that investor. With the presence of a market, the market is interposed between seller and buyer and, ideally, transmits information to the investor in the processed form of a market price. Thus, the market is performing a substantial part of the valuation process performed by the investor in a face-to-face transaction. The market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price.

Presumptions typically serve to assist courts in managing circumstances in which direct proof, for one reason or another, is rendered difficult . . . . The courts below accepted a presumption, created by the fraud-on-the-market theory and subject to rebuttal by petitioners, that persons who had traded Basic shares had done so in reliance on the integrity of the price set by the market, but because of petitioners' material misrepresentations that

price had been fraudulently depressed.... Congress expressly relied on the premise that securities markets are affected by information, and enacted legislation to facilitate an investor's reliance on the integrity of those markets:

> No investor, no speculator, can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells. The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings [*sic*] about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indices of real value....

The presumption is also supported by common sense and probability. Recent empirical studies have tended to confirm Congress' premise that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations.... [Levinson thus prevailed].

Questions

1. Did the Private Securities Litigation Reform Act of 1995 (PSLRA) change the result for future cases?
2. To what extent did the decision open the floodgates to investors' lawsuits whereby they pointed to some exaggerated statement or other misstatement as the underlying reason for purchasing a security they otherwise would not have purchased?[1]

In the following cases, the effects of the PSLRA are illustrated especially concerning the element of materiality and its relevance to optimistic projections of a company's future performance.

City of Omaha v. CBS Corp.

No. 11–2575 (2d Cir. May 10, 2012)

The City of Omaha, the Nebraska Civilian Employees' Retirement System, and the City's Police and Fire Retirement System sued the CBS Corp. and others alleging violation of Exchange Act §10b and SEC Rule 10b-5 for misrepresentations regarding CBS's revenue and the value of its assets in 2008. In October 2008, CBS announced the performance of an interim impairment test on its existing goodwill and that, as a result, it expected to incur a noncash impairment charge during the third quarter of 2008 of

approximately $14 billion. The plaintiffs alleged that CBS and the other defendants knew the results much earlier in the year and, by failing to disclose the facts sooner, they acted knowingly and recklessly in violation of the act and rule.

The federal court of appeals upheld the district court's dismissal of the action finding that the plaintiffs failed to plausibly allege that they believed the statements regarding goodwill at the time they made them to plead a material misstatement or omission. The complaint contained only conclusory statements, not factual allegations, to support their claims and was devoid of allegations that the defendants did not believe in their statements of opinion regarding CBS' goodwill at the time they made them. Citing the Basic Inc. case above, the complaint failed to show reliance upon a fraudulently inflated price as required by the act and rule. In essence, the estimates of goodwill and loan loss reserves were subjective and thus were statements of opinion rather than fact, which, thus, would not support their claims.

In re Boston Scientific Corp. Securities Litigation

No. 1:05-cv-11934-DPW (1st Cir. July 12, 2012)

The First Circuit Court of Appeals also dismissed the within class action lawsuit on the basis of lack of materiality. Boston Scientific makes and sells medical devices in many countries employing over 25,000 employees. The claim in this case was that some 30 percent of its sales in late 2008 and early 2009 were of cardiac rhythm management (CRM) devices handled by a group within the company devoted to such products. CRM devices are implantable devices that use electric pulses to treat a patient's cardiac condition that include pacemakers and implantable cardioverter defibrillators. The devices are typically marketed and sold directly to physicians by Boston Scientific's CRM sales staff. In August 2009, Boston Scientific began an audit of CRM sales expense reports from recent trips of sales representatives who accompanied physician customers on tours of Boston Scientific manufacturing facilities. Twenty-one sales reps were questioned about whether food and entertainment provided exceeded permissible limits. In September Boston Scientific received a subpoena from the U.S. Department of Health and Human Services (HHS), requesting information about contributions made by CRM to charities with ties to physicians or their families.

On October 20, 2009, the first day of the period stated in the plaintiffs' complaint, Boston Scientific announced its results for the third quarter of 2009, and issued a press release noting that although CRM product sales had increased by 8 percent during the quarter, the CRM group's level of

growth was disappointing. During a conference with investors and analysts, the CEO and the president of the CRM group made encouraging statements about CRM sales. Specifically, they said that current growth was slower than expected because they had underestimated the time it would take to bring 150 newly hired sales representatives up to normal productivity levels; that the prospect of increased market share existed as the new hires completed training over 9–12 months; that "[w]e have solid growth in our CRM business, and we have also added a number of people on the sales force on a global basis," and that "the outlook is still positive but mixed as it relates to market growth expectations." These and other statements made concerning forward-looking actions by the company were found by both the district court and the court of appeals not to be false or misleading nor were later statements incomplete or half-truths.

The court noted that the Private Securities Litigation Reform Act (PSLRA) requirement that a "strong inference" of scienter be pled requires the complaint to set forth facts making the inference of scienter "cogent and at least as compelling as any opposing inference one could draw from the facts alleged." The bland statements of the CEO were neither dishonest nor reckless. Moreover, a company need not reveal all information known to it. Companies do not have to disclose immediately all information that might conceivably affect stock prices; the burden and risks to management of an unlimited and general obligation would be extreme and could easily disadvantage shareholders in numerous ways (e.g., if a new invention were prematurely disclosed to competitors or a takeover plan to the target company). Thus, the securities laws forbid false or misleading statements in general but impose more specific disclosure obligations only in particular circumstances.

The U.S. Supreme Court revisited the "fraud-on-the-market" theory on February 27, 2013. In *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds*, No. 11–1085, S. Ct., (February 27, 2012) a majority of the justices determined that proof of materiality is not necessary when the district court adjudicates whether to grant class certification; rather the said issue is to be determined when the case is decided on its merits. The lower court need only examine whether members of the class have common questions rather than issues affecting them solely individually. It reversed the decision of the Court of Appeals for the Ninth Circuit which had ruled that in a misrepresentation case the district court had to require proof of materiality before certifying a plaintiff class based on the fraud-on-the-market theory and to allow the defendant Amgen to present evidence rebutting the applicability of the fraud-on-the-market theory before certifying the plaintiff case on that theory.

Scienter. The meaning of "scienter was defined and discussed in the following seminal case. In essence, it is "a mental state embracing intent to deceive, manipulate, or defraud."

Ernst & Ernst v. Hochfelder

425 U.S. 185 (1976)

FACTS: Petitioner (Defendant), Ernst & Ernst, is an accounting firm. From 1946 through 1967 it was retained by First Securities Company of Chicago (First Securities), a small brokerage firm and member of the Midwest Stock Exchange and of the National Association of Securities Dealers, to perform periodic audits of the firm's books and records. In connection with these audits Ernst & Ernst prepared for filing with the SEC (commission) the annual reports required of First Securities under §17 (a) of the 1934 Act. It also prepared responses to the financial questionnaires of the Midwest Stock Exchange (Exchange) for First Securities.

Respondents [Plaintiffs] were customers of First Securities who invested in a fraudulent securities scheme perpetrated by Leston B. Nay, president of the firm and owner of 92 percent of its stock. Nay induced the respondents to invest funds in "escrow" accounts that he represented would yield a high rate of return. Respondents did so from 1942 through 1966, with the majority of the transactions occurring in the 1950s. In fact, there were no escrow accounts as Nay converted respondents' funds to his use immediately upon receipt. These transactions were not in the customary form of dealings between First Securities and its customers. The respondents drew their personal checks payable to Nay or a designated bank for his account. No such escrow accounts were reflected on the books and records of First Securities, and none was shown on its periodic accounting to respondents in connection with their other investments. Nor were they included in First Securities' filings with the Commission or the Exchange.

In an action for damages against Ernst & Ernst under §10 (b) of the 1934 Act, the complaint charged that Nay's escrow scheme violated §10 (b) and SEC's Rule 10b-5 and that Ernst & Ernst had "aided and abetted" Nay's violations by its "failure" to conduct proper audits of First Securities. Respondents' cause of action rested on a theory of negligent nonfeasance. The premise was that Ernst & Ernst had not utilized "appropriate auditing procedures" in its audits of First Securities, thereby failing to discover internal practices of the firm said to prevent an effective audit. The practice principally relied on was Nay's rule that only he could open mail addressed to him at First Securities or addressed to First Securities to his attention, even if it arrived in his absence. Respondents contended that if Ernst & Ernst had conducted a proper audit, it would have discovered this "mail rule." The existence of the rule then would have been disclosed in reports to the Exchange and to the SEC by Ernst & Ernst as an irregular procedure that prevented an effective audit. This would have led to an investigation of Nay that would have revealed the fraudulent scheme. Respondents specifically disclaimed the existence of fraud or intentional misconduct on the part of Ernst & Ernst.

ISSUE: Whether a private cause of action for damages will lie under §10 (b) and Rule 10b-5 in the absence of any allegation of "scienter"—intent to deceive, manipulate, or defraud?

DECISION: The court stated the action must be dismissed in the absence of the allegation of scienter.

REASONING (Powell, J.): The 1934 Act was intended principally to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges . . . .

Although §10 (b) does not by its terms create an express civil remedy for its violation, and there is no indication that Congress or the Commission [SEC] when adopting Rule 10b-5 contemplated such a remedy, the existence of a private cause of action for violations of the statute and the Rule is now well established . . . .

§10 (b) makes unlawful the use or employment of "any manipulative or deceptive device or contrivance" in contravention of Commission rules. The words "manipulative or deceptive" used in conjunction with "device or contrivance" strongly suggest that §10 (b) was intended to proscribe knowing or intentional misconduct . . . .

[T]he Commission contends that nothing in the language "manipulative or deceptive device or contrivance" limits its operation to knowing or intentional practices . . . . The commission then reasons that since the "effect" upon investors of given conduct is the same regardless of whether the conduct is negligent or intentional, Congress must have intended to bar all such practices and not just those done knowingly or intentionally. The logic of this effect-oriented approach would impose liability for wholly faultless conduct where such conduct results in harm to investors, a result the Commission would be unlikely to support. But apart from where its logic might lead, the Commission would add a gloss to the operative language of the statute quite different from its commonly accepted meaning . . . . The argument simply ignores the use of the words "manipulative," "device," and "contrivance"—terms that make unmistakable a congressional intent to proscribe a type of conduct quite different from negligence. Use of the word "manipulative" is especially significant. It is and was virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities . . . .

When a statute speaks so specifically in terms of manipulation and deception, and of implementing devices and contrivances—the commonly understood terminology of intentional wrongdoing—and when its history reflects no more expansive intent, we are quite unwilling to extend the scope of the statute to negligent conduct . . . .

[In Footnote 12, the court defines the meaning of "scienter."] In this opinion the term "scienter" refers to a mental state embracing intent to deceive, manipulate, or defraud. In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act.

Questions

1. The Supreme Court rejected the negligence standard for a violation of §10(b); rather it imposed the much higher standards of proof that the person intentionally violated the act. Reading the statute, can you make an argument that the court imposed a standard that Congress did not intend?
2. When a court imposes a standard that Congress did not intend, how may the standard be changed?

Economic Loss. The elements of proof necessary to bring a claim under §10(b) and Rule 10b-5 include the allegation of financial loss. In the following case, the court was called upon to decide whether there was, in fact, an economic loss inasmuch as the price of securities had recovered from its earlier losses.

Rosado v. China North East Petroleum Holdings Ltd.

No. 11-4544-cv (2d Cir. Aug. 1, 2012)

FACTS: Acticon and Rosado are the lead plaintiffs in a consolidated class action lawsuit that alleged China North East Petroleum (NEP) violated §§10(b) and 20(a) of the Securities Exchange Act of 1934 under SEC Rule 10b-5. It was alleged by them that NEP misled investors about its reported earnings, proven oil reserves; did not account for certain warrants until the expiration date in accordance with the Generally Accepted Accounting Principles; there was a wrongful transfer of funds by the CEO from the company's account to his personal account; and there was a lack of internal controls. It was further alleged that NEP revealed this information through a series of corrective disclosures in April 2010 and in May 2010, the New York Stock Exchange halted trading on its stock. NEP argues that these allegations are not sufficient to allege economic loss because its share price rebounded on certain days after the final disclosure to the point that Acticon could have sold its holdings and avoided a loss. Acticon had purchased 60,000 NEP shares with an average purchase price of $7.25 per share. NEP stock had closed at a price higher than $7.25 on 12 days during October and November of 2010 after NEP was relisted. The district court dismissed the case holding that the plaintiff had not suffered an economic

loss as required by statute because they had multiple opportunities to recover their losses.

ISSUE: Whether the fact that a stock's share price recovered soon after the fraud became known defeats an inference of economic loss in a securities fraud suit?

DECISION: The court held that the said price recovery did not defeat an inference of economic loss.

REASONING (STRAUB, J.) "The Supreme Court has held that, to maintain a private damages action under §10(b) and Rule 10b-5, 'a plaintiff must prove (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and loss causation.' " . . . NEP argues that because its stock price rose higher than Acticon's average purchase price on various dates in the months following the close of the class period, Acticon has failed to plead economic loss as a matter of law . . . .

Traditionally, economic loss in §10(b) cases has been determined by use of the "out-of-pocket" measure for damages. Under that measure, "a defrauded buyer of securities is entitled to recover only the excess of what he paid over the value of what he got." . . . In other words, damages "consist of the difference between the price paid and the 'value' of the stock when bought. The Supreme Court adopted the out-of-pocket measure of damages in *Affiliated Ute Citizens v. United States*," 406 U.S. 128, 155 (1972). Referring to 15 U.S.C. §78bb(a)(1), which limits recovery to "actual damages" for violations of 9 the Securities Exchange Act of 1934, the Supreme Court held that "the correct measure of 10 damages under §28 of the Act, 15 U.S.C. §78bb(a), is the difference between the fair value of all that the [plaintiff] received and the fair value of what he would have received had there been no fraudulent conduct."

In the Private Securities Litigation Reform Act of 1995 ("PSLRA"), Congress included a bounceback provision that caps the amount of damages available in a securities fraud action. The provision states that in any private action . . . in which the plaintiff seeks to establish damages by reference to the market price of a security, the award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid . . . by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market . . . . The provision further defines "mean trading price" as "an average of the daily trading price of that security, determined as of the close of the market each day during the 90-day period." . . . In essence, this provision "does not calculate damages based on the single day decline in price, but instead allows the security an opportunity to recover" over a period of 90 days . . . . "Thus, if the mean

trading price of a security during the 90-day period following the correction is greater than the price at which the plaintiff purchased his stock then that plaintiff would recover nothing under the PSLRA's limitation on damages." . . . But if the mean trading price during the 90-day period is less than the plaintiff's purchase price, then the plaintiff may recover out-of-pocket damages up to the difference between her purchase price and the mean trading price.

The PSLRA's legislative history indicates that Congress imposed this limitation because it believed that "[c]alculating damages based on the date corrective information is disclosed may substantially overestimate plaintiff's actual damages." . . . . It intended the "bounceback" provision to have the effect of "limiting damages to those losses caused by the fraud and not by other market conditions." Aside from imposing the bounce-back cap on recoverable damages, Congress did not otherwise disturb the traditional out-of-pocket method for calculating damages in the PSLRA . . . . The limitation upon damages imposed by the District Court—and by the other district court decisions upon which it relied—is inconsistent with both the traditional out-of-pocket measure for damages and the bounce-back cap imposed in the PSLRA . . . .

Further, a share of stock that has regained its value after a period of decline is not functionally equivalent to an inflated share that has never lost value. This analysis takes two snapshots of the plaintiff's economic situation and equates them without taking into account anything that happened in between; it assumes that if there are any intervening losses, they can be offset by intervening gains. But it is improper to offset gains that the plaintiff recovers after the fraud becomes known against losses caused by the revelation of the fraud if the stock recovers value for completely unrelated reasons. Such a holding would place the plaintiff in a worse position than he would have been absent the fraud. Subject to the bounce-back limitation imposed by the PSLRA, a securities fraud action attempts to make a plaintiff whole by allowing him to recover his out-of-pocket damages, that is, the difference between what he paid for a security and the uninflated price . . . . In the absence of fraud, the plaintiff would have purchased the security at an uninflated price and would have also benefited from the unrelated gain in stock price. If we credit an unrelated gain against the plaintiff's recovery for the inflated purchase price, he has not been brought to the same position as a plaintiff who was not defrauded because he does not have the opportunity to profit (or suffer losses) from "a second investment decision unrelated to his initial decision to purchase the stock." . . . .

At this stage in the litigation, we do not know whether the price rebounds represent the market's reactions to the disclosure of the alleged fraud or whether they represent unrelated gains. We thus do not know whether it is proper to offset the price recovery against Acticon's losses in determining Acticon's economic loss. Accordingly, the recovery does not negate the inference that Acticon has suffered an economic loss . . .

For the reasons above, the judgment of the District Court is VACATED and the case is REMANDED for further proceedings not inconsistent with this opinion.

Questions

1. Discuss under what circumstances, if any, the rebound of a securities' price would be a defense to a lawsuit.
2. What are the implications of the decision as they relate to companies restating their earnings? Does it open these companies to extensive litigation?

Standing. In order to bring a lawsuit a person must have standing, that is, there must be a close connection between that person and the outcome of the lawsuit. Standing may be granted by a statute that permits an aggrieved person to sue on his or her behalf or on behalf of others similarly situated. Some statutes permit only a government agency to commence an action while denying that right to an individual irrespective of the harm that individual may incur. Standing thus is an important issue in connection with the securities acts. The following U.S. Supreme Court case discusses standing in connection with a §10b-5 claim.

Blue Chip Stamps v. Manor Drug Stores

421 U.S. 723 (1975)

FACTS: In 1963 the U.S. filed a civil antitrust action against Blue Chip Stamp Co. (Old Blue Chip), a company in the business of providing trading stamps to retailers, and nine retailers who owned 90 percent of its shares. In 1967 the action was terminated by the entry of a consent decree. The decree contemplated a plan of reorganization whereby Old Blue Chip was to be merged into a newly formed corporation, Blue Chip Stamps (New Blue Chip). The holdings of the majority shareholders of Old Blue Chip were to be reduced, and New Blue Chip, one of the petitioners here, was required under the plan to offer a substantial number of its shares of common stock to retailers who had used the stamp service in the past but who were not shareholders in the old company. Under the terms of the plan, the offering to nonshareholder users was to be proportional to past stamp usage and the shares were to be offered in units consisting of common stock and debentures.

The reorganization plan was carried out, the offering was registered with the SEC as required by the 1933 Act, and a prospectus was distributed to all offerees as required by §5 of that act . . . . Somewhat more than 50 percent of the offered units were actually purchased. In 1970, two years after the offering, the respondent, a former user of the stamp service and therefore

an offeree of the 1968 offering, filed this suit against Old and New Blue Chip, eight of the nine majority shareholders of Old Blue Chip, and the directors of New Blue Chip.

Respondent's complaint alleged, inter alia, that the prospectus prepared and distributed by Blue Chip in connection with the offering was materially misleading in its overly pessimistic appraisal of Blue Chip's status and future prospects. It alleged that Blue Chip intentionally made the prospectus overly pessimistic in order to discourage the respondent and other members of the allegedly large class whom it represents from accepting what was intended to be a bargain offer, so that the rejected shares might later be offered to the public at a higher price. The complaint alleged that class members because of and in reliance on the false and misleading prospectus failed to purchase the offered units. The respondent therefore sought on behalf of the alleged class some $21,400,000 in damages representing the lost opportunity to purchase the units; the right to purchase the previously rejected units at the 1968 price; and in addition, it sought some $25,000,000 in exemplary damages.

ISSUE: Whether the offerees of a stock offering, made pursuant to an antitrust consent decree and registered under the Securities Act of 1933, may maintain a private cause of action for money damages where they allege that the offeror has violated the provisions of Rule 10b-5 of the SEC, but where they have neither purchased nor sold any of the offered shares?

DECISION: The court decided that that Manor Drugs, the plaintiff/respondent, had no standing to sue under Rule 10b-5.

REASONING (Rehnquist, J.): [The Court initially set forth the provisions of §10b-5 and discussed the history of the Securities Acts of 1933 and 1934.] §10(b) of the 1934 Act does not by its terms provide an express civil remedy for its violation. Nor does the history of this provision provide any indication that Congress considered the problem of private suits under it at the time of its passage . . . . Similarly there is no indication that the Commission in adopting Rule 10b-5 considered the question of private civil remedies under this provision.

[The court then recited that there was overwhelming consensus among the lower courts that there was an implied right of private action under Rule 10b-5. It then noted that the Court of Appeals of the 2d Circuit in the case of *Birnbaum v. Newport Steel Corp.* that the plaintiff class for purposes of a private damage action under §10 (b) and Rule 10b-5 was limited to actual purchasers and sellers of securities.]

In 1957 and again in 1959, the Securities and Exchange Commission sought from Congress amendment of §10 (b) to change its wording from "in connection with the purchase or sale of any security" to "in connection with the purchase or sale of, *or any attempt to purchase or sell,* any security . . . . " Neither change was adopted by Congress . . . . The longstanding acceptance by the courts, coupled with Congress' failure to reject *Birnbaum*'s reasonable interpretation of the wording of §10 (b), wording

which is directed toward injury suffered "in connection with the purchase or sale" of securities, argues significantly in favor of acceptance of the *Birnbaum* rule by this Court . . . .

Three principal classes of potential plaintiffs are presently barred by the *Birnbaum* rule. First are potential purchasers of shares, either in a new offering or on the Nation's postdistribution trading markets, who allege that they decided not to purchase because of an unduly gloomy representation or the omission of favorable material which made the issuer appear to be a less favorable investment vehicle than it actually was. Second are actual shareholders in the issuer who allege that they decided not to sell their shares because of an . . . unduly rosy representation or a failure to disclose unfavorable material. Third are shareholders, creditors, and perhaps others related to an issuer who suffered loss in the value of their investment due to corporate or insider activities in connection with the purchase or sale of securities which violate Rule 10b-5. It has been held that shareholder members of the second and third of these classes may frequently be able to circumvent the *Birnbaum* limitation through bringing a derivative action on behalf of the corporate issuer if the latter is itself a purchaser or seller of securities . . . . But the first of these classes, of which respondent is a member, cannot claim the benefit of such a rule . . . .

We believe that the concern expressed for the danger of vexatious litigation which could result from a widely expanded class of plaintiffs under Rule 10b-5 is founded in something more substantial than the common complaint of the many defendants who would prefer avoiding lawsuits entirely to either settling them or trying them. These concerns have two largely separate grounds.

The first of these concerns is that in the field of federal securities laws governing disclosure of information even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment. The very pendency of the lawsuit may frustrate or delay normal business activity of the defendant which is totally unrelated to the lawsuit . . . .

The second ground for fear of vexatious litigation is based on the concern that, given the generalized contours of liability, the abolition of the *Birnbaum* rule would throw open to the trier of fact many rather hazy issues of historical fact the proof of which depended almost entirely on oral testimony . . . .

We quite agree that if Congress had legislated the elements of a private cause of action for damages, the duty of the Judicial Branch would be to administer the law which Congress enacted; the Judiciary may not circumscribe a right which Congress has conferred because of any disagreement it might have with Congress about the wisdom of creating so expansive a liability. But as we have pointed out, we are not dealing here with any private

right created by the express language of §10 (b) or of Rule 10b-5. No language in either of those provisions speaks at all to the contours of a private cause of action for their violation. However, flexibly we may construe the language of both provisions; nothing in such construction militates against the *Birnbaum* rule. We are dealing with a private cause of action which has been judicially found to exist, and which will have to be judicially delimited one way or another unless and until Congress addresses the question. Given the peculiar blend of legislative, administrative, and judicial history which now surrounds Rule 10b-5, we believe that practical factors to which we have adverted, and to which other courts have referred, are entitled to a good deal of weight.

Questions

1. Standing ordinarily means that the party suing must have been injured by the defendant. The respondent, Manor Drug Stores, alleged that it was damaged substantially by the actions of the defendant/petitioner, Blue Chip stamps. Why was it denied standing under the circumstances?
2. As a result of the decision, plaintiffs began suing under state law asserting similar type claims. What did Congress do concerning such claims?

Forward-Looking Statements

Senior officers of a corporation, especially the CEO at the annual shareholders meetings and in annual reports, tend to give a positive spin concerning future projections for the following and subsequent years. The term "bespeaks" has been used to connote such expressions. The question arises as to at what point optimistic projections constitute fraud? Courts have had substantial difficulty in determining these otherwise muddled waters.[2] The following 10b-5 case discusses the issue.

Iowa Public Employees Retirement System v. Mf Global, Ltd.

620 F.3rd 137 (2d Cir. 2010)

FACTS: In the morning hours of February 27, 2008, a broker at MF Global, Ltd. lost $141.5 million speculating in wheat futures. The broker, Evan Dooley, accumulated the losses by taking positions vastly in excess of the firm's trading limits and collateral requirements. MF Global was responsible for settling Dooley's trades at the clearinghouse, and absorbed the losses. When news reached the markets on February 28, MF Global's stock price fell 28 percent; it fell a further 17 percent the day after, resulting in a two-day market capitalization loss exceeding $1.1 billion.

The Dooley trading incident revealed to the public that MF Global's internal risk controls had not been applied to brokers trading for their own accounts (or taking client orders by phone). MF Global had controls for limiting its exposure to market risks in brokerage accounts by restricting trading and by managing margin credit with collateral and other requirements. But MF Global sometimes deactivated the controls (as with Dooley) to speed transactions.

This putative class action was filed on March 6, 2008, alleging, on behalf of certain purchasers of MF Global stock, that the firm misrepresented and failed to disclose relevant material information in a prospectus and registration statement issued when the brokerage firm went public in July 2007.

ISSUE: Whether the district court erred in applying the bespeaks doctrine to material misstatements and omissions in the July 2007 prospectus and registration statement of MF Global, which failed to disclose that its internal control systems did not apply to its brokers?

DECISION: The court of appeals reversed the dismissal of the claim stating that the bespeaks doctrine was not applicable to the facts at hand.

REASONING (Jacobs, J.): Here, it is alleged, for example, that the prospectus "failed to disclose the material fact that [MF Global's] Risk Management System protocols and procedures . . . did not apply to the Company's employees . . . [when] trading for their own accounts." That allegation specifies an omission of present fact, to which bespeaks caution does not apply: The applicability of MF Global's risk-management system to employee accounts was ascertainable when the challenged statements were made. It was therefore error for the District Court to rely on the bespeaks-caution doctrine to dismiss that claim.

Claims premised on allegations concerning risk management were dismissed by the District Court on the ground that cautionary language elsewhere in the prospectus rendered the cited statements or omissions nonactionable pursuant to the bespeaks-caution doctrine.

To prevail on a [Securities Act of '33] §11 or §12(a)(2) claim, a plaintiff must show that the relevant communication either misstated or omitted a material fact . . . . The bespeaks-caution doctrine is a corollary of "the well-established principle that a statement or omission must be considered in context . . . . "

A forward-looking statement accompanied by sufficient cautionary language is not actionable because no reasonable investor could have found the statement materially misleading . . . . In such circumstances, it cannot be supposed by a reasonable investor that the future is settled, or unattended by contingency . . . .

It is settled that the bespeaks-caution doctrine applies only to statements that are forward-looking . . . . Here, it is alleged, for example, that the prospectus "failed to disclose the material fact that [MF Global's] Risk Management System protocols and procedures . . . did not apply to the

Company's employees . . . [when] trading for their own accounts." That allegation specifies an omission of present fact, to which bespeaks caution does not apply: The applicability of MF Global's risk-management system to employee accounts was ascertainable when the challenged statements were made.

Investors are interested in issuer statements only insofar as those statements bear on the future. But while it is true that predictions about the future can represent interpretations of present facts (and vice versa), there is a discernible difference between a forecast and a fact, and courts are competent to distinguish between the two. A forward-looking statement (accompanied by cautionary language) expresses the issuer's inherently contingent prediction of risk or future cash flow; a non-forward-looking statement provides an ascertainable or verifiable basis for the investor to make his own prediction.

The line can be hard to draw, and we do not now undertake to draw one. However, a statement specifying the risk of default is distinct from a statement of present or historical financial instability, even though they both bear upon the same risk. And a statement of confidence in a firm's operations may be forward-looking—and thus insulated by the bespeaks-caution doctrine—even while statements or omissions as to the operations in place (and present intentions as to future operations) are not.

A statement may contain some elements that look forward and others that do not . . . . A characterization of present or historical fact may be partially predictive . . . . A present fact like an appraisal or valuation may depend on predictions: of future cash flows, for example, or future risks . . . . A forecast may extrapolate present or historical facts into the future . . . . But in each instance the forward-looking elements and the non-forward-looking are severable.

Here, characterizations of MF Global's risk-management system—that the system was "robust," for example—invite the inference that the system will reduce the firm's risk. However, bespeaks caution does not apply insofar as those characterizations communicate present or historical fact as to the measures taken . . . . ("Cautionary words about future risk cannot insulate from liability the failure to disclose that the risk has transpired.")

Questions

1. It is customary for senior executives, especially at a shareholders' meeting, to give a positive spin on a company's future outlook. At what point does such talk constitute possible fraud on investors?
2. In this case, did the alleged misrepresentations fall under the bespeaks-caution doctrine? The court believed that they did not. Can you make a case for the management of the company?

The following case also discusses a bespeaks type of alleged false and fraudulent misleading statements made in the company's annual report.

Weiner v. Quaker Oat Co.

129 F.3d 310 (3rd Cir. 1997)

Weiner's complaint alleged that the company and its CEO disseminated false and misleading information in violation of §10(b) of the '34 Act. It allegedly did so by continuing to announce or let stand certain projected figures for earnings growth and debt-to-equity ratio that the company and its CEO allegedly knew had become inaccurate in its planned, highly leveraged acquisition of Snapple Beverage Corp. made to increase the company's debt to make it a less attractive target for a hostile takeover. The company's Annual Report for 1994 stated that its total debt-to-total capitalization ratio at the end of fiscal 1994 was 68.8 percent on a book-value basis, in line with its guideline in the upper 60 percent range. On November 2, 1994, Quaker and Snapple announced that Quaker would acquire Snapple in a tender offer and merger transaction for $1.7 billion in cash. Subsequent to this announcement, the price of Quaker stock fell $7.375 per share—approximately 10 percent of the stock's value. To finance the acquisition, Quaker had obtained a $2.4 billion credit from a banking group led by NationsBank Corp. The Snapple acquisition nearly tripled Quaker's debt, from approximately $1 billion to approximately $2.7 billion. The acquisition also increased Quaker's total debt-to-total capitalization ratio to approximately 80 percent.

Plaintiffs maintained that defendants had known that the impending purchase of Snapple would drive Quaker's total debt-to-total capitalization ratio up and earnings growth down, but had, nonetheless, failed to adjust their public projections for those figures. This failure, plaintiffs claimed, had artificially inflated the price of Quaker's stock in the period from August 4 to November 1, 1994. Keeping the stock price up during this period, plaintiffs alleged, had kept Quaker from itself being taken over. When the deal with Snapple was revealed, and the price of Quaker stock fell to reflect what plaintiffs maintain was the true value of a company that had just taken on an additional $1.7 billion in debt, investors, who had believed defendants' representations as to growth and total debt-to-total capitalization ratio projections, experienced a 10 percent loss in the worth of their stock.

The issue before the Court was whether and in what circumstances a corporation and its officers have an obligation to investors to update, or at least not to repeat, particular projections regarding the corporation's financial situation. The court of appeals, in reversing the dismissal of the claim by the district court stated that it found that a trier of fact could conclude that a reasonable investor reading the 1993 Annual Report published

on October 4, 1993, and then the 1994 Annual Report published on September 23, 1994, would have no ground for anticipating that the total debt-to-total capitalization ratio would rise as significantly as it did in fiscal 1995. There was after all no abjuration of the "upper 60 percent range" guideline. The company had predicted the rise from 59 percent to the "upper 60 percent range" in the 1993 report and that rise had occurred by and was confirmed in the 1994 report. Therefore, it was reasonable for an investor to expect that the company would make another such prediction if it expected the ratio to change markedly in the ensuing year. The failure to correct the projected ratio in its 1994 report in the light of the merger with Snapple removed it from the protection of the bespeaks-caution doctrine.

Private Securities Litigation Reform Act of 1995[3]

The PSLRA was enacted in order to minimize the practice of certain law firms that commenced class actions against companies alleging wrongdoings in general terms and then proceed on "fishing expeditions" to attempt to uncover malfeasance on the part of companies. The very liberal discovery rules in litigation in the United States generally permits litigants to engage in extensive pretrial discovery proceedings thereby forcing companies to open their books and records. Rather than engage in such costly litigation, companies often settled for millions of dollars, with the law firms that commenced the actions receiving sizeable fees. Congress addressed the alleged abuses by the enactment of PSLRA.

The statute dramatically changed the requirements for litigation to take place. It mandated that, in any private action wherein the plaintiff alleges that the defendant made an untrue statement or omitted to state a material fact necessary to make the statement made not misleading, "the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed."

It further provided that "in any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."

The effect of the statute is to prevent litigants from making broad allegations of fraud but must initially in its complaint state specifically exactly what the allegations of fraud and malfeasance are and/or state such facts that render a strong inference that the defendant intended to commit the wrongful act. Thus, numerous lawsuits that were commenced have been dismissed at the outset, thereby preventing attorneys for plaintiffs from to engaging in pretrial discovery proceedings (aka "fishing expeditions"), which often resulted in the discovery of some wrongful act sufficient to compel a sizeable settlement of the case.

Insider Trading

Insider trading is a major problem for stock exchanges globally. It is the use of information, not otherwise available to the general public, for the purpose of purchasing, selling, or otherwise transacting in securities to the often immense profit for the person having access to the confidential or as yet unreported data. Examples of insider trading include inside knowledge gained from a senior officer that the company just signed a major new contract or that a promising drug has fared poorly; by a junior attorney of a law firm who learns about a merger being entered into; and by a financial reporter who purchases or sells a security on a Monday knowing that his or her selection of the said security to be published days later will influence the price of the stock after its publication. Each of these circumstances represents actual cases that led to criminal and/or civil actions against the person taking advantage of the inside knowledge.

It is not insider trading when securities firms, especially hedge funds, are prepared to transact in a security immediately after an important announcement is made, even at midnight while most other investors learn of the news hours later. It is not difficult for the SEC and SROs to ascertain suspicious activity. With today's computer technology, insider trading becomes evident simply by looking at sales activity a day or two before an important announcement is made by a company. For example, a person who invests little in securities suddenly buys or shorts a particular security just before the said announcement, thereby making a sizeable profit, may come within the radar screen of regulators. The insider trading prohibition is prohibited under Exchange Act, §10(b) and Rule 10b-5. Rule 10b-5, *Employment of Manipulative and Deceptive Practices*, recited earlier in the chapter, states:

> SEC Rule 14e-3—Transactions in Securities on the Basis of Material, Nonpublic Information in the Context of Tender Offers states:

a. If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive, or manipulative act or practice within the meaning of §14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:

   1. The offering person
   2. The issuer of the securities sought or to be sought by such tender offer, or
   3. Any officer, director, partner or employee, or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a

reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise

b. § 15(f), Prevention of misuse of material, nonpublic information, is also applicable. It provides that every registered broker or dealer shall establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material, nonpublic information by the broker or dealer or any person associated thereto. Anyone who uses insider information can be held liable. A tippee can be liable if the tipper breached a fiduciary duty and the tippee knew or had reason to know that the tipper was breaching the duty.

The following SEC enforcement action is illustrative of forbidden conduct.

SEC v. Jantzen

No. 1:10-cv-00740-JRN (W.D. Tex. January 25, 2011)

The defendants, husband and wife, were charged with insider trading. The defendant, Marlene Jantzen, was a former assistant to an executive at Dell, Inc. Her husband, the defendant, John Jantzen, was a registered securities broker. The Jantzens were charged by the SEC with insider trading in connection with a September 21, 2009, public announcement that Dell would acquire Perot Systems, Corp. in a tender offer transaction. The court specifically found that "Marleen tipped John who took unprecedented and persistent action to ensure that they were able to maximize their informational advantage." The court also found that the evidence showed "a high degree of *scienter,* particularly with regard to John, who, as a licensed securities broker certainly knew what he was doing."

The SEC alleged that Marleen Jantzen learned, through an internal Dell e-mail material, nonpublic information regarding Dell's impending tender offer for the shares of Perot Systems, Inc., and thereafter tipped her husband to the inside information. The court found that on September 18, 2009, the last trading day before the tender offer announcement, Marleen Jantzen made a highly unusual cash transfer to the couples' joint brokerage account. Within minutes of this transfer, John Jantzen bought Perot Systems call options and stock and Dell securities in the joint account—in total, purchasing 500 shares of Perot Systems common stock and 24 Perot Systems call option contracts. On September 21, 2009, Dell and Perot Systems jointly announced the tender offer for Perot Systems' shares. The stock price immediately rose from $17.91 to $29.56, or approximately 65 percent from the prior day's closing price. When John Jantzen cashed out that day, the couple reaped one-day trading profits of $26,920.50.

On February 29, 2012, the court entered summary judgment against the Jantzens having found that both Jantzens insider traded in violation of

§ 10(b) and 14(e) of the Exchange Act, and Rules 10b-5 and 14e-3(a) thereunder, and that Marleen Jantzen also violated Exchange Act Rule 14e-3(d). The court enjoined the Jantzens from future violations of those provisions and ordered them to pay disgorgement of $26,920.50, representing profits gained as a result of the illegal insider trading, plus prejudgment interest.

The question arose whether Rule 10b-5 prohibits insider trading inasmuch as the wording does not specifically delineate it as a forbidden practice but rather has been interpreted by the SEC as falling with subdivision (c). In the following case, the U.S. Supreme Court placed limits on the interpretation of when unlawful insider trading has occurred.

Chiarella v. United States

445 U.S. 222 (1980)

Chiarella, Petitioner/Defendant, who was employed by a financial printer that had been engaged by certain corporations to print corporate takeover bids, deduced the names of the target companies from information contained in documents delivered to the printer by the acquiring companies and, without disclosing his knowledge, purchased stock in the target companies, and sold the shares immediately after the takeover attempts were made public. He was charged under Exchange Act 10b-5(b) and Rule 10b-5, which made it unlawful for any person to "employ any device, scheme, or artifice to defraud," or to "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

The district court's charge permitted the jury to convict the petitioner if it found that he willfully failed to inform sellers of target company securities that he knew of a forthcoming takeover bid that would make their shares more valuable. Petitioner's conviction was affirmed by the court of appeals. The Supreme Court reversed his conviction holding that petitioner had no affirmative duty to disclose the information as to the plans of the acquiring companies. He was not a corporate insider, and he received no confidential information from the target companies. Nor could any duty arise from petitioner's relationship with the sellers of the target companies' securities, for he had no prior dealings with them, was not their agent, was not a fiduciary, and was not a person in whom the sellers had placed their trust and confidence. A duty to disclose under §10(b) does not arise from the mere possession of nonpublic market information.

The court said, "First, not every instance of financial unfairness constitutes fraudulent activity under 10 (b) . . . . Second, the element required to make silence fraudulent—a duty to disclose—is absent in this case.

No duty could arise from petitioner's relationship with the sellers of the target company's securities, for petitioner had no prior dealings with them. He was not their agent, he was not a fiduciary, and he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete . . . stranger who dealt with the sellers only through impersonal market transactions."

In the following seminal case, the Supreme Court embraced a "misappropriation" theory of omissions, holding in *United States v. O'Hagan* that misappropriating confidential information for securities trading purposes, in breach of a duty owed to the source of that information, gives rise to a duty to disclose or abstain.

U.S. v. O'Hagan

521 U.S. 642 (1997)

FACTS: O'Hagan was a partner in the law firm of Dorsey & Whitney in Minneapolis, Minnesota. In July 1988, Grand Metropolitan PLC (Grand Met), a company based in London, England, retained Dorsey & Whitney as local counsel to represent Grand Met regarding a potential tender offer for the common stock of the Pillsbury Company, headquartered in Minneapolis. Both Grand Met and Dorsey & Whitney took precautions to protect the confidentiality of Grand Met's tender offer plans. O'Hagan did no work on the Grand Met representation. Dorsey & Whitney withdrew from representing Grand Met on September 9, 1988. Less than a month later, on October 4, 1988, Grand Met publicly announced its tender offer for Pillsbury stock.

On August 18, 1988, while Dorsey & Whitney was still representing Grand Met, O'Hagan began purchasing call options for Pillsbury stock. Each option gave him the right to purchase 100 shares of Pillsbury stock by a specified date in September 1988. Later in August and in September, O'Hagan made additional purchases of Pillsbury call options. By the end of September, he owned 2,500 unexpired Pillsbury options, apparently more than any other individual investor . . . . O'Hagan also purchased, in September 1988, some 5,000 shares of Pillsbury common stock, at a price just under $39 per share. When Grand Met announced its tender offer in October, the price of Pillsbury stock rose to nearly $60 per share. O'Hagan then sold his Pillsbury call options and common stock, making a profit of more than $4.3 million. O'Hagan was indicted and convicted on 57 counts of fraud against his law firm and its client, Grand Met, mail fraud, securities fraud, and other statutes.

ISSUES: (1) Is a person who trades in securities for personal profit, using confidential information misappropriated in breach of a fiduciary duty to the source of the information, guilty of violating § 10(b) and Rule 10b-5?

(2) Did the commission [SEC] exceed its rulemaking authority by adopting Rule 14e-3(a), which proscribes trading on undisclosed information in the tender offer setting, even in the absence of a duty to disclose?

DECISION: The court determined that the defendant did violate the said statutory provision and rule and that the SEC did not exceed its rulemaking authority proscribing trading on undisclosed information.

REASONING (Ginsburg, J.): A person who trades in securities for personal profit, using confidential information misappropriated in breach of a fiduciary duty to the source of the information, may be held liable for violating §10(b) and Rule 10b-5 (a). § l0(b) proscribes (1) using any "deceptive device" (2) "in connection with the purchase or sale of any security," in contravention of SEC rules. The Commission adopted Rule 10b-5 pursuant to its §l0(b) rulemaking authority; liability under Rule l0b-5 does not extend beyond conduct encompassed by §10(b)'s prohibition . . . . Under the "traditional" or "classical theory" of insider trading liability, a violation of §l0(b) and Rule l0b-5 occurs when a corporate insider trades in his corporation's securities on the basis of material, confidential information he has obtained by reason of his position. Such trading qualifies as a "deceptive device" because there is a relationship of trust and confidence between the corporation's shareholders and the insider that gives rise to a duty to disclose or abstain from trading. *Chiarella* v. *United States,* 445 U.S. 222, 228–229.

Under the complementary "misappropriation theory" urged by the Government here, a corporate "outsider" violates §l0(b) and Rule l0b-5 when he misappropriates confidential information for securities trading purposes, in breach of a fiduciary duty owed to the source of the information, rather than to the persons with whom he trades. (b) Misappropriation, as just defined, is the proper subject of a §l0(b) charge because it meets the statutory requirement that there be "deceptive" conduct "in connection with" a securities transaction. First, misappropriators deal in deception: A fiduciary who pretends loyalty to the principal while secretly converting the principal's information for personal gain dupes or defrauds the principal. A company's confidential information qualifies as property to which the company has a right of exclusive use; the undisclosed misappropriation of such information constitutes fraud akin to embezzlement . . . . Deception through nondisclosure is central to liability under the misappropriation theory . . . .

The theory is thus consistent with *Santa Fe Industries, Inc.* v. *Green,* 430 U.S. 462, 473–476, a decision underscoring that §l0(b) is not an all-purpose breach of fiduciary duty ban, but trains on conduct that is manipulative or deceptive. Conversely, full disclosure forecloses liability: Because the deception essential to the theory involves feigning fidelity to the information's source, if the fiduciary discloses to the source that he plans to trade on the information, there is no "deceptive device" and thus no §l0(b) violation.

Second, §10(b)'s requirement that the misappropriators' deceptive use of information be "in connection with the purchase or sale of [a] security" is satisfied by the misappropriation theory because the fiduciary's fraud is consummated not when he obtains the confidential information, but when, without disclosure to his principal, he uses the information in purchasing or selling securities. The transaction and the breach of duty coincide, even though the person or entity defrauded is not the other party to the trade, but is, instead, the source of the nonpublic information. Because undisclosed trading both deceives of the information and harms members of the investing public, the misappropriation theory is tuned to an animating purpose of the Exchange Act: to ensure honest markets, thereby promoting investor confidence. It would make scant sense to hold a lawyer-turned-trader like O'Hagan a §10(b) violator if he works for a law firm representing the target of a tender offer, but not if he works for a firm representing the bidder. The statute's text requires no such resulting on the basis of misappropriated, nonpublic information both deceives the source of syllabus the information and harms members of the investing public, the misappropriation theory is tuned to an animating purpose of the Exchange Act: to ensure honest markets, thereby promoting investor confidence. It would make scant sense to hold a lawyer-turned-trader like O'Hagan a § 10(b) violator if he works for a law firm representing the target of a tender offer, but not if he works for a firm representing the bidder. The statute's text requires no such result.

(c) The Eighth Circuit erred in holding that the misappropriation theory is inconsistent with §10(b). First, that court understood the theory to require neither misrepresentation nor nondisclosure; as this Court explains, however, deceptive nondisclosure is essential to §10(b) liability under the theory. Concretely, it was O'Hagan's failure to disclose his personal trading to Grand Met and Dorsey, in breach of his duty to do so, that made his conduct "deceptive" under §10(b). Second, the Eighth Circuit misread this Court's precedents when it ruled that, under *Chiarella* v. *United States,* 445 U.S. 222, 230, 232, 233; *Dirks* v. *SEC,* 463 U.S. 646, 655; and *Central Bank of Denver, N. A.* v. *First Interstate Bank of Denver, N. A.,* 511 U.S. 164, 191, only a breach of a duty to parties to a securities transaction, or, at the most, to other market participants such as investors, is sufficient to give rise to §10(b) liability. *Chiarella,* 445 U.S., at 238, 239, 240–243, 245, expressly left open the question of the misappropriation theory's validity, and *Dirks,* 463 U.S., at 665, 666–667, also left room for application of the misappropriation theory in cases such as this one. *Central Bank's* discussion concerned only private civil litigation under §10(b) and Rule 10b-5, not criminal liability (pp. 660–665).

(d) Vital to this Court's decision that criminal liability may be sustained under the misappropriation theory is the Exchange Act's requirement that the Government prove that a person "willfully" violated Rule 10b-5 in order to establish a criminal violation, and the Act's provision that a

defendant may not be imprisoned for such a violation if he proves that he had no knowledge of the Rule. The requirement of culpable intent weakens O'Hagan's charge that the misappropriation theory is too indefinite to permit the imposition of criminal liability. See *Boyce Motor Lines, Inc. v. United States,* 342 U.S. 337, 342. The Eighth Circuit may address on remand O'Hagan's other challenges to his §10(b) and Rule 10b-5 convictions . . . .

2. As relevant to this case, the SEC did not exceed its rulemaking authority under §14(e) by adopting Rule 14e-3(a) without requiring a showing that the trading at issue entailed a breach of fiduciary duty. § 14(e) prohibits "fraudulent . . . acts . . . in connection with any tender offer," and authorizes the SEC to "define, and prescribe means reasonably designed to prevent, such acts." Adopted under that statutory authorization, Rule 14e-3(a) forbids any person to trade on the basis of material, nonpublic information that concerns a tender offer and that the person knows or should know has been acquired from an insider of the offeror or issuer, or someone working on their behalf, unless within a reasonable time before any purchase or sale such information and its source are publicly disclosed. Rule 14e-3(a) imposes a duty to disclose or abstain from trading whether or not the trader owes a fiduciary duty to respect the confidentiality of the information. In invalidating Rule 14e-3(a), the Eighth Circuit reasoned, inter alia, that §14(e) empowers the SEC to identify and regulate "fraudulent" acts, but not to create its own definition of "fraud"; that, under *Schreiber* v. *Burlington Northern, Inc.,* 472 U.S. 1,7–8, §l0(b) interpretations guide construction of §14(e); and that, under *Chiarella, supra,* at 228, a failure to disclose information can be "fraudulent" for §10(b) purposes only when there is a duty to speak arising out of a fiduciary or similar relationship of trust and confidence. This Court need not resolve whether the SEC's §14(e) fraud-defining authority is broader than its like authority under §10(b), for Rule 14e-3(a), as applied to cases of this genre, qualifies under §14(e) as a "means reasonably designed to prevent" fraudulent trading on material, nonpublic information in the tender offer context. A prophylactic measure properly encompasses more than the core activity prohibited.

Under §14(e), the SEC may prohibit acts not themselves fraudulent under the common law or §10(b), if the prohibition is reasonably designed to prevent acts and practices that are fraudulent. See *Schreiber, supra*, at 11, n. 11. This Court must accord the SEC's assessment in that regard controlling weight unless it is arbitrary, capricious, or manifestly contrary to the statute. *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844. In this case, the SEC's assessment is none of these. It is a fair assumption that trading on the basis of material, nonpublic information will often involve a breach of a duty of confidentiality to the bidder or target company or their representatives. The SEC, cognizant of proof problems that could enable sophisticated traders to escape responsibility for such trading, placed in Rule 14e-3(a) a "disclose or abstain from trading"

command that does not require specific proof of a breach of fiduciary duty. Insofar as it serves to prevent the type of misappropriation charged against O'Hagan, the Rule is therefore a proper exercise of the SEC's prophylactic power under §14(e).

Questions

(1) Discuss the legal theories that may apply to the conduct of the defendant.
(2) Why were the classical theories of insider trading not utilized in the within case?

Subsequent to the said decisions, the SEC adopted new Rules 10b5-1 and 10b5-2 that incorporated the Supreme Court's O'Hagan's decision.[4] Section 10b5-1 concerns trading "on the basis of" material nonpublic information in insider trading cases. The rule states that the "manipulative and deceptive devices" prohibited by §10(b) of the act (15 U.S.C. 78j) and §240.10b-5 thereunder include, among other things, the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information. A purchase or sale of a security of an issuer is "on the basis of" material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale.

The rule also provides for affirmative defenses that may be raised to the rule. They include that before becoming aware of the information, (1) the person had entered into a binding contract to purchase or sell the security; (2) instructed another person to purchase or sell the security for the instructing person's account, or (3) adopted a written plan for trading securities as detailed in the regulation.

Section 240.10b5-2 "Duties of trust or confidence in misappropriation insider trading case" provides a nonexclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the "misappropriation" theory of insider trading under §10(b) of the act and Rule 10b-5. The sections applies to any violation of §10(b) of the act (15 U.S.C. 78j(b)) and §240.10b-5 thereunder that is based on the purchase or sale of securities on the basis of, or the communication of, material nonpublic information misappropriated in breach of a duty of trust or confidence.

The enumerated "duties of trust or confidence" refer to a "duty of trust or confidence" that exists in the following circumstances, among others: (1) whenever a person agrees to maintain information in confidence; (2) whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences,

such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality; and (3) whenever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling, provided, however, that the person receiving or obtaining the information may demonstrate that no duty of trust or confidence existed with respect to the information, by establishing that he or she neither knew nor reasonably should have known that the person who was the source of the information expected that the person would keep the information confidential, because of the parties' history, pattern, or practice of sharing and maintaining confidences, and because there was no agreement or understanding to maintain the confidentiality of the information.

Insider trading is more than one person using or giving to another person insider information. It may involve an extraordinarily complex series of maneuvers. Visually the reader should look up the Wall Street Journal's "Galleon Web"[5] whereby many persons were indicted or investigated, particularly, Rajat Gupta, a former managing partner of McKinsey & Co. and director at Goldman Sachs Group and Proctor & Gamble Co., who was convicted of securities fraud and conspiracy in June 2012 by a federal jury for leaking inside information to hedge-fund manager Raj Rajaratnam.

Stock Act: insider trading by members of Congress

Due to the revelation on the television program "60 Minutes" and subsequent publicity, it was discovered that members of Congress took advantage of nonpublic information by the purchase and sale of securities at substantial profit to themselves. With the revelation and obvious embarrassment, the "Stop Trading on Congressional Knowledge Act" (STOCK Act) was signed into law by President Barack Obama on April 4, 2012. Section 2 of the act amends the Commodity Exchange Act to require the commission by rule to "prohibit any person from buying or selling any commodity for future delivery or swap while such person is in possession of material nonpublic information relating to any pending or prospective legislative action relating to such commodity if—(1) such information was obtained by reason of such person being a member or employee of Congress; or (2) such information was obtained from a member or employee of Congress, and such person knows that the information was so obtained." The act extends the prohibition to federal employees with respect to confidential information not made available to the general public.

In addition, members of Congress are to report to their respective Clerk of the House of Representatives of Secretary of the Senate, within 90 days, the purchase, sale, or exchange of stocks, bonds, commodity futures, and other forms of securities involving at least $1,000. The television news station, Cable News Network (CNN), uncovered a loophole in the Stock Act, namely, that while members of Congress could not take advantage of insider information, nevertheless, the law did not prohibit members of the Congress person's family from profiting from

the said information. Accordingly, Congress passed an amendment to the Stock Act on August 2, 2012, to include spouses and children in the prohibition.

The Dodd-Frank Act, §746, *Insider Trading,* amended the Commodity Exchange Act[6] to include not only congressional persons but also any federal government employee who, because of his or her position, acquires nonpublic information that may affect or tend to affect the price of any commodity in interstate commerce, including any swap, and uses the information for personal gain by entering into a contract of sale or option of a commodity for future delivery or to assist another person to do so.

Aiding and Abetting Violators of §10b and Rule 10b-5

How far does the scope of §10b and Rule 10b-5 apply? The issue arose in several cases before the U.S. Supreme Court. In *Central Bank, N.A. v. First Interstate Bank, N.A.,* 511 U.S. 164 (1994), the court determined that mere "aiders and abettors" of fraud cannot be held liable under the act and rule. The issue was addressed again in *Stoneridge Investment Partners.*

Stoneridge, Llc v. Scientific-Atlanta, Inc.

552 U.S. 148 (2008)

In Stoneridge, Charter, a cable operator, engaged in practices that constituted fraudulent conduct in order that its quarterly reports would meet Wall Street expectations for cable subscriber growth and operating cash flow. The fraud included wrongful classification of its customer base, failure to timely report loss of customers, improper capitalization of costs, and manipulation of its billing cutoff dates to inflate its earnings. As the court stated, in order to meet a shortfall in earnings it entered into contractual arrangements with Scientific-Atlanta and Motorola whereby the latter companies supplied Charter with the digital cable converter (set top) boxes that Charter furnished to its customers. Charter arranged to overpay respondents $20 for each set top box it purchased until the end of the year, with the understanding that respondents/defendants would return the overpayment by purchasing advertising from Charter. The plaintiffs alleged that the transactions had no economic substance. The complaint stated that because Charter would then record the advertising purchases as revenue and capitalize its purchase of the set top boxes in violation of generally accepted accounting principles, Scientific-Atlanta and Motorola aided and abetted Charter to fool its auditor into approving a financial statement showing it met projected revenue and operating cash flow numbers.

The court decided, however, that §10(b)'s implied private right of action does not extend to aiders and abettors. Scientific-Atlanta and Motorola had no duty to disclose and their deceptive acts were not communicated to the public. There was no showing that investors had knowledge of the

deceptive acts during the relevant times nor was there proof of reliance on the acts stated as the basis for their claim. "It was Charter, not respondents, that misled its auditor and filed fraudulent financial statements; nothing respondents did made it necessary or inevitable for Charter to record the transactions as it did." The court further noted that the decision did not preclude the SEC from bringing civil and//or criminal charges for such actions but private parties would be precluded from asserting claims against aiders and abettors of wrongful acts under the said act and rule unless primary liability was established rather than as aiding and abetting the conduct.

Dodd-Frank and the Stoneridge Decision. There was an effort to include in the Dodd-Frank Act a provision that effectively would have reversed the Central Bank and Stoneridge decisions and would have allowed private relief against those persons who "advise on or assist in structuring securities transactions and who have actual knowledge of securities fraud." The amendment was not included in the final Act. Section 929Z of the Dodd-Frank Act, however, directs the Comptroller General to undertake a study to determine whether to permit private relief against aiders and abettors and the SEC was given broader powers under §929O to prosecute persons who aid and abet violations knowingly or recklessly.[7]

The Commodity Exchange Act of 1936

Introduction

Among the many causes and events that allegedly brought about the Great Depression of the 1930s were the commission of fraud, price manipulation, and other unlawful acts affecting the commodities stock market. One of the many reforms of the Franklyn Roosevelt Administration was the passage of the Commodity Exchange Act of 1936.[8] Its ostensible purposes are to serve the public interest by a system of self-regulation of trading facilities, clearing systems, market participants, and market professionals under the oversight of the SEC. In addition, the act seeks to "deter and prevent price manipulation or any other disruptions to market integrity; ensure the financial integrity of all transactions avoid systemic risk; protect all market participants from fraudulent or other abusive sales practices and misuses of customer assets; and to promote responsible innovation and fair competition among boards of trade, other markets and market participants."

Commodities Futures Trading Commission

In 1974, the act was amended to create the Commodities Futures Trading Commission, comprising five commissioners appointed by the president, no more

than three of whom may be members of the same political party, with the advice and consent of Congress. Its mission reflects that of the Commodity Exchange Act of 1936, that is "to protect market users and the public from fraud, manipulation, abusive practices and systemic risk related to derivatives that are subject to the Commodity Exchange Act, and to foster open, competitive, and financially sound markets."

Extraterritorial Application of the Exchange Act

One of the most controversial areas of U.S. law is the attempt to exert its jurisdiction over acts and actors beyond the U.S. borders. The Dodd-Frank Act provides for such enforcement of the Exchange Act and the Investment Advisers Act of 1940 in §929P(b) wherein it states that the federal district courts of the United States shall have jurisdiction of an action or proceeding brought or instituted by the commission or the United States alleging a violation of the antifraud provisions of the Exchange Act or of the Investment Advisers Act involving—"(1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors"; or "(2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States." Whether or not countries whose citizens are affected will cooperate with the U.S. courts depends on the nature of the alleged violations and compacts entered into between the nations.

There is no provision for a private right of action under this section; however, §929Y mandates a "Study on Extraterritorial Private Rights of Action" by SEC, which is to solicit public comment and thereafter conduct a study to determine the extent to which private rights of action under the antifraud provisions of the Exchange Act of 1934 should be extended to cover the above-stated conduct. The study is to consider and analyze (1) the scope of such a private right of action, including whether it should extend to all private actors or whether it should be more limited to extend just to institutional investors or otherwise; (2) what implications such a private right of action would have on international comity; (3) the economic costs and benefits of extending a private right of action for transnational securities frauds; and (4) whether a narrower extraterritorial standard should be adopted. The report is to be made to the Senate on Banking, Housing, and Urban Affairs of the Senate and to the Committee on Financial Services of the House.

The Exchange Act is silent as to the application and enforcement of its mandates beyond U.S. borders. Thus it was left to the courts to interpret to what degree, if any, the act applies to companies in foreign jurisdictions.[9] Except for Title VII that concerns swaps, the Dodd-Frank Act appears to be silent concerning its application abroad. The latest ruling by the U.S. Supreme Court, concerning §10b of the Exchange Act, narrows the territorial scope of the act.

Morrison v. National Australia Bank Ltd.

558 U.S.__ (2010)

FACTS: National Australia Bank Ltd. is the largest bank in Australia. Its shares are traded on the Australian Stock Exchange Ltd. and other exchanges. In the United States, shares may be purchased on the New York Stock Exchange in the form of National's American Depositary Receipts. The complaint alleges that in February 1998, National bought respondent HomeSide Lending, Inc., a mortgage servicing company headquartered in Florida. Its business was to receive fees for servicing mortgages. The rights to receive the fees can provide a valuable income stream depending, in part, on whether the mortgage to which it applies will be fully repaid before it is due, terminating the need for servicing. HomeSide calculated the present value of its mortgage-servicing rights by using valuation models designed to take this likelihood into account. It recorded the value of its assets, and the numbers appeared in National's financial statements.

From 1998 until 2001, National's annual reports and other public documents proclaimed the success of HomeSide's business, and its CEO and chief operating officer (COO) did the same in public statements. On July 5, 2001, however, National announced that it was writing down the value of HomeSide's assets by $450 million; and then again on September 3, by another $1.75 billion. The prices of the shares of stock and depository receipts dropped significantly. National thereafter explained that the write-down was the result of a failure to anticipate the lowering of prevailing interest rates, which led to more refinancings and other mistaken assumptions in the financial models, and the loss of goodwill. The complaint alleges that HomeSide and its senior officers had manipulated HomeSide's financial models to make the rates of early repayment unrealistically low in order to cause the mortgage-servicing rights to appear more valuable than they really were. The complaint also alleges that they were aware of this deception by July 2000, but did nothing about it, all in violation of §§10(b) and 20(a) of the Securities and Exchange Act of 1934 SEC Rule 10b–5.

ISSUE: Whether §10(b) of the Securities Exchange Act of 1934 provides a cause of action to foreign plaintiffs suing foreign and American defendants for misconduct in connection with securities traded on foreign exchanges?

DECISION: The court affirmed the lower courts' dismissal of the complaint based upon the Exchange Act §10(b) silence concerning the extraterritorial reach of the section.

REASONING (Scalia, J.): It is a "longstanding principle of American law 'that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States . . . .' " Thus, "unless there is the affirmative intention of the Congress clearly

expressed" to give a statute extraterritorial effect, "we must presume it is primarily concerned with domestic conditions . . . . " When a statute gives no clear indication of an extraterritorial application, it has none . . . .

Rule 10b-5, the regulation under which petitioners have brought suit, was promulgated under §10(b), and "does not extend beyond conduct encompassed by §10(b)'s prohibition." *United States* v. *O'Hagan*, . . . Therefore, if §10(b) is not extraterritorial, neither is Rule 10b-5. On its face, §10(b) contains nothing to suggest it applies abroad:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe . . . "

Petitioners and the Solicitor General contend, however, that three things indicate that §10(b) or the Exchange Act in general has at least some extraterritorial application.

First, they point to the definition of "interstate commerce," a term used in §10(b), which includes "trade, commerce, transportation, or communication . . . between any foreign country and any State." 15 U.S.C. §78c(a)(17). But "we have repeatedly held that even statutes that contain broad language in their definitions of 'commerce' that expressly refer to '*foreign* commerce' do not apply abroad."

Petitioners and the Solicitor General next point out that Congress, in describing the purposes of the Exchange Act, observed that the "prices established and offered in such transactions are generally disseminated and quoted throughout the United States and foreign countries." 15 U.S.C. §78b(2). The antecedent of "such transactions," however, is found in the first sentence of the §, which declares that "transactions in securities as commonly conducted upon securities exchanges and over-the counter markets are affected with a national public interest." §78b. Nothing suggests that this *national* public interest pertains to transactions conducted upon *foreign* exchanges and markets. The fleeting reference to the dissemination and quotation abroad of the prices of securities traded in domestic exchanges and markets cannot overcome the presumption against extraterritoriality.

Finally, there is §30(b) of the Exchange Act, 15 U.S.C. §78dd(b), which *does* mention the Act's extraterritorial application: "The provisions of [the Exchange Act] or of any rule or regulation thereunder shall not apply to any person insofar as he transacts a business in securities without the jurisdiction of the United States," unless he does so in violation of regulations promulgated by the Securities and Exchange Commission "to

prevent . . . evasion of [the Act].” (The parties have pointed us to no regulation promulgated pursuant to §30(b).) The Solicitor General argues that “[this] exemption would have no function if the Act did not apply in the first instance to securities transactions that occur abroad . . . . ”

We are not convinced. In the first place, it would be odd for Congress to indicate the extraterritorial application of the whole Exchange Act by means of a provision imposing a condition precedent to its application abroad. And if the whole Act applied abroad, why would the Commission's enabling regulations be limited to those preventing “evasion” of the Act, rather than all those preventing “violation”? The provision seems to us directed at actions abroad that might conceal a domestic violation, or might cause what would otherwise be a domestic violation to escape on a technicality.

§ 10(b) reaches the use of a manipulative or deceptive device or contrivance only in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States. This case involves no securities listed on a domestic exchange, and all aspects of the purchases complained of by those petitioners who still have live claims occurred outside the United States. Petitioners have therefore failed to state a claim on which relief can be granted.

Questions

(1) What impact does the decision have on transactions of foreign securities abroad even if they affect U.S. residents?

(2) Are there any circumstances wherein the court would uphold either a private or a governmental lawsuit concerning §10(b) of the Exchange Act?

(3) Did the Dodd-Frank Act have any effect on the results of the decision?

International Regulation of Securities Markets

IOSCO

The International Organization of Securities Commissions (IOSCO), with its home office in Spain, is the leading international organization that sets forth proposed standards for securities regulation. Its mission is to cooperate in developing, implementing, and promoting adherence to standards that it has adopted in cooperation with the many governmental securities globally. The standards are aimed at protecting, enhancing, and promoting investor confidence by the maintenance of efficient and transparent markets and by addressing systemic risks. It seeks to strengthen information

exchange, cooperation of enforcement authorities against securities' misconduct, and assist in developing markets, markets infrastructure, and the implementation of regulation.[10] IOSCO's basic principles of securities regulation are annexed as Appendix A.[11]

European Union Securities Directives

The European Union has issued a number of programs and directives concerning diverse areas of securities laws. Among them are:

Financial Services Action Plan

Financial Services Action Plan (FSAP) was created in 1999 and was to last for six years. It was an ambitious program to create a single market for financial services. Consisting of 42 articles concerning the harmonization of the financial services market within the EU, it had four strategic objectives, namely, (1) develop a single European market in wholesale financial services; (2) create open and secure retail markets; (3) ensure financial stability through establishing state-of-the-art prudential rules and supervision; and (4) set wider conditions for an optimal single market. The stated priorities were the revision of a common legal framework for integrated and securities markets; the removal of barriers to raising capital in the EU; the assurance of the continued stability of the European markets; and the creation of a secure and transparent environment for inter-EU state restructuring. Among the measures undertaken were harmonized financial disclosure regimes for listed issuers based on common international accounting standards, the Prospectus Directive, and the Transparency Directive.

In a final report concerning its effectiveness, it concluded that the observable market impacts differed in the three major areas of banking, securities, and insurance. In the securities realm, there were a number of complex measures that were undertaken but there was a clear impact in unifying the rules and regulations governing the securities market. FSAP's impact on insurance was the least notable while the impact on banking was unclear due to the banking crisis that exists to the present day.[12]

The Lamfalussy Process

The European Council of Economics and Finance Ministers, chaired by Baron Alexandre Lamfalussy, in March 2001, made recommendations for the securities industry in four areas or levels as follows:

Level One: The European Parliament and the Council are to issue directives or recommendations establishing the core values of a law and building guidelines on its implementation. The directives were to be general in scope to serve as

the framework for the harmonization of securities regulation. The regulatory implementation of the recommendations was to be accomplished by a regulatory committee of EU representatives of the EU national ministers of finance and an advisory committee of national financial supervisors. The areas to be covered are banking, securities, and insurance.

Level Two: In consultation with various groups and committees and considering the position of the European Parliament, the Commission is to adopt implementing measures. The measures are to be prepared by sector-specific committees and regulators advise on technical details which are then brought to a vote in front of member state representatives. Once approved, the measures become immediately effective without further approval of the council or Parliament pursuant to a directive approved by them.

Level Three: For the technical preparation of the implementing measures, the commission is advised by Committees, made up of representatives of national supervisory bodies, referred to as the "Level 3" Committees—the Committee of European Banking Supervisors, the Committee of European Insurance and Occupational Pensions Supervisors, and the Committee of European Securities Regulators. These Committees set up by Commission have the task of implementing the EU directives by securing more effective cooperation between national supervisors and the convergence of supervisory practices.

Level Four: The Commission enforces the timely and correct transposition of EU legislation into national law.

The result of the Lamfalussy process was the acceleration of market integration. Financial institutions and products became increasingly cross-EU border based thereby bring product innovation and complexity. It also led to cross-border and cross-sectoral mergers and acquisitions.

The Prospectus Directive[13]

The purpose of the 2003 Directive was to harmonize the drawing up, approval, and distribution of the prospectus to be published and distributed to the public when securities are offered or admitted to trading on a regulated market within a member state. The said member states may not permit an offer of securities to be made within their jurisdiction unless accompanied by a prospectus. Exceptions include offers made to qualified investors; offers to fewer than 100 natural persons; offers to investors who acquire securities of at least EUR 50,000 per investor, or where the total sum of securities offered are less that EUR 100,000. There are provisions for exemption for shares already issued of the same class unless issued for increase in capital; securities offered in connection with a takeover in an exchange offer or merger; and shares offered free of charge allotted to existing shareholders or employees.

A "qualified investor" is (a) a legal entity authorized to operate in financial markets or other financial institutions, national or regional governments, and supranational institutions (IMF, European Central Bank, etc.), international

organizations and investors, who are natural persons with whom the investor has carried out transactions of a significant size on securities markets at an average frequency of, at least, ten per quarter over the previous four quarters; (b) the size of the investor's securities portfolio exceeds EUR 0.5 million permitted to or so designated by a member state or (c) the investor works or has worked for at least one year in the financial sector in a professional position that requires knowledge of securities investment.

Transparency Directive[14]

The purpose of the directive is to increase the harmonization and transparency of financial information distributed to member states. It establishes requirements for annual, periodic, and current information by issuers whose shares are traded in public exchanges. The 2004 Directive, however, may be replaced by the proposed directive "amending Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and Commission Directive 2007/14/EC."[15] The purpose of the amendment is to ensure a high level of investor confidence through equivalent transparency for securities issuers and investors throughout the EU.

The Transparency Directive requires issuers of publicly traded securities to publish periodic financial information about the issuer's performance over the financial year and ongoing information on major holdings of voting rights. It also sets forth minimum standards for access to and storage of regulated information. It complements other EU directives that impose obligations concerning market abuse and prohibit insider trading. It also endeavors to assist small- and medium-sized issuers by creating templates for what should be included in management reports to be filed with the member state. It further ensures transparency by requiring payments made to governments in extractive fields (natural resources), a harmonized regime for notification of major holdings of voting rights, and transparency of information to investors concerning all public securities in the member states.

Markets in Financial Instruments Directive[16]

MiFID replaced the Investment Services Directive (ISD), which was adopted in 1993, and there is further consideration for a new version of MiFID under discussion at the time of this writing. The member states and a majority of the European Parliament consented to the directive that governs the financial markets. The directive was passed to improve the competitiveness of EU financial markets by creating a single market for investment services and activities. It also sought to ensure a high degree of harmonized protection for investors in financial instruments such as shares, bonds, derivatives, and various structured products. MiFID has brought greater competition across Europe in the provision of services to investors and between trading venues. This has helped contribute to deeper,

more integrated, and liquid financial markets. It has also driven down costs for issuers, delivering better and cheaper services for investors, and contributing to economic growth and job creation in Europe.[17]

The EU Commission has proposed amending MiFID II in order to meet certain alleged shortcomings of MiFID I. The amended directive is divided into two parts: (1) a regulation that sets forth requirements of transparency of data available to investors and other interested persons; transaction data to be made available to securities' authorities; the removal of barriers to nondiscriminatory clearing facilities; the mandatory trading of derivatives on organized exchanges; supervisory provisions, especially concerning derivatives and services by third-party firms; (2) a directive that sets forth specific requirements for investment services; exemptions; organizational and conduct of business requirements for investment firms; requirements of data services; and other rules.

As amended, the new MiFID would offer a new type of trading venue into the regulatory framework, namely, the Organized Trading Facility (OTF). The facility would incorporate platforms that previously were not regulated such as standardized derivatives contracts. It would allow for different business models to ensure that all trading venues play by the same transparency rules and thus mitigate conflicts of interest. Small- and medium-sized enterprises would have separate treatment to ensure a quality label for these platforms. It is also intended that the amended MiFID would introduce new safeguards for algorithmic and high-frequency trading activities that have dramatically sped trading and also possible systemic risks. It would also increase transparency of trading activities to include "dark pools," which are trading volumes or liquidity not available on public platforms. There would be a new transparency for nonequities markets, that is, bonds, structured finance products, and derivatives.

MiFID would reinforce supervisory powers and provide a stricter framework for commodity derivatives by expanding the powers of the European Securities and Markets Authority and other financial regulators. It is also intended to build stronger investor protection by stricter requirements for portfolio management, investment advice, and the offer of complex financial products such as structured products. Independent advisers and portfolio managers would be prohibited from making or receiving third-party payments or other monetary gains.[18]

The amended directive contains a revision of exemptions concerning providers of investment services that also deal on their own account. Exemptions were added to exclude persons who deal on their own account as an exclusive activity or as part of another nonfinancial corporate activity or nonfinancial commodity-trading activity. There are upgrades to the market structure framework consisting of a new category of organized trading facilities that do not correspond to the trading facilities previously covered, whereby they will be subject to identical transparency rules and requirements to ensure greater competition and cross-border trading brought about by advances in technology. The directive provides for enhanced organizational requirements to ensure efficient functioning and integrity of markets especially to firms engaged in high-frequency trades by adopting appropriate risk controls.

China Securities Laws

In China, the applicable legislation is the "Securities Law of the People's Republic of China" (PRC), which was initially adopted in 1998 but revised in 2005.[19] Comprising 12 chapters and 240 articles, it is a lengthy eclectic document encompassing much of the rules and regulations of its Western counterparts. It iterates in its general provisions the application of the law that governs stocks, bonds, and other securities recognized by law. It prohibits fraud, insider trading, and/or manipulation of securities. Other applicable laws are the Law of the PRC for Investment in Securities, and the Companies Law of the PRC, both adopted on April 28, 2009.

Article 6 of the statute appears to have taken the position of the Glass-Steagall Act, that is, the separation of the different entities so that there would be no crossover. The article states that "the divided operation and management shall be adopted by the industries of securities, banking, trust as well as insurance. The securities companies and the business organs of banks, trust and insurance shall be established separately, unless otherwise provided for by the state." The fear was the accumulation of too much power in any particular industry. Recall that China looks abroad in determining whether to adopt particular rules and regulations. Thus, when the Glass-Steagall Act was replaced by the Gramm-Leach-Bliley Act, which removed the division of commercial from investment banking and other businesses, China relaxed its prohibitions. It has permitted banks to become involved in asset management, insurance, and broker-dealer activities.[20]

Similarly, the Securities Law prohibits a public issuance of securities unless examined and approved by the China Securities Regulatory Commission (CSRC). An issuer filing an application for public issuance of stocks or corporate bonds through an underwriter has to use the services of one approved by law. Initial public offerings (IPOs) have to satisfy a number of requirements including a "sound and well-operated organization with a sound financial status," a business license, constitution, prospectus, underwriter, and bank for receipt of funds. There is substantial similarity between China's securities law and that of the United States in that registration is required for public issuance of stocks or convertible corporate bonds that includes all pertinent information including the prospectus. The issuance of an IPO may only be done by a company with fully operating organization that is capable of making profits and has a sound financial basis without irregularity over the past three years. A stock company must possess at least RMB 30 million yuan and a limited liability must have at least RMB 30 million yuan.

There are comparable requirements for issuance of corporate bonds and offers by proxy. Subsequent transactions in stocks and bonds, establishment of stock exchanges and securities companies are all regulated in substantial detail. A securities industry association (SRO) is created by law to which all securities companies must belong. Its functions include the education and organization of its members; collecting information; safeguarding the rights and interests of its members; setting forth rules by which its members must abide; conducting mediation for disputes between members and clients; and other such functions.

Chapter III, Section IV, of the PRC's Securities Law prohibits certain trading acts. The major prohibition is against insider trading. Any insider who has access to any insider information of securities trading or who unlawfully obtained such information is prohibited from taking advantage of the information to engage in securities trading. Insiders having access to insider information of securities trading include a broad list of persons: directors, supervisors, and senior managers; shareholders holding 5 percent or more of shares in the company; the holding company of the company; and persons engaged in the issuance of securities; functionaries of securities regulatory body; and persons involved in underwriting, stock exchanges, securities registration, and clearing agencies. Interestingly, it contains prohibitions that the United States now in the STOCK Act finally prohibits, that is, prohibitions against state functionaries who receive confidential information.

Its Chapter 11, Legal Liabilities, extensively sets forth the penalties for unlawful public issuance of securities; fraud; and other malfeasance. Penalties include a cease-and-desist order; fines of 30,000–300,000 yuan [6.25 yuan is about $1 dollar] or fines of 1–5 percent of funds illegally raised; fines of 300,000–600,000 yuan for fraud and comparable sums for moneys raised. The reader should consult the very extensive chapter, which contains 51 articles spelling out the possible penalties for the many types of violations.

The Securities Law has provisions for the transaction of securities that have strict rules for maintenance of secrecy of accounts by stock exchanges and other securities institutions; reimbursement to the company of profits gained by senior corporate managers who hold 5 percent or more of stock in the company and who, within six months of purchase sell the said shares; and publicized reasonable charges for the transaction of securities (Article 47).

Stock exchanges are governed by Chapter V of the Securities Law. A "stock exchange" is defined as "a legal person that provides the relevant place and facilities for concentrated securities trading, organizes and supervises the securities trading and applies a self-regulating administration" (Article 102). The stock exchange is required to have a constitution, a council with a general manager subject to the China regulatory authority. Practitioners must not have been the subject of disciplinary proceedings within the past five years and be free from conflict of interest. The exchange must guarantee a fair centralized trading, announce up-to-the-minute quotations, and take measures to suspend trading or speed trading under emergency situations. The securities company must comply with the rules of the exchange, bear the legal responsibilities of settlement and delivery of the stocks, and comply with the formalities of transfer registration of securities. The exchange shall establish a risk fund account from the fees received for use under defined purposes.

China Securities Regulatory Commission

The CSRC is a ministry under the State Council that regulates China's securities and futures markets and its functions are in many respects like the SEC

in the United States. Consisting of 18 departments, it has 36 regional bureaus in all provinces, autonomous regions, municipalities, and cities. Its function is to ensure the orderly and lawful operation of the securities and futures markets. Among the departments are those of Public Offering Supervision, Market Supervision, Listed Company Supervision, Investment Fund Supervision, two Enforcement Bureaus, as well Departments of Research, Accounting, and Legal Affairs.

Located in Beijing, the CSRC has significant supervisory and administrative functions. Included among them are the following:

- Study and formulate policies and development plans for the securities and futures markets
- Draft relevant laws and regulations governing the said markets
- Administer the domestic securities and futures regulatory institutions
- Supervise the issuance, listing, trading, custody and settlement of stocks, convertible bonds, bonds of securities companies
- Supervise the listing, trading, and settlement of domestic contract-based futures; and monitor the overseas futures businesses of the domestic institutions in accordance with the relevant regulations
- Supervise the securities and futures exchanges as well as their senior management
- Supervise the securities and futures business institutions, securities investment fund management companies, securities depository and clearing corporations, futures clearing institutions, securities and futures investment consulting institutions, and securities credit rating institutions; examine and approve the qualifications of fund custodian institutions
- Supervise the direct or indirect issuance and listing of shares overseas by domestic enterprises as well as the listing of convertible bonds by the companies listed overseas
- Investigate and penalize the activities in violation of the relevant securities and futures laws and regulations
- Perform other duties as assigned by the State Council[21]

The following decision is an example of CSRC enforcement.

CSRC Administrative Sanction Decision (On Ye Zhigang)
[2012] No. 2

March 28, 2012

In January 2006, Ye Zhigang joined the Research Institute of Haitong Securities. In April 2008, he was appointed as the chief analyst responsible for studying the machinery industry and writing research reports. The research report he completed was to be sent to customers by e-mail. Recipients included the internal staff of Haitong Securities, all domestic fund

companies, insurance companies and other institutions, as well as some individual customers. Before Research Institute of Haitong Securities delivered the research reports written by Ye Zhigang on numerous occasions from September 2006 to April 2009, Ye Zhigang bought many stocks recommended in the reports many times through his own account and the securities accounts of Liu and Ren. After the delivery of the reports, he then sold the stocks to make a profit.

The CSRC charged him with unlawful market manipulation under Paragraph 1.4 of Article 77 of Securities Law and "manipulating the securities market" under Article 203 of Securities Law. After an investigation and hearing, Ye Zhigang's illegal income of 325,787.19 RMB yuan was seized and a fine of one million RMB yuan was imposed.

In Chapter 6, we will discuss swaps and the international regulation of swaps and securities and U.S. and international efforts to combat corruption particularly of governmental officials.

APPENDIX A
IOSCO Objectives and Principles of Securities Regulation

A. Principles Relating to the Regulator

1. The responsibilities of the Regulator should be clear and objectively stated.
2. The Regulator should be operationally independent and accountable in the exercise of its functions and powers.
3. The Regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.
4. The Regulator should adopt clear and consistent regulatory processes.
5. The staff of the Regulator should observe the highest professional standards, including appropriate standards of confidentiality.
6. The Regulator should have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate.
7. The Regulator should have or contribute to a process to review the perimeter of regulation regularly.
8. The Regulator should seek to ensure that conflicts of interest and misalignment of incentives are avoided, eliminated, disclosed or otherwise managed.

B. Principles for Self-Regulation

9. Where the regulatory system makes use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for

their respective areas of competence, such SROs should be subject to the oversight of the Regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.

C. Principles for the Enforcement of Securities Regulation

10. The Regulator should have comprehensive inspection, investigation and surveillance powers.
11. The Regulator should have comprehensive enforcement powers.
12. The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.

D. Principles for Cooperation in Regulation

13. The Regulator should have authority to share both public and non-public information with domestic and foreign counterparts.
14. Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.
15. The regulatory system should allow for assistance to be provided to foreign Regulators who need to make inquiries in the discharge of their functions and exercise of their powers.

E. Principles for Issuers

16. There should be full, accurate and timely disclosure of financial results, risk and other information which is material to investors' decisions.
17. Holders of securities in a company should be treated in a fair and equitable manner.
18. Accounting standards used by issuers to prepare financial statements should be of a high and internationally acceptable quality.

F. Principles for Auditors, Credit Ratings Agencies, and other information service providers

19. Auditors should be subject to adequate levels of oversight.
20. Auditors should be independent of the issuing entity that they audit.
21. Audit standards should be of a high and internationally acceptable quality.
22. Credit rating agencies should be subject to adequate levels of oversight. The regulatory system should ensure that credit rating agencies whose ratings are used for regulatory purposes are subject to registration and ongoing supervision.

23. Other entities that offer investors analytical or evaluative services should be subject to oversight and regulation appropriate to the impact their activities have on the market or the degree to which the regulatory system relies on them.

G. Principles for Collective Investment Schemes

24. The regulatory system should set standards for the eligibility, governance, organization and operational conduct of those who wish to market or operate a collective investment scheme.
25. The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.
26. Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.
27. Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.
28. Regulation should ensure that hedge funds and/or hedge funds managers/advisers are subject to appropriate oversight.

H. Principles for Market Intermediaries

29. Regulation should provide for minimum entry standards for market intermediaries.
30. There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.
31. Market intermediaries should be required to establish an internal function that delivers compliance with standards for internal organization and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk, through which management of the intermediary accepts primary responsibility for these matters.
32. There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.

I. Principles for Secondary Markets

33. The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.
34. There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike

an appropriate balance between the demands of different market participants.

35. Regulation should promote transparency of trading.
36. Regulation should be designed to detect and deter manipulation and other unfair trading practices.
37. Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.
38. Securities settlement systems and central counterparties should be subject to regulatory and supervisory requirements that are designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.

CHAPTER 6

U.S. and International Regulation of Swaps and Efforts to Combat Corruption

Introduction

Among the many causes attributable to the financial crisis of 2007–2009 was the virtually unregulated and greatly misunderstand nature of complex instruments known as derivatives. A "derivative" has been defined as "a financial contract whose value is derived from the performance of underlying market factors, such as interest rates, currency exchange rates, and commodity, credit, and equity prices." It includes a variety of financial contracts such as structured debt obligations and deposits, swaps, futures, options, caps, floors, collars, forwards, and combinations of the said types of obligations.[1]

Heretofore, derivatives were not regulated due to the provisions of the Commodity Futures Modernization Act of 2000[2] that specifically prohibited their regulation as futures, which was premised on the theory that trades in derivatives were accomplished by sophisticated investors who did not require governmental protection. Therefore, banks and securities dealers, in essence, were free to deal in such securities limited only by vague safety and soundness standards. The addition of §§2(g) and 2(h) to the Commodity Exchange Act (CEA) by §§206B and 206C of the Gramm-Leach-Bliley Act, which created exemptions for bilateral swap markets and for exempt commodities including oil and energy products, has been cited by scholars as the "Enron Loopholes" and as contributing factors in the ensuing financial crisis. As a result, the Dodd-Frank Act made substantial changes in the law concerning the regulation of derivatives.

The provisions of the Dodd-Frank Act changed the regulatory landscape of derivatives and, in particular, the form of derivatives known as "swaps." Therefore, we will discuss the statutory pronouncements and the final rules issued pursuant to the act in considerable detail. Title VII of Dodd-Frank, "Wall Street Transparency and Accountability Act of 2010," is the statutory basis for regulation of swaps. As provided for in the act, the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) were given a joint mandate to develop and publish final rules to elaborate on and enforce the statutory provisions. Accordingly, on August 13, 2012, the two

commissions jointly published the Final Rules that define, explain, and carry out the mandate.[3]

We previously discussed the structure of the SEC in Chapter 3. The CFTC was created by the passage of the CEA of 1936.[4] The act was passed as a result of congressional findings of fraud, price manipulation, and other unlawful acts affecting the stock market. Its ostensible purposes are:

- To serve the public interest by a system of self-regulation of trading facilities, clearing systems, market participants, and market professionals under the oversight of the commission
- Deter and prevent price manipulation or any other disruptions to market integrity
- Ensure the financial integrity of all transactions avoid systemic risk
- Protect all market participants from fraudulent or other abusive sales practices and misuses of customer assets
- Promote responsible innovation and fair competition among boards of trade, other markets, and market participants

Dodd-Frank Act and Swaps

The Dodd-Frank Act amended the CEA and the Securities and Exchange Act of 1934 by expanding the definitions of the relevant terms under Title VII. The purpose of the statute was to provide a comprehensive regulatory framework for swaps, security-based swaps, and mixed swaps so as to reduce systemic risk, increase transparency, and promote market integrity in order that investors and institutions may intelligently decide whether to engage in such activity.[5] The means of accomplishing such protection and transparency are by the comparable methods used for broker-dealers, investment advisers, and the like, namely, by providing for the registration and regulation of swap dealers, security-based swap dealers, and other major swap participants. Other requirements include clearing and trade execution requirements, extensive recordkeeping, and enhanced rulemaking authority of the two commissions. Each commission is given specific regulatory authority, to wit, swaps are to be regulated by the CFTC, while security-based swaps come under SEC jurisdiction, which also has antifraud authority over and access to information from certain CFTC-regulated entities.

Definitions

Swap

The definition of a "swap" is given in §1a(47) of the CEA but Dodd-Frank added to it under Title VII, §721(a)(21). In essence, it is a form of a derivative whereby the parties exchange the cash flows of financial instruments to the other. As amended, the CEA defines a swap broadly as any agreement, contract, transaction, or combination thereof.

- That is a put, call, cap, floor, or similar option of any kind for the purchase or sale or based on the value of one or more interest or other rate, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind
- That provides for any purchase, sale, payment, or delivery that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence
- That provides for the executory basis for the exchange, on a fixed or contingent basis, of one or more payments based on the value of one or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind, or any interest therein or based on the value thereof, and that transfers, as between the parties to the transaction, in whole or in part, the financial risk associated with a future change in such value or level without also conveying a current or future direct or indirect ownership in an asset including any enterprise or investment pool or liability that incorporates the financial risk so transferred.

There are many types of swaps including an interest rate swap; a rate floor, cap, or collar; a currency or cross-currency rate swap; a basis swap; a foreign exchange swap; a total return swap; an equity index or equity swap; a debt or debt index swap; a credit or credit default swap; a weather swap; an energy swap; a metal swap; an agricultural swap; an emissions swap; and a commodity swap. Among the purposes of such swaps is to hedge against certain risks or simply bet that certain occurrences will or will not occur. For example, a company selling products abroad may want assurance against devaluation of the currency used to purchase its products.[6]

Security-Based Swap

A "security-based swap" is an agreement, contract, or transaction that is a swap and "is based on (1) an index that is a narrow-based security index, including any interest therein or on the value thereof; (2) a single security or loan, including any interest therein or on the value thereof; or (3) the occurrence, nonoccurrence, or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial condition, or financial obligations of the issuer."[7]

Major Swap Participant

A "major swap participant" is any person who is not a swap dealer and (1) maintains a substantial position in swaps for any of the major swap categories as determined by the CFTC, excluding positions held for hedging or mitigating

commercial risk; and positions maintained by any employee benefit plan; or (2) is a financial entity that is highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements established by an appropriate banking agency, and maintains a substantial position in outstanding swaps in any major swap category as determined by the CFTC.[8]

Swap Dealer

A "swap dealer" is any person who (1) holds itself out as a dealer in swaps; (2) makes a market in swaps; (3) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (4) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.[9]

Security-Based Swap Dealer

A security-based swap dealer is any person who (1) holds himself/herself/it out as a dealer in security-based swaps; (2) makes a market in security-based swaps; (3) regularly enters into security-based swaps with counterparties as an ordinary course of business for his/her/its account; or engages in any activity known in the trade as a dealer or market maker in security-based swaps.[10] The term does not include a person that enters into security-based swaps for such person's own account rather than as a part of regular business or where the swap dealer engages in a de minimus quantity of security-based swap dealing on behalf of customers.

Regulation of Swaps

Registration and Regulation of Swap Dealers and Major Swap Participants

It is unlawful for any person to act as a swap dealer or as a major swap participant unless such person is registered with the CFTC. The application form and manner is to be prescribed by the commission. The said persons have a continuing obligation to submit reports and other pertinent information to the CFTC as it may require. Swap dealers that are registered with a depository institution or with the SEC must also register with the CFTC. The said commission may not prescribe rules imposing prudential requirements on swap dealers and major participants for which there is a prudential regulator. There are requirements that swap dealers and major participants, whether they are banks or are not banks, meet designated minimum capital requirements and minimum initial and variation margin requirements. The provisions make clear that the standards for capital and margin are sufficient to offset the greater risk both to participants and to the financial system as a whole.[11]

Each registered swap dealer and major swap participant is to maintain records as required by the CFTC including daily trading records and related records such

as e-mails of the swaps. The daily trading records are to be maintained for each counterparty as well as a complete audit trail for conducting comprehensive and accurate trade reconstructions. The registered swap dealers and major swap participants are to observe business conduct standards as set forth by the CFTC that relate to fraud, manipulation, and abusive practices involving swaps. They comprise diligent supervision of the swap business; adherence to applicable position limits; and other standards as the CFTC may prescribe. The said standards shall include eligibility standards; disclosures to counterparties by the swap dealers or major participants of information about the material risks and characteristics of the swap; and any material incentives or conflicts of interest that they may have in connection with the swap. For cleared swaps, the swap dealer, on request of the counterparty, shall provide receipt of the daily mark of the transaction from the appropriate derivatives clearing organizations or from the swap dealer of major participant for uncleared swaps. The dealer has the duty to communicate in a fair and balanced way based on the principles of fair dealing and good faith. There are special other requirements when he/she/it acts as advisers.[12]

Every swap dealer and major participants are to designate an individual to serve as a chief compliance officer who shall report to the senior officer of the concern. The said officer shall review compliance of statutory and regulatory compliance; resolve conflicts of interest; establish procedures for remediation of noncompliance issues; institute procedures for the handling, management response, remediation, retesting, and closing of noncompliance issues; and submit annual reports prescribed by the CFTC.

Swap Facility

A person who operates a swap execution facility must register it as such facility or as a designated contract market even if it is also registered with the SEC as a swap execution facility. The facility may make available any swap for trading and may facilitate trade processing of any swap. It must comply with applicable rules and regulations of the CFTC and ensure that trading, trade processing, and participation rules protect against abuses and have the capacity to detect, investigate, and enforce those rules. Trading may occur only in swaps that are not readily susceptible to manipulation. The said facility is required to monitor trade and trade processing and establish rules that allow it to obtain all necessary information to properly perform its functions.[13]

Enforcement

The Dodd-Frank Act amended the CEA in connection with any swap to prohibit a person to use any manipulative or deceptive device thereof, or to do so with respect to the price of any swap or commodity or for future delivery in contravention of the CFTC's rules and regulations. It further prohibits the furnishing of false or misleading statement of material fact to the CFTC, including statements in the filed registration statement. If the CFTC determines that a

violation may have taken place, it may initiate a complaint against the offending person, which is followed by a hearing. The commission has subpoena powers, may compel witnesses to testify, and may invoke the aid of any federal court to compel attendance and the furnishing of documents.

Sanctions

Sanctions include the following:

- Prohibition of trading of swaps
- Suspension up to 180 days or revocation of the person's registration
- Civil penalty not to exceed the greater of $140,000 or triple the monetary gain to such person for each violation
- Where the actions were willful, a civil penalty of up to $1 million or triple the monetary gain
- Restitution to customers of damages caused by the violation
- A cease and desist order by the CFTC[14]

Registration of Security-Based Swap Dealers and Major Security-Based Participants

As stated in the opening paragraphs of this chapter, the Gramm-Leach-Bliley Act prohibited regulation of security-based swap agreements (SBSAs) and derivatives generally on the theory that legal protections against fraud and manipulation were not needed with respect to sophisticated investors. As a result of the Enron and other corporate scandals, the said provisions were repealed by Dodd-Frank Act, §762. The requirements of the Dodd-Frank Act applicable to security-based swap dealers and major security-based participants are comparable to those of swap dealers and major participants, except that it is the SEC to which such dealers and participants register.

Exclusions from Swaps and Security-Based Swaps

Insurance and Insurance Products Safe Harbor
Both commissions determined that traditional insurance products are not within the definition of swaps because they are subject to federal and state regulatory regimes. Insurance is given its usual definition of a contract that protects against proven losses by a person with an insurable interest to the extent of the actual loss, and, also, that the said contract is not traded separately from the insured interest in an organized market or over the counter (OTC). There are comparable provisions for reinsurance contracts and for nonadmitted insurance. In the case of financial guaranty insurance policies (bond insurance or bond wraps), any acceleration of payments must be at the discretion of the provider of the insurance guaranty.

Other insurance products that are excluded include surety bonds, fidelity bonds, health insurance, title insurance, annuities, private mortgage insurance,

and reinsurance. There is also an "Insurance Grandfather" exclusion for any agreement, contract, or transaction entered into on or before the effective date of the Final Rule provided it meets the above requirements. It also includes the provisions of the federal Patient Protection and Affordable Care Act of 2010. An insurance product that insures swaps that are not security-based swaps or mixed swaps is not excluded. It is treated as an integral part of the swap itself because the guarantor's resources are added to the analysis of the swap. If the guarantor is financially more capable than the swap counterparty, the analysis of the swap becomes more dependent on the creditworthiness of the guarantor.[15]

Forward Contracts

A forward contract is also excluded from the definition of a "swap." It is defined as "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled." A "nonfinancial commodity" is a commodity that can be physically delivered or is an agricultural commodity. Also included in the forward contract exclusion are environmental commodities, even though they have an intangible nature. They are considered to be commercial merchandizing transactions whose primary purpose is to transfer ownership of the commodity and not to transfer solely its price risk.

The CFTC used the principles underlying the CFTC's "Brent Interpretation" regarding book-outs in connection with the forward exclusion from futures. Book-out transactions are effectuated through a subsequent, separately negotiated agreement that qualifies for the safe harbor forward exclusion. The Brent Interpretation first occurred in 1990 when the parties to crude oil contracts were allowed to individually negotiate cancellation agreements or book-outs with other parties. The CFTC took the view that while such book-out agreements may extinguish a party's delivery obligation, they are separate, individually negotiated, new agreements. In the distribution chain, another party (or parties) is entitled to require delivery of the commodity to be made through it, as required under the contracts. Thus, they are forward, not futures, contracts.

Similarly, if an investment vehicle were to own a gold mine and sell the output of the contract for forward delivery, or own a chain of jewelry stores that produces its own jewelry from raw materials and purchase a supply of gold from another entity's gold mine in order to provide raw materials for its jewelry stores, such contracts would qualify as forward contracts under the Brent Interpretation. Further exclusions as forward contracts include physical exchange transactions whereby a gas utility enters into a transaction with another gas utility or other market participant to take delivery of natural gas at one delivery point in exchange for the same quantity of gas to be delivered at an alternative delivery point in order to transfer ownership to rationalize delivery of physical supplies.

Included within the definition of swaps and not excluded are commodity options. When commodity options are embedded in forward contracts, the CFTC stated that it will engage in a two-step analysis. It will focus on (1) whether the option operates on the price or the delivery term of the forward contract, and (2) secondary trading. Thus, where a forward contract contains an embedded commodity option or options, it will be considered to be an excluded

nonfinancial commodity forward contract and not a swap if the embedded options: (1) may be used to adjust the forward contract price but do not undermine the overall nature of the contract as a forward contract; (2) do not target the delivery term so that the predominant feature of the contract is actual delivery; and (3) cannot be severed and marketed separately from the overall forward contract in which they are embedded. The CFTC will look at the particular facts and circumstances of the transaction in making its determination.

Consumer and Commercial Agreements, Contracts, and Transactions

The commissions noted that consumers enter into agreements that concern their household and personal lives, which may appear to fall within the definition of a swap. Similarly, businesses and other entities enter into agreements relating to acquisitions or sales of tangible and intangible property, provisions of services, employment of individuals, and other agreements that may also fall within the swap definition. Examples include evidences of indebtedness with a variable rate of interest; commercial contracts with an acceleration, escalation, or indexation clause; agreements to acquire personal or real property or to obtain mortgages; and the like. It is the position of the commissions that Congress did not intend that such agreements come within the meaning of swaps.

As stated, with respect to agreements, contracts, or transactions entered into by consumers for household or personal use, the commissions have excluded them from the definition of a swap. Included are the following agreements, contracts, or transactions:

- To acquire or lease real or personal property; obtain a mortgage; provide personal services; or to sell or assign rights owned by the consumer such as intellectual property rights (patents, trademarks, copyrights)
- To purchase products or services for personal, family, or household purposes at a fixed price or a capped or collared price, at a future date or over a certain time period including, for example, agreements to purchase home heating oil where the consumer takes delivery and the counterparty is a merchant that delivers the oil to the area where the consumer resides
- Provide for an interest rate cap or lock on a consumer loan or mortgage, where the benefit of the rate cap or lock is realized only if the loan or mortgage is made to the consumer
- Consumer loans or mortgages with variable rates of interest or embedded interest rate options
- For services that are consumer product warranties, extended service plans, or buyer protection plans
- Consumer options to acquire, lease, or sell reap or personal property, such as options to lease apartments or purchase rugs and paintings, and purchases made through consumer layaway plans
- Where the consumer may cancel the transaction without legal cause
- Consumer guarantees of credit card debt, automobile loans, and mortgages of a friend or relative[16]

Commercial agreements, contracts, or transactions that involve customary business arrangements excludible from the definition of a swap include the following:

- Employment contracts and retirement benefit arrangements
- Sales, servicing, or distribution arrangements
- Where the purpose is to effect a business combination transaction
- The purchase, sale, lease, or transfer of real property, intellectual property, equipment, or inventory
- Warehouse lending arrangements in connection with building an inventory of assets in anticipation of such assets
- Mortgage or mortgage purchase commitments, or sales of installment loan agreements or contracts or receivables
- Fixed or variable interest rate commercial loans or mortgages entered into by banks and nonbanks including those entered into by the Farm Credit System institutions and the Federal Home Loan Banks or where such loans or mortgages are embedded with interest rate locks, caps, or floors provided they do not provide exposure to enhanced or inverse performance or other such risks
- Leases, service contracts, and employment agreements with escalation clauses linked to an underlying commodity such as an interest rate or consumer price index

Securities
A security that is subject to the Securities Exchange Act of 1934 is not deemed to be a swap or a security-based swap.

Foreign Exchange Forwards and Foreign Exchange Swaps
Subject to the determination of the Secretary of the Treasury and to certain reporting requirements and business conduct standards, a **s**wap and a security-based swap do not include a foreign exchange forward or foreign exchange swap. A "foreign exchange forward" is defined as a transaction that solely involves the exchange of two different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange. A "foreign exchange swap" is defined as a transaction that solely involves (A) an exchange of two different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange; and (B) a reverse exchange of the said two currencies at a later date, and at a fixed rate that is agreed upon on the inception of the contract covering the exchange. Not excluded are a currency or cross-currency swap; a currency option; foreign exchange option or foreign exchange rate option; or a nondeliverable forward involving foreign exchange.

The secretary, in making his or her determination is to consider whether the required trading and clearing of foreign exchange swaps and forwards would create systemic risk, lower transparency, or threaten the financial stability of the United States; whether they are already subject to a regulatory regime comparable

to those enunciated in Dodd-Frank; the extent to which bank regulators or participants in the said trades provide adequate supervision, including capital and margin requirements; the extent of adequate payment and settlement systems; and the use of a potential exemption of the said swaps and forwards to evade regulatory requirements.[17]

Antievasion

The act and Final Rule make it unlawful for a person to use an insurance, bank, or foreign exchange forward format or to conduct activities outside the United States in order to evade registration and other regulatory requirements. Thus, the form, label, and written documentation used for such transaction are not dispositive of the true nature of the transaction. An exception is provided where the transaction is subject to the Securities Exchange Act of 1934.[18] Where one of the parties but not the other party willfully evades the swap definition, such person will be subject to all CEA provisions and regulations including appropriate sanctions. The CFTC will not consider transactions, entities, or instruments structured in a manner solely motivated by a legitimate business purpose to constitute evasion. On the other hand, if the structured transaction is meant to evade the requirements of Title VII, then a willful evasion may be determined. There may be a willful evasion even in the absence of fraud, deceit, or unlawful activity; rather, willfulness (scienter) is the critical basis for a finding of evasion. All such transactions and the like will be analyzed on a case-by-case basis.[19]

Security-Based Swap Agreements

A "security-based swap agreement" is defined as a swap agreement of which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, including any interest therein. It does not include a security-based swap with certain exceptions such as a swap based on an index of securities that is not a narrow-based security index but rather is a broad-based security index, and an index credit default swap (CDS) that is not based on a narrow-based security index or the issuers of securities in a narrow-based security index. A swap based on a U.S. Treasury security or certain other municipal securities would also be considered under the SBSA definition.[20]

There are minimal books and records requirements for SBSAs. The Final Rules provide that a person registered as a swap data repository need not keep and maintain records concerning SBSAs including daily trading record other than those required under the CEA and by the CFTC, which are deemed sufficient for regulatory purposes. They also apply to a swap dealer, a major swap participant, a security-based swap dealer, and to a major security-based swap participant.[21]

Mixed Swap

A "mixed swap" is defined as an agreement, contract, or transaction that is a security-based swap and is also based (a) on the value of one or more interest

or other rates, currencies, commodities, instruments, of indebtedness, indices, quantitative measures, other financial or economic interest or property of any kind, or (b) the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence.[22] It is both a security-based swap and a swap. It is so designated in order to bridge the regulatory gap of a swap and a security-based swap as mandated by Dodd-Frank Title VII, §712(a)(8). Examples of a mixed swap include the value of an oil corporation and the price of oil; where there is a reference in a Title VII instrument of both securities and commodities; or instruments that are called "best of" or "outperformance" swaps that require a payment based on the higher of the performance of a security and a commodity. On the other hand, agreements based on the occurrence of an event, such as agreements that also include termination and default events relating to either or both of the counterparties relating to a single issuer of a security, will not be deemed to fall within the definition.

The commissions adopted two rules concerning the regulation of mixed swaps. The comments to the Final Rules noted that swap dealers and major swap participants are to be comprehensively regulated by the CFTC while the SEC is responsible for the regulation of security-based swap dealers and major security-based swap participants. The first of the rules concerns the "regulation of bilateral uncleared mixed swaps entered into by dually-registered dealers or major participants." In such cases, where at least one of the parties is dually registered with the CFTC as a swap dealer or major swap participant and with the SEC as a security-based swap dealer or major security-based swap participant, the participants will be subject to all applicable provisions of the federal securities laws and regulations. Such participant will be subject to the provisions of the Commodities Exchange Act (CEA) and the CFTC only with respect to examinations and information sharing, enforcement, reporting, real-time reporting, capital, and position limits. In addition, CFTC enforcement authority is subject to the antifraud, antimanipulation, and other business conduct provisions of the CEA.

With respect to "regulatory treatment of other mixed swaps," any person who wants to list, trade, or clear a mixed swap may request both commissions to issue an order permitting such activity. The said person need only comply with the parallel provisions of the CEA or the Exchange Act of 1934. A person submitting a request must provide both commissions with all material information regarding the mixed swap; its economic consequences; the specified parallel provisions applicable to the request; and an analysis of the nature and purposes of the parallel provisions, their comparability, extent of any conflict of the parallel provisions, and such other information as requested by the two commissions. After a hearing and comment, the commissions may provide the said order.

Clearing Requirements

Section 723 states that it is unlawful for any person to engage in a swap unless that person submits the swap for clearing to a derivatives clearing organization

that is registered under the act or otherwise exempted from registration under the act. There are two approaches in determining whether a swap or group or class thereof are to be required to be cleared: (1) The SEC or CFTC may determine whether the said swap or group or class should be required to be cleared; or (2) a clearinghouse may initiate such a determination by the commissions if it intends to accept for clearing a swap or group or class thereof.

The act states five factors the commissions are to make concerning the mandatory clearing determination. They are:

- The existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data
- The availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded
- The effect on the mitigation of systemic risk, taking into account the size of the market for such contract and the resources of the derivatives clearing organization available to clear the contract
- The effect on competition, including appropriate fees and charges applied to clearing
- The existence of reasonable legal certainty in the event of the insolvency of the relevant derivatives clearing organization or one or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds, and property

There is an exception from mandatory clearing requirement for swaps if one of the counterparties (1) is not a financial entity; (2) is using swaps to hedge or mitigate commercial risk; and (3) notifies the respective commission how the counterparty generally meets its financial obligations associated with entering into noncleared swaps.

The clearing agencies are required to be registered with the SEC under the Exchange Act of 1934. Title VII gives the Board of Governors of the Federal Reserve authority with respect to risk management of clearing agencies and financial institutions. The prudential requirements of the SEC may be reviewed by the Federal Reserve Board, which may recommend new risk management standards for the SEC to adopt.[23]

Miscellaneous Issues

Bailouts

Section 716 of Dodd-Frank prohibits federal assistance to any swaps entity with respect to any swap such as the use of advances from the Federal Reserve credit facility; Federal Deposit Insurance Corporation insurance or guarantees for the purpose of making any loans to any swaps entity; purchasing assets from the said entity; or entering into any assistance arrangement including tax breaks.

An insured depositary institution or its affiliates are exempt from the prohibition under certain specified conditions.

New Financial Products Approval

The inventiveness of new financial products by Wall Street cannot be minimized as was discovered during the financial crisis. The Dodd-Frank Act addresses the issue when new products thereafter are proposed. Among the questions that may arise is whether the SEC or the CFTC has the jurisdiction to regulate the said products. Section 718 provides that any person who proposes a novel derivative product that has elements of both securities and contracts of sale of a commodity for future delivery or options thereof may concurrently provide notice and furnish a copy of the filing with both the SEC and the CFTC for approval. If the filing is with one commission only, the said commission may notify and provide a copy of the filing to the other commission. The CFTC has 21 days after receipt of a notice of filing to request the SEC for a determination as to whether the filing is a security that comes within the SEC's jurisdiction. If no such notice is given, the SEC may make such a request to the CFTC within the said 21 days after notice of the filing. A determination is to be made by the commissions within 120 days after receipt of the request.

Transactions Entered Into by Foreign Central Banks, Foreign Sovereigns, International Financial Institutions, and Similar Entities

When a counterparty is a Federal Reserve bank, the federal government, or a federal agency backed by the full faith and credit clause of the United States, such counterparty is exempt from the definition of a "swap." The Commission, however, declined to exclude transactions in which a counterparty is a foreign bank, a foreign sovereign, an international financial institution, or similar entity. The reason given by the commissions is that the counterparties, who may be swap dealers, major swap participants, security-based swap dealers, or major security-based swap participants, may then couple with the foreign counterparties and thus would have no regulatory obligations concerning the said swaps. These regulated counterparties could develop significant exposure to the foreign entities without the knowledge of the commissions. The clearly designated swaps are in fact swaps that were not excluded under Dodd-Frank.[24]

International Regulation of Swaps

The Dodd-Frank Act, §719(c), requires the commissions to conduct a study and report to Congress on how swaps and security-based swaps, as well as clearing house and clearing agency, are regulated in the United States, Asia, and Europe. The aim of the act is to identify the areas of regulation that are similar and dissimilar so that they may be harmonized. Accordingly, the "Joint Report on International Swap Regulation" was prepared and submitted on January 31, 2012.[25] The Group of 20 (G-20),[26] responding to the financial crisis, agreed in September 2009 that "all standardized OTC derivative contracts should be

traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties" (CCPs) by the end of 2012 and should be reported to trade repositories. Noncentrally cleared contracts would have to maintain higher capital requirements.

The U.S. Financial Stability Board made 21 recommendations to the G-20 that were summarized under four categories:

- *Standardization*: The derivatives market should be standardized so as to increase central clearing and trading on organized platforms in order to minimize systemic risk and improve market transparency
- *Central Clearing*: To implement the standardization of the derivatives market, it will be necessary to identify those factors to determine whether a derivative contract is standardized and suitable for clearing
- *Exchange or Electronic Platform Trading*: Identify the actions needed to fully achieve the G-20 commitment that all standardized products be traded on exchanges or electronic trading platforms
- *Reporting to Trade Repositories*: The respective authorities of the G-20 must have a global view of the OTC derivatives market through full and timely access to the data necessary to achieve their mandates. The data must be comprehensive, uniform, and reliable

The proposed recommendations were endorsed by the G-20 members. A key player in this area is International Organization of Securities Commissions (IOSCO), which has formed a Task Force on OTC Derivatives Regulation in order to coordinate the efforts of securities and futures regulators to develop supervisory and oversight structures relating to the OTC derivatives market and to develop international standards relating to OTC regulation.

Regulatory Framework for OTC Derivatives by Representative Members

Canada

Canada comprises ten provinces and three territories. The provinces are mainly responsible for the regulation of OTC derivatives, and regulations may vary among them. As of the date of the Joint Report, some of the provinces were adopting a framework that would regulate OTC derivatives through a registration process. The Canadian Securities Administrators have initiated and released a consultation document that addresses potential prudential requirements, reporting, trading, and enforcement. The Investment Industry Regulatory Association of Canada oversees investment dealers that trade derivatives and is in consultation with the provinces concerning registration and regulatory requirements for the derivatives. Inasmuch as the reporting of OTC derivative transactions or positions had heretofore not been regulated, national legislation is being considered requiring provincial registration and clearing.

Brazil

Brazilian OTC derivatives are regulated by the Comissao de Valores Mobiliarios (CVM). Although the types of derivatives that counterparties may engage in are not limited by law, they must be approved by the CVM. Commercial banks, investment firms, and brokers that enter into OTC derivatives must be reported to a trade repository (TR), which must then be approved by the CVM. Capital requirements for noncentrally cleared derivatives contracts are required to have higher capital requirements than centrally cleared derivatives contracts. Derivatives are not centrally cleared by the government but may be centrally cleared if requested by the counterparties. All OTC derivatives are to be retorted to a TR. Managing entities of organized markets are allowed by law to strengthen minimum standards for intermediaries' operation on organized markets and are responsible for establishing operational and governance rules for TRs.

European Union

The European Union (EU) is undergoing fundamental restructuring relating to OTC derivatives, which regulation thereof was previously left to the member states. It has published proposed legislation known as the European Market Infrastructure Regulation (EMIR). As a regulation, if adopted, it would be binding on all member states without additional ratification by them. Implementation of certain provisions of the regulation would be by the European Securities and Markets Authority together with the European Banking Authority.

EMIR's mission is to increase transparency in the OTC derivatives market and to reduce counterparty credit and operational risks. In order to accomplish its mission, it requires that all derivatives transactions be reported to TRs, which would entail the creation of a new regulatory framework for the TRs. It further requires that eligible OTC derivatives be cleared through derivatives CCPs and take measures to reduce counterparty credit and operational risk. No distinction is made between swaps and security-based swaps. The European Commission has submitted draft proposals known as "Markets in Financial Instruments" (MiFID) and "Markets in Financial Instruments Regulation" (MIFIR) that concern disclosure of data on trading activity; mandatory execution of trades in OTC derivatives on trading venues; the removal of barriers between trading venues and providers of clearing services to ensure more competition; and specific advisory actions regarding financial instruments and positions in OTC derivatives.

The EU regulations would apply to all classes of derivatives, OTC, or traded on a regular market. They would cover all types of financial institutions including banks, insurance companies, asset management companies, pension funds, and hedge funds. EMIR would require risk management standards, including collateralization (margining), to be implemented by counterparties to bilateral OTC derivatives; segregated exchange collateral; and that clearing members offer client segregation to their clients.

The EU has also proposed two Capital Requirement Directives that would incorporate Basel III standards into EU and national law. Financial institutions

and nonfinancial institutions above a certain threshold must ensure that appropriate measures be taken to mitigate operational and credit risk. Such measures would include the timely confirmation of the terms of the OTC derivatives; robust and auditable processes for reconciliation of portfolios of OTC derivatives; early identification and resolution of disputes; and management of associated risks.

All OTC derivatives declared subject to clearing must be cleared through an authorized or recognized CCP. The CCPs would be subject to supervision and oversight by national competent authorities of the member states. All derivatives, whether centrally cleared or otherwise, would have to be reported by financial and nonfinancial counterparties. There would be registration and supervision requirements applicable to all TRs. The registered TRs would have to ensure that the information they maintain is reliable, secure, and protected. There would be registration requirements for trading venues. These trading venues would be required to have transparency with respect to pre- and posttrade prices and volume for all derivative transactions, whether OTC or traded on an organized venue.

Japan

In May 2010, Japan passed the "Amendment to the Financial Instruments and Exchange Act" (FIEA), which gave the Japanese financial regulator authority to regulate OTC derivatives. It covers financial products such as equity swaps, interest rate swaps, and other such products, excluding commodities. Financial institutions may engage in derivatives or act as intermediaries but they are required to be registered. Japan has implemented Basel II requirements for banks that include enhanced measurements of risks related to securitization and trading book exposures. It has no separate licensing requirements for derivatives dealers provided that the financial institutions engaging in the said activity register with the appropriate governmental agency.

All financial institutions have to comply with business conduct rules as promulgated. Clearing though a CCP is mandatory for trades that are significant in volume and would reduce settlement risks in the domestic market. All CCPs have to be licensed and must have capital in excess of 1 billion yen, as well as authorized internal operating rules, expertise in clearing transactions in financial instruments, and an adequate infrastructure to ensure timely collateral calls for settlement of liability. There are mandatory reporting requirements for OTC derivatives for financial institutions including the storing and reporting of trade information to a TR or other governmental agencies. In addition, there are registration and regulatory requirements for markets and for repositories.

China

China's regulation of OTC derivatives is as yet evolving. There has been increased standardization of OTC derivatives products although it was unclear as of this writing whether all assets classes will be covered. Institutions engaging in OTC derivatives transactions must use the agreements developed by the National

Association of Financial Market Institutional Investors. Anticipated regulations would include mandatory or reporting of all OTC derivatives transactions to TRs and the designation of clearing requirements, likely by the Shanghai Clearing House. There are advanced regulatory requirements in other parts of Asia, particularly South Korea, Australia, Hong Kong, and Singapore.

Conclusion

Joint Report of the SEC and CFTC

The report concluded that the G-20 and the crisis of 2007 and thereafter has influenced greatly the development of standards for the hitherto unregulated derivatives markets. The member countries of the G-20 have adopted in great part a unified set of goals of central clearing; trading on exchanges and electronic trading platforms; reporting to TRs; standardization; and capital requirements. There continue to be some differences and issues remaining among the member countries and globally. A number of countries continue to lack registration and compliance requirements. There continues to be a need to monitor minimum required capital requirements in accordance with Basel II or III Accords and to adopt uniform standards across jurisdictions.

There are different mandatory clearing requirements especially between the EU and the United States that need to be addressed as well as whether nonfinancial entities that use swaps should be required to hedge their commercial risks. There are inconsistencies concerning the segregation of client collateral. The U.S. model of legal segregation from operational commingling is yet to be determined by other G-20 states. Reporting to TRs for all swaps transactions appear to be in the horizon with the United States and the European Union preparing regulations for such reporting. Whether or not to permit regulatory access concerning swaps, especially to foreign regulators, require future solutions by the appropriate authorities. Because of the different privacy concerns among nations, the public dissemination of data remains controversial. Other issues remaining to be standardized include the requirement that swaps be executed on designated facilities and matters related to trading venues.

Foreign Corrupt Practices Act

Background

As a result of bribery scandals in the mid-1970s wherein the Lockheed Aircraft Corporation was alleged to have bribed senior Japanese officials, as well as Prince Bernhard of the Netherlands, to obtain aircraft orders and the revelation that some 400 corporations had engaged in making illegal payments in excess of $300 million to foreign public officials and domestic political candidates and political parties, the "Foreign Corrupt Practices Act" (FCPA) was enacted in 1977.[27] It was later amended in 1998 as the "International Anti-Bribery Act" in order to conform to and implement the antibribery convention of the

Organization of Economic Cooperation and Development (OECD). An additional problem of past practices was that shareholders were kept in the dark about the accounting practices used by companies to conceal illegal payments. There was no accountability for the "slush" funds that were often noted as "consultant fees" on corporate books and records.

Federal enforcement of the FCPA has been spotty, often dependent on which political party was in power at the executive branch. There have been major philosophical disagreements concerning such payments inasmuch as American companies often lost competitive bids to companies abroad, especially to French and German companies that had little incentive to avoid dishonest payment practices. The result of U.S. aggressive enforcement in the past was a substantial loss of jobs for American workers. The Clinton administration was sympathetic to the claim of loss of jobs by unfair competitive bidding, the estimated annual losses being over $30 billion. To address the one-sided enforcement of the FCPA, it demanded that the OECD also enact and compel members to adopt provisions that were comparable to U.S. law. The result was the adoption on November 21, 1997, of the "Convention on Combatting Bribery of Foreign Public Officials in International Business Transactions," which came into effect on February 15, 1999 and that is discussed below.

The Obama administration has taken an aggressive posture to enforcement of the FCPA. Among the enforcement actions by the SEC in 2012 include one against Pfizer, the pharmaceutical company that allegedly made illegal payments through its subsidiaries in a number of countries including China, Russia, and the Czech Republic for which conduct it agreed to pay $45 million in settlement of the charges. At least three medical device companies, Orthofix International, Biomet, and Smith & Nephew, were charged with and/or agreed to pay fines for payment of bribes to diverse persons covered by the act. Moreover, many foreign firms have reached settlements with the SEC under the act with respect to alleged bribes. The firms include Siemens, the German engineering firm; Daimler, the maker of Mercedes-Benz automobiles; Alcatel-Lucent, the French telecommunications company; and JGC Corporation, a Japanese consulting company. Foreign companies became liable under U.S. law because they have a U.S. presence due to stock listings or do business therein.[28] Members of the House of Representatives recently questioned Wal-Mart concerning its subsidiary in Mexico for alleged bribery, money laundering, and tax evasion.

Provisions

There are two major sections to the FCPA and to the OECD convention that prohibit certain conduct by issuers. The first concerns the prohibition of bribery of certain foreign persons; and the second prohibition addresses books, records, and internal accounting that disguises prohibited conduct.

Bribery

FCPA, §78dd-1, "Prohibited foreign trade practices by issuers," states that it shall be unlawful for issuers covered by the act or for any persons associated with the

issuer, corruptly to offer, pay, promise to pay, or authorize payment of money or anything of value to:

- Any foreign official in order to influence any act or decision in his or her official capacity to do or omit any act in violation of said official's lawful duty or to secure any improper advantage; or to induce the said foreign official to use his or her influence with a foreign government or instrumentality to affect or influence it concerning any act or decision to assist the issuer to obtain, retain, or direct business to any person
- Any foreign political party or official thereof or any candidate for foreign political office for the said purposes
- Any person, knowing that all or a portion of the money or thing of value will be offered or given to the said foreign official, political party, or candidate for office, for the state purposes

In the case that follows, it was unclear whether the particular act of bribery sufficed to meet the requisite requirements of the FCPA. The case is set forth to illustrate the act's requirements to sustain a criminal conviction of the defendants.

U.S. v. Kay

359 F. 3d 738 (5th Cir. 2004)

FACTS: American Rice, Inc. (ARI), is a Houston-based company that exports rice to foreign countries, including Haiti. Rice Corporation of Haiti (RCH), a wholly owned subsidiary of ARI, was incorporated in Haiti to represent ARI's interests and deal with third parties there. As an aspect of Haiti's standard importation procedure, its customs officials assess duties based on the quantity and value of rice imported into the country. Haiti also requires businesses that deliver rice therein to remit an advance deposit against Haitian sales taxes based on the value of that rice, for which deposit a credit is eventually allowed on Haitian sales tax returns when filed.

In 2001, a grand jury charged Kay with violating the FCPA and, subsequently, returned an indictment, which charged both Kay and Murphy with 12 counts of FCPA violations. The indictment contained detailed factual allegations about (1) the timing and purposes of Congress's enactment of the FCPA, (2) ARI and its status as an "issuer" under the FCPA, (3) RCH and its status as a wholly owned subsidiary and "service corporation" of ARI, representing ARI's interest in Haiti, and (4) defendants' citizenship, their positions as officers of ARI, and their status as "issuers" and "domestic concerns" under the FCPA. The indictment also spelled out in detail how Kay and Murphy allegedly orchestrated the bribing of Haitian customs officials to accept false bills of lading and other documentation that intentionally understated by one-third the quantity of rice shipped to Haiti, thereby significantly reducing ARI's customs duties

and sales taxes. The indictment alleged the details of the bribery scheme's machinations, including the preparation of duplicate documentation, the calculation of bribes as a percentage of the value of the rice not reported, the surreptitious payment of monthly retainers to Haitian officials, and the defendants' purported authorization of withdrawals of funds from ARI's bank accounts with which to pay the Haitian officials, either directly or through intermediaries—all to produce substantially reduced Haitian customs and tax costs to ARI.

In contrast, without any factual allegations, the indictment merely paraphrased the one element of the statute that is central to this appeal, only conclusionally accusing defendants of causing payments to be made to Haitian customs officials: for purposes of influencing acts and decisions of such foreign officials in their official capacities, inducing such foreign officials to do and omit to do acts in violation of their lawful duty, and to obtain an improper advantage, in order to assist ARI in obtaining and retaining business for, and directing business to ARI and RCH. Although it recites in great detail the discrete facts that the government intended to prove to satisfy each other element of an FCPA violation, the indictment recited no particularized facts that, if proved, would satisfy the "assist" aspect of the business nexus element of the statute, that is, the nexus between the illicit tax savings produced by the bribery and the assistance such savings provided or were intended to provide in obtaining or retaining business for ARI and RCH. Neither did the indictment contain any factual allegations whatsoever to identify just what business in Haiti (presumably some rice-related commercial activity) the illicit customs and tax savings assisted (or were intended to assist) in obtaining or retaining, or just how these savings were supposed to assist in such efforts. In other words, the indictment recited no facts that could demonstrate an actual or intended cause-and-effect nexus between reduced taxes and obtaining identified business or retaining identified business opportunities.

As a result the district court, on motion by the defendants, dismissed the indictment holding that, as a matter of law, bribes paid to obtain favorable tax treatment are not payments made to "obtain or retain business" within the intendment of the FCPA, and thus are not within the scope of that statute's proscription of foreign bribery.

ISSUES: (1) Whether bribes to obtain illegal but favorable tax and customs treatment can ever come within the scope of the statute?

(2) If so, whether, in combination, there are minimally sufficient facts alleged in the indictment to inform the defendants regarding the nexus between, on the one hand, Haitian taxes avoided through bribery, and, on the other hand, assistance in getting or keeping some business or business opportunity in Haiti?

DECISION: The court determined (1) that such bribes may come within the scope of the statute; and (2) that the indictment stated facts

that, if true, are sufficient to establish that a violation of the FCPA was committed by the defendants.

REASONING (Weiner, J.): The FCPA prohibits payments to foreign officials for purposes of:

(i) influencing any act or decision of such foreign official in his official capacity, (ii) inducing such foreign official to do or omit to do any act in violation of the lawful duty of such official, or (iii) securing any improper advantage in order to assist [the company making the payment] in obtaining or retaining business for or with, or directing business to, any person.

None contend that the FCPA criminalizes every payment to a foreign official: It criminalizes only those payments that are intended to (1) influence a foreign official to act or make a decision in his official capacity, or (2) induce such an official to perform or refrain from performing some act in violation of his duty, or (3) secure some wrongful advantage to the payor. And even then, the FCPA criminalizes these kinds of payments only if the result they are intended to produce—their quid pro quo—will assist (or is intended to assist) the payor in efforts to get or keep some business for or with "any person." Thus, the first question of statutory interpretation presented in this appeal is whether payments made to foreign officials to obtain unlawfully reduced customs duties or sales tax liabilities can ever fall within the scope of the FCPA, i.e., whether the illicit payments made to obtain a reduction of revenue liabilities can ever constitute the kind of bribery that is proscribed by the FCPA. The district court answered this question in the negative.

[The court recited the history of the original statute and its later amendments.] Given the foregoing analysis of the statute's legislative history, we cannot hold as a matter of law that Congress meant to limit the FCPA's applicability to cover only bribes that lead directly to the award or renewal of contracts. Instead, we hold that Congress intended for the FCPA to apply broadly to payments intended to assist the payor, either directly or indirectly, in obtaining or retaining business for some person, and that bribes paid to foreign tax officials to secure illegally reduced customs and tax liability constitute a type of payment that can fall within this broad coverage. In 1977, Congress was motivated to prohibit rampant foreign bribery by domestic business entities, but nevertheless understood the pragmatic need to exclude innocuous grease payments from the scope of its proposals. The FCPA's legislative history instructs that Congress was concerned about both the kind of bribery that leads to discrete contractual arrangements and the kind that more generally helps a domestic payor obtain or retain business for some person in a foreign country; and that Congress was aware that this type includes illicit payments made to officials to obtain favorable but unlawful tax treatment.

Congress expressly emphasized that it did not intend to prohibit "so-called grease or facilitating payments," such as "payments for expediting

shipments through customs or placing a transatlantic telephone call, securing required permits, or obtaining adequate police protection, transactions which may involve even the proper performance of duties." Instead of making an express textual exception for these types of noncovered payments, the respective committees of the two chambers sought to distinguish permissible grease payments from prohibited bribery by only prohibiting payments that induce an official to act "corruptly," i.e., actions requiring him "to misuse his official position" and his discretionary authority, not those "essentially ministerial" actions that "merely move a particular matter toward an eventual act or decision or which do not involve any discretionary action."

In short, Congress sought to prohibit the type of bribery that (1) prompts officials to misuse their discretionary authority and (2) disrupts market efficiency and U.S. foreign relations, at the same time recognizing that smaller payments intended to expedite ministerial actions should remain outside of the scope of the statute. The Conference Report explanation, on which the district court relied to find a narrow statutory scope, truly offers little insight into the FCPA's precise scope; however, it merely parrots the statutory language itself by stating that the purpose of a payment must be to induce official action "so as to assist an issuer in obtaining, retaining or directing business to any person."

Furthermore, by narrowly defining exceptions and affirmative defenses against a backdrop of broad applicability, Congress reaffirmed its intention for the statute to apply to payments that even indirectly assist in obtaining business or maintaining existing business operations in a foreign country. Finally, Congress's intention to implement the convention, a treaty that indisputably prohibits any bribes that give an advantage to which a business entity is not fully entitled, further supports our determination of the extent of the FCPA's scope.

Thus, in diametric opposition to the district court, we conclude that bribes paid to foreign officials in consideration for unlawful evasion of customs duties and sales taxes could fall within the purview of the FCPA's proscription. We hasten to add, however, that this conduct does not automatically constitute a violation of the FCPA: It still must be shown that the bribery was intended to produce an effect—here, through tax savings—that would "assist in obtaining or retaining business."

[Concerning the sufficiency of the indictment, the court stated:] Where guilt depends so crucially upon such a specific identification of fact, our cases have uniformly held that an indictment must do more than simply repeat the language of the criminal statute . . . . As noted at the outset of this opinion, the indictment contains no such specific allegations. Except for closely paraphrasing the objective "purpose" language of the statute regarding the aim of the bribe being to produce some conduct by a foreign official, the results of which (quid pro quo) will assist in obtaining or retaining foreign business for some person (business nexus), the indictment

alleges nothing whatsoever about (1) the nature of the assistance purportedly intended or produced by the lowered taxes, (2) the identity of the particular business or business opportunity the obtaining or retaining of which was being sought, or (3) the way (nexus) such assistance was supposed to help get or keep such business or opportunity. As such, the indictment's sufficiency hinges on a determination whether the business nexus element of the crime is core.

We conclude that, as important to the statute as the business nexus element is, it does not go to the FCPA's core of criminality. When the FCPA is read as a whole, its core of criminality is seen to be bribery of a foreign official to induce him to perform an official duty in a corrupt manner. The business nexus element serves to delimit the scope of the FCPA by eschewing applicability to those bribes of foreign officials that are not intended to assist in getting or keeping business, just as the "grease" provisions eschew applicability of the FCPA to payments to foreign officials to cut through bureaucratic red tape and thereby facilitate matters. Therefore, the indictment's paraphrasing of the FCPA's business nexus element passes the test for sufficiency, despite alleging no details regarding what business is sought or how the results of the bribery are meant to assist, passes the test for sufficiency.

We cannot credit the district court's per se ruling that the fiscal benefits of the maladministration of foreign revenue laws by foreign officials in consideration for illicit payments by United States businessmen or business entities can never come within the scope of the FCPA. Just as bribes to obtain such illicit tax benefits do not ipso facto fall outside the scope of the FCPA, however, neither are they per se included within its scope. We are satisfied that–for purposes of the statutory provisions criminalizing payments designed to induce foreign officials unlawfully to perform their official duties in administering the laws and regulations of their country to produce a result intended to assist in obtaining or retaining business in that country–an unjustified reduction in duties and taxes can, under appropriate circumstances, come within the scope of the statute.

As the district court held the indictment insufficient based on its determination that the kind of bribery charged in the indictment does not come within the scope of the FCPA, that court never reached the question whether the indictment was sufficient as to the business nexus element of the crime, for which the charging instrument merely tracked the statute without alleging any discrete facts whatsoever. As we conclude that the business nexus element of the FCPA does not go to the core of criminality of that statute, we hold that the indictment in this case is sufficient as a matter of law. For the foregoing reasons, therefore, the judgment of the district court dismissing the indictment charging defendants with violations of the FCPA is reversed and the case is remanded for further proceedings consistent herewith.

Questions

1. At what point does the payment of bribes pass from mere grease or facilitation payments to actual bribes that fall within the FCPA or to the OECD convention?
2. Is it a defense that no competing company was affected by the alleged payments?

Reporting Requirement and Prohibition

FCPA, §78m, affects the filing of reports by an issuer of a security required to be registered with the SEC. Section 78(b) requires every such issuer to make and keep reports in reasonable detail that fairly reflect the transactions and disposition of the assets of the company, and to devise a system of internal accounting controls to provide reasonable assurances to conform to generally accepted accounting principles, have management's authorization, and the recorded accountability for assets be made at reasonable intervals. The key section is §78(b)(5), which states that "no person shall knowingly circumvent or knowingly fail to implement a system of internal accounting controls or knowingly falsify any book, record, or account."

SEC v. Dow Chemical Co.,

Administrative Proceeding, No. 3–12567 (D.D.C. 2007)

The SEC instituted a civil complaint against Dow Chemical for violation of the books and records provision of the FCPA. Specifically, it was alleged that the Dow subsidiary, DE-Nocil Crop Protection Ltd. (DE-Nocil), headquartered in Mumbai, India, manufactured and marketed pesticides and other products primarily for use in the Indian agriculture industry. Commencing in 1996, the subsidiary made approximately $39,700 in improper payments to an official in India's Central Insecticides Board to expedite the registration of three DE-Nocil products. Most of these payments were made through agreements with contractors, which added fictitious charges on its bills, or issued false invoices, to DE-Nocil. The contractors then disbursed these extra funds, at DE-Nocil's direction, to the Central Insecticide Board official. In addition, from 1996 and to 2001, DE-Nocil made $87,400 in improper payments consisting of an estimated $37,600 for gifts, travel, entertainment and other items; $19,000 to government business officials; $11,800 to sales tax officials; $3,700 to excise tax officials; and $1,500 to customs officials. As a result, Dow Chemical agreed to pay a $375,000 civil penalty in settlement of the allegations without admission or denial of the said allegations.[29]

It should be noted that liability extended to the books of records of a subsidiary located in a foreign country.[30]

Exceptions and Affirmative Defenses
Not all offers or giving of things of value are covered by the act. Thus, the statute does not apply to facilitation or expedition of governmental action, or to secure a performance of a *routine* government action by a foreign official, political party, or party official. The affected issuer may raise affirmative defenses to prosecution that the thing of value was lawful under the laws and regulations of the foreign person's country; or was a reasonable bona fide expenditure, such as travel and lodging expenses, incurred on behalf of said foreign persons that relate to the promotion, demonstration, or explanation of products or services or the execution or performance of a contract with a foreign government or agency thereof.

Penalties
A firm that violates the act is subject to a fine of up to $2 million and/or a civil penalty in an action brought by the Attorney General up to $10,000. A natural person such as an officer, employee, agent, or stockholder is liable of a fine not to exceed $250,000 and/or imprisonment of up to five years for criminal violation or up to $10,000 for a civil violation. Additional penalties may include disgorgement of profits and a ban from obtaining government contracts and licenses.

Enforcement
Private Civil Claims. Although the act does not provide for private lawsuits under the FCPA, lawsuits may and have been instituted by persons harmed (usually by companies that lost their bids) against the issuers who violated the FCPA. The legal theoretical bases for such lawsuits include a claim of violation of the Racketeer Influenced and Corrupt Organizations Act,[31] shareholder derivative lawsuits, and whistle-blower claims under the Dodd-Frank and Sarbanes-Oxley Acts.

The main vehicle of enforcement is by the U.S. government, which may institute criminal or civil proceedings. Generally, civil lawsuits are preferred by the government because of the lesser standard of proof and the reluctance of companies to proceed with a plenary trial on the merits.

The following U.S. Supreme Court case concerns the chief executive officer (CEO) of an American company who gave a substantial bribe to a Nigerian national to obtain a construction contract for his firm. The question presented to the court brings into play the "Act of State" doctrine. In essence, it has been the policy of the United States not to question the acts of a sovereign government concerning what it does within its own territory. If the acts harm U.S. interests, then it is left to the other branches of the U.S. government to respond to such act. In an early Supreme Court case, it stated that "the courts of one country will not sit in judgment on the acts of the government of another done within its own territory. Regardless of grievances by reason of such acts the resolution thereof must be obtained through means open to be availed or by sovereign powers as between themselves."[32]

Kirkpatrick v. ETC, International

493 U.S. 400 (1990)

FACTS: In 1981, Harry Carpenter, who was then chairman of the board and chief executive officer of petitioner, W.S. Kirkpatrick & Co., Inc. (Kirkpatrick), learned that the Republic of Nigeria was interested in contracting for the construction and equipment of an aeromedical center at Kaduna Air Force Base in Nigeria. He made arrangements with Benson "Tunde" Akindele, a Nigerian citizen, whereby Akindele would endeavor to secure the contract for Kirkpatrick. It was agreed that, in the event the contract was awarded to Kirkpatrick, Kirkpatrick would pay to two Panamanian entities controlled by Akindele a "commission" equal to 20 percent of the contract price, which would in turn be given as a bribe to officials of the Nigerian government. In accordance with this plan, the contract was awarded to petitioner, W.S. Kirkpatrick & Co., International (Kirkpatrick International), a wholly owned subsidiary of Kirkpatrick; Kirkpatrick paid the promised "commission" to the appointed Panamanian entities; and those funds were disbursed as bribes. All parties agree that Nigerian law prohibits both the payment and the receipt of bribes in connection with the award of a government contract. [If local law did permit the act, it would not violate the FCPA.]

Respondent, Environmental Tectonics Corporation, International, an unsuccessful bidder for the Kaduna contract, learned of the 20 percent "commission" and brought the matter to the attention of the Nigerian Air Force and the U.S. embassy in Lagos. Following an investigation by the FBI, the United States brought charges against both Kirkpatrick and Carpenter for violations of the FCPA. Both individuals pleaded guilty.

Respondent then brought this civil action in the U.S. District Court against Carpenter, Akindele, petitioners, and others, seeking damages under several criminal statutes. The petitioners/defendants moved to dismiss the complaint on the ground that the action was barred by the act of state doctrine.

The district court concluded that the act of state doctrine applies if the inquiry presented for judicial determination includes the motivation of a sovereign act that would result in embarrassment to the sovereign or constitute interference in the conduct of foreign policy of the United States. Applying that principle to the facts at hand, the court held that respondent's suit had to be dismissed because, in order to prevail, respondents would have to show that

> the defendants or certain of them intended to wrongfully influence the decision to award the Nigerian Contract by payment of a bribe, that the Government of Nigeria, its officials, or other representatives knew of the offered consideration for awarding the Nigerian Contract to Kirkpatrick, that the bribe was actually received or anticipated and that, "but for" the

> payment or anticipation of the payment of the bribe, ETC would have been awarded the Nigerian Contract.

The court of appeals for the Third Circuit reversed the dismissal of the lawsuit. The court found particularly persuasive the letter to the district court from the legal adviser to the Department of State, which had stated that, in the opinion of the department, judicial inquiry into the purpose behind the act of a foreign sovereign would not produce the "unique embarrassment, and the particular interference with the conduct of foreign affairs, that may result from the judicial determination that a foreign sovereign's acts are invalid."

ISSUE: Whether the act of state doctrine bars a court in the United States from entertaining a cause of action that does not rest upon the asserted invalidity of an official act of a foreign sovereign, but that does require imputing to foreign officials an unlawful motivation (the obtaining of bribes) in the performance of such an official act?

DECISION: The Supreme Court decided unanimously that the act of state doctrine did not bar the civil lawsuit and affirmed the decision of the U.S. Court of Appeals.

REASONING (Scalia, J.). This Court's description of the jurisprudential foundation for the act of state doctrine has undergone some evolution over the years. We once viewed the doctrine as an expression of international law, resting upon "the highest considerations of international comity and expediency." We have more recently described it, however, as a consequence of domestic separation of powers, reflecting "the strong sense of the Judicial Branch that its engagement in the task of passing on the validity of foreign acts of state may hinder" the conduct of foreign affairs. Some justices have suggested possible exceptions to application of the doctrine, where one or both of the foregoing policies would seemingly not be served: an exception, for example, for acts of state that consist of commercial transactions, since neither modern international comity nor the current position of our Executive Branch accorded sovereign immunity to such acts; or an exception for cases in which the Executive Branch has represented that it has no objection to denying validity to the foreign sovereign act, since then the courts would be impeding no foreign policy goals.

The parties have argued at length about the applicability of these possible exceptions, and, more generally, about whether the purpose of the act of state doctrine would be furthered by its application in this case. We find it unnecessary, however, to pursue those inquiries, since the factual predicate for application of the act of state doctrine does not exist. Nothing in the present suit requires the court to declare invalid, and thus ineffective as "a rule of decision for the courts of this country," the official act of a foreign sovereign.

In every case in which we have held the act of state doctrine applicable, the relief sought or the defense interposed would have required a court in

the United States to declare invalid the official act of a foreign sovereign performed within its own territory. In the present case, by contrast, neither the claim nor any asserted defense requires a determination that Nigeria's contract with Kirkpatrick International was, or was not, effective.

Petitioners point out, however, that the facts necessary to establish respondent's claim will also establish that the contract was unlawful. Specifically, they note that, in order to prevail, respondent must prove that petitioner Kirkpatrick made, and Nigerian officials received, payments that violate Nigerian law, which would, they assert, support a finding that the contract is invalid under Nigerian law. Assuming that to be true, it still does not suffice. The act of state doctrine is not some vague doctrine of abstention, but a "*principle of decision* binding on federal and state courts alike." As we said in [a prior case] "the act within its own boundaries of one sovereign State . . . becomes . . . a rule of decision for the courts of this country." Act of state issues only arise when a court *must decide*—that is, when the outcome of the case turns upon—the effect of official action by a foreign sovereign. When that question is not in the case, neither is the act of state doctrine. That is the situation here. Regardless of what the court's factual findings may suggest as to the legality of the Nigerian contract, its legality is simply not a question to be decided in the present suit, and there is thus no occasion to apply the rule of decision that the act of state doctrine requires.

Petitioners insist that the policies underlying our act of state cases—international comity, respect for the sovereignty of foreign nations on their own territory, and the avoidance of embarrassment to the Executive Branch in its conduct of foreign relations—are implicated in the present case because, as the District Court found, a determination that Nigerian officials demanded and accepted a bribe "would impugn or question the nobility of a foreign nation's motivations," and would "result in embarrassment to the sovereign or constitute interference in the conduct of foreign policy of the United States." The United States, as *amicus curiae,* favors the same approach to the act of state doctrine, though disagreeing with petitioners as to the outcome it produces in the present case. We should not, the United States urges, "attach dispositive significance to the fact that this suit involves only the *motivation for, rather than the 'validity' of, a foreign sovereign act,*" *and should eschew "any rigid formula for the resolution of act of state cases generally." In some future case, perhaps*, "litigation . . . based on alleged corruption in the award of contracts or other commercially oriented activities of foreign governments could sufficiently touch on 'national nerves' that the act of state doctrine or related principles of abstention would appropriately be found to bar the suit," and we should therefore resolve this case on the narrowest possible ground, viz., that the letter from the legal advisor to the District Court gives sufficient indication that, "in the setting of this case," the act of state doctrine poses no bar to adjudication.

These urgings are deceptively similar to what we said in [a prior case] where we observed that sometimes, even though the validity of the act of a foreign sovereign within its own territory is called into question, the policies underlying the act of state doctrine may not justify its application. We suggested that a sort of balancing approach could be applied—the balance shifting against application of the doctrine, for example, if the government that committed the "challenged act of state" is no longer in existence. But what is appropriate in order to avoid unquestioning judicial acceptance of the acts of foreign sovereigns is not similarly appropriate for the quite opposite purpose of expanding judicial incapacities where such acts are not directly (or even indirectly) involved. It is one thing to suggest, as we have, that the policies underlying the act of state doctrine should be considered in deciding whether, despite the doctrine's technical availability, it should, nonetheless, not be invoked; it is something quite different to suggest that those underlying policies are a doctrine unto themselves, justifying expansion of the act of state doctrine (or, as the United States puts it, unspecified "related principles of abstention") into new and uncharted fields.

The short of the matter is this: Courts in the United States have the power, and ordinarily the obligation, to decide cases and controversies properly presented to them. The act of state doctrine does not establish an exception for cases and controversies that may embarrass foreign governments, but merely requires that, in the process of deciding, the acts of foreign sovereigns taken within their own jurisdictions shall be deemed valid. That doctrine has no application to the present case, because the validity of no foreign sovereign act is at issue.

Questions

1. Look up the case of *Banco Nacional de Cuba v. Sabbatino*, 376 U.S. 398 (1964). Compare the results of that seminal case with the Kirkpatrick case. Did this case in effect overrule the prior decision?
2. Compare and contrast by researching the "act of state" doctrine with the "Foreign Sovereign Immunities Act."
3. Look up "Transparency International." Which nations are least prone to bribery of foreign public officials? Which nations are most the most corrupt in this regard?

Global Efforts to Combat Corruption

OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions

The United States, aware that its anticorruption initiative was causing loss of American jobs mainly to companies in Germany and France, whose laws

prohibited bribery within its borders but not beyond thereof, prevailed upon the OECD to initiate a proposed convention that emulated U.S. efforts. There were other factors at play also in causing OECD to consider an antibribery convention. They included the view that bribery undermined the integrity of governments and their leadership; the harm to legitimate competitive companies that lost bids due to the malfeasance of their competitors; the harm to consumers who were denied the best products at the lowest prices; and the efforts of private organizations, particularly, Transparency International and its Corruption Perception Index, to increase awareness of the problems that bribery brings about. Accordingly, the OECD Committee on International Investment and Multinational Enterprises made recommendations for the facilitation of the criminalization of bribery of foreign public officials. The result was the adoption of the "Convention on Combating Bribery of Foreign Public Officials in International Business Transactions," which required the 30-nation membership to enact implementing statutes by December 31, 1998.[33]

Article 1 of the convention, "The Offense of Bribery of Public Officials," provided that each member state of the OECD make it a criminal offense under its laws for any person to bribe or to aid, abet, authorize, incite, attempt, or conspire to do so, directly or indirectly, a public official or a third party to cause an official to act or refrain from acting with respect to international business transactions. In other articles, the convention is identical to those stated of the United States whose laws have conformed to the convention. A small facilitation payment is not banned. Bribery of public officials and the like is unlawful even if the best qualified bidder of a contract gave the bribe or money or other consideration. Sanctions mandated by the convention include imprisonment for natural persons and extradition to other member states that have jurisdiction over the offense.

The second major provision also repeats the U.S. accounting requirements that prohibit off-the-books expenditures, incorrect identification of expenditures, and the use of false documents to evade exposure. Each state is to render assistance to other parties to the convention, which may not use the excuse of bank secrecy as a basis for failing to assist. The prohibited conduct is an extraditable offense irrespective of whether or not extradition treaties exist among the parties to the convention.

Inter-American Convention against Corruption

Under the auspices of the Organization of American States, the Inter-American Convention Against Bribery was adopted on March 29, 1996, at which time 21 of the 34 member states signed the convention. Today, all parties but one of the OAS countries [Cuba] have ratified it. It is similar to the OECD convention with the same two main provisions against bribery of public officials and the like and the accounting provisions. Interestingly, it also adds a provision in Article IX, Unjust Enrichment, that provides that each party to the convention take

measures to make "a significant increase in the assets of a government official that he cannot reasonably explain in relation to his lawful earnings during the performance of his functions" an offense. The effect of the unlawful act on government property is irrelevant. Extradition of offenders is also provided for in the convention.[34]

United Nations Convention against Corruption[35]

The convention is also similar to the conventions discussed above in its promotion of transparency and goals of prevention of bribery but does have distinctive provisions in its own right. The convention applies to the prevention, investigation, and prosecution of corruption and to the freezing, seizure, confiscation, and return of the proceeds of offences. It cautions that the sovereignty of each state be respected by signatories. The main article is No. 5 that provides that each state party shall develop and implement or maintain effective, coordinated anticorruption policies that promote the participation of society and reflect the principles of the rule of law, proper management of public affairs and public property, integrity, transparency and accountability. Each state party must promote and develop programs to combat bribery.

Article 7 stresses the need to develop a program that provides for the training and educated civil service system based on merit, equity, and aptitude. Article 9 provides that each state party establish systems of procurement that are based on transparency, competition, and objective criteria in decision making to prevent corruption. Among the steps to be taken are the public distribution of information relating to procurement procedures and contracts; the establishment, in advance, of conditions for participation; the use of objective and predetermined criteria for public procurement decisions; an effective system of domestic review; and screening procedures and training requirements.

Additional articles include provisions for transparency in reporting of decision-making processes; simplifying administrative procedures; publishing periodic reports concerning efforts to combat corruption; judicial independence; the promotion of cooperation between law enforcement agencies and relevant private entities; and the development of standards and procedures designed to safeguard the integrity of relevant private entities, including codes of conduct for the proper performance of business activities. The convention also calls for the prohibition of (1) off-the-books accounts; (2) the making of off-the-books or inadequately identified transactions; (3) the recording of nonexistent expenditure; (4) the entry of liabilities with incorrect identification of their objects; (5) the use of false documents; and (6) the intentional destruction of bookkeeping documents earlier than foreseen by the law.

There are measures for the prevention of misuse of procedures against private entities such as subsides and licenses granted by public authorities; the prevention of conflicts of interest; and the assurance that private enterprises have sufficient

internal auditing controls to assist in preventing and detecting acts of corruption; and that the accounts and required financial statements of such private enterprises be subject to appropriate auditing and certification procedures.

The convention incorporates antimoney laundering provisions; the criminalization and enforcement of antibribery measures; the prevention of bribery of foreign public officials and officials of public international organizations; embezzlement, misappropriation, or other diversion of public property by public officials; trading on influence; abuse of functions; illicit enrichment; bribery in the public sector; freezing and seizure of assets of offending persons; and cooperation with other law enforcement authorities.

The U.K. Bribery Act of 2010

One of the most aggressive efforts legislatively to combat corruption is the U.K. Bribery Act of 2010.[36] Although the act covers a broad range of active and passive bribery both domestically and of foreign persons, the discussion herein concerns that of bribery of a foreign public official. Section 6 of the act states that a person who bribes a foreign public official is guilty of an offense if the person's intention is to influence the said official in his or her capacity as a foreign public official. The person must also intend to obtain or retain (a) business, or (b) an advantage in the conduct of business. The said person bribes the official only if, directly, or indirectly, the person offers, promises, or gives any financial or other advantage to the said official or to another person at the foreign official's request and with his or her consent or acquiescence, and the official is neither permitted nor required by his or her country's written law to be influenced in his or her capacity as a foreign public official by the offer, promise, or gift.

The reference to the official's capacity as a foreign public official includes any omission to exercise those functions and any use of his or her positions as such official, even if not within the official's authority. Like the U.S. and OECD provisions, there are exceptions for bona fide hospitality, promotional, or other legitimate business expenses but even small, facilitation payments for routine government action could trigger a Section 6 offense where the intent is to induce improper conduct on the part of the foreign public official. There is substantial prosecutorial discretion in determining whether or not to initiate charges against the alleged offender of the act.

Section 7 of the Bribery Act makes a commercial organization liable if a person associated with the firm bribes another person with the intention of obtaining or retaining business or an advantage in the conduct of business for that organization. It is an affirmative defense to prosecution if the firm is able to demonstrate that there were adequate procedures in place to prevent persons associated with it to prevent bribery. The government set forth "Six Principles" or procedures to be put in place by commercial organizations if they desire to avoid prosecution. They are:

- Principle 1. *Proportionate procedures*. A commercial organization's procedures to prevent bribery by persons associated with it are proportionate to the bribery risks it faces and to the nature, scale, and complexity of the commercial organization's activities. They are also clear, practical, accessible, effectively implemented, and enforced.
- Principle 2. *Top-level commitment*. The top-level management of a commercial organization (be it a board of directors, the owners or, any other equivalent boy or persons) is committed to preventing bribery by persons associated with it. They foster a culture within the organization in which bribery is never acceptable.
- Principle 3. *Risk Assessment*. The commercial organization assesses the nature and extent of its exposure to potential external and internal risks of bribery on its behalf by persons associated with it. The assessment is periodic, informed, and documented.
- Principle 4. *Due diligence*. The commercial organization applies due diligence principles, taking a proportionate and risk-based approach, in respect of persons who perform or will perform services for or on behalf of the organization, in order to mitigate identified bribery risks.
- Principle 5. *Communication* (including training). The commercial organization seeks to ensure that its bribery prevention policies and procedures are embedded and understood throughout the organization through internal and external communication, including training that is proportionate to the risks it faces.
- Principle 6. *Monitoring and review*. The commercial organization monitors and reviews procedures designed to prevent bribery by persons associated with it and makes improvements where necessary.

Other International Efforts

There are numerous other organizations, both public and private entities, which have sought to combat bribery, especially of public officials in other countries. Among them are the Council of Europe Criminal Convention on Corruption,[37] the Bank of Reconstruction and Finance (World Bank); the International Monetary Fund; the World Trade Organization; the Asian Development Bank; the U.S. Agency for International Development.

Conclusion

In this text, we have endeavored to present the varieties of corporate governance that coexist internationally. With the increasing globalization of corporate entities brought about technologically with the geometric growth of computers and other devices and the immense advancements in transportation, it becomes necessary to have an acquaintance with both national and international rules and

regulations governing international trade of goods and services. Albeit the study of international systems is complex, there has been a decided effort to harmonize them so as to facilitate their interactions for the sake of all peoples globally. This text is the first of two texts that explore these systems. In the second volume, entitled *Laws and Regulations in Global Financial Markets*, we continue with a study of the legal aspects relating to the financial industry. They include the rules and regulations of investment advisers; broker-dealers; bankruptcy especially reorganization, banking, property, consumer protection, insurance, and financial literacy.

Notes

Chapter 1

NOTE: The style of endnotes is that utilized in law texts, which differs from other styles such as the Chicago Manual Style.

1. 17 U.S. (Wheat) 518 (1819).
2. 421 U.S. 809 (1975).
3. 410 U.S. 113 (1973).
4. 425 U.S. 748 (1976).
5. From a headnote prepared by the Reporter of Decisions—www.law.cornell.edu/supct/html/08-205.ZS.html.
6. The facts, in almost all of the cases in this text, are taken directly from the opinions in the said cases.
7. www.fsa.gov.uk/pubs/other/principles.pdf.
8. There are many commentaries concerning the subject including the following: Nick de la Mare, *Total Design: A multi-disciplinary look at the assumption and reality of a designed world, available at* http://designmind.frogdesign.com/blog/rules-vs-principles.html; Doug Macnamara & Banff Executive Leadership Inc., *Improving Governance Performance: Rules-Based vs. Principles-Based Approaches*, *available at* www.banffexeclead.com/ . . . /Leadership%20Acumen%2016%20V1 . . . .; and Anita I. Anand, *Rules v. Principles as Approaches to Financial Market Regulation*, 49 HARV. INT. L.J., (April 7, 2009), *available at* www.harvardilj.org/attach.php?id=172.
9. Commissioner Roel C. Campos, Principles v. Rules, Address Before the Association Française des Entreprises Privées (June 14, 2007), *available at* www.sec.gov/news/speech/2007/spch061407rcc.htm.
10. This author was counsel to a New York State Senator in the early 1980s when proposals were made to unify the New York State Court system but the proposals were and continue to be rejected annually presumably because they would lessen the number of judges needed for the many Courts and, thus deprive political parties from disbursing these highly sought positions.
11. For an easy-to-read explanation of the U.S. Federal Court system, see *Understanding the Federal Courts*, http://www.usCourts.gov/outreach/structure.jpg.
12. In practical terms, the statement is correct. Article III, Section 2 (2) of the Constitution, does grant original jurisdiction to the U.S. Supreme Court "in all cases affecting ambassadors, other public ministers, and consuls, and those in which a State shall be party . . . . " Such trials actually takes place before a Master appointed by the Court, who renders a report recommending a particular result, which report almost always becomes the decision of the Court.

13. 444 U.S. 286 (1980).
14. Pub. L. 104–167, 109 Stat. 737.
15. Celotex Corp. v. Catrek, 477 U.S. 317 (1986), 323, 325.
16. Anderson v. Liberty Lobby, Inc., 477 U.S. 242 (1986).
17. *Id*. at 247–249.
18. 809 F.2d 626, 631.
19. Matsushita v. Zenith Ratio Corp., 921 F.2d 1343, 1349 (6th Cir. 1991).
20. *Id*. at 251–252.
21. King v. Simpson, 189 F.3d 284, 287 (2d Cir. 1999).
22. Steinberg v. PRT Group, Inc., 88 F. Supp.2d 294 (S.D.N.Y. 2000).
23. Tarshis v. Riese Org. 211 F.3d 30, 35 (2d Cir. 2000).
24. www.law.cornell.edu/wex/declaratory_judgment.
25. 140 F. Supp. 2d 1088 (W.D. Wash. 2001).
26. No. 012761 (Va. Sup. Ct., November 1, 2002).
27. Tom Doherty Assoc. v. Saban Entertainment, Inc., 60 F.3d 27, 33 (2d Cir. 1995).

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2. Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (New York: Harcourt, Brace & World, 1932).
3. 116 Stat. 745.
4. Pub.L. 111–203 Stat. 124 Stat. 1376–2223.
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9. Todd Ross, *SEC Takes On Chinese Deloitte Unit over Audit Records,* THE AMERICAN LAWYER (May 11, 2012), www.law.com/jsp/cc/PubArticleCC.jsp?id=1202553099117.
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11. Securities and Exchange Commission, *Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 For Issuers With Public Float Between $75 and $250 Million* (April 2011), www.sec.gov/news/studies/2011/404bfloat-study.pdf.
12. Economist.com, *Sarbanes-Oxley: Five Years under the Thumb,* (July 26, 2007), www.economist.com/business/displaystory.cfm?story_id=9545905.
13. Examples include the Federal Deposit Insurance Corporation Improvement Act, 12 U.S.C. § 1831j(a)(1); USA Patriot Act, 31 U.S.C. §5328; and the Federal Credit Union Act, 12 U.S.C. §1709b(a)(1). For a list of these statutes and states statues and commentaries, see Heidi Goldstein Shepherd and James W. Nagle,

Employee Whistleblower Claims—A Legal Overview, Goodwin Proctor LLP, www.goodwinprocter.com/. . ./6231A3817D27409FB7BD336035822 . . .

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16. See, for example, Wang, Marian, *Why No Financial Prosecutions? Ex-Justice Official Says It's Just Too Hard* (December 6, 2011), PRO PUBLICA, http://www.propublica.org/article/why-no-financial-crisis-prosecutions-official-says-its-just-too-hard.
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18. Andrew Moss, *Aviva CEO, Resigns After Shareholder Revolt On Compensation*, The Huffington Post (May 8, 2012) huffingtonpost.com/2012/05/08/andrew-moss-aviva-ceo-resigns_n_1499209.html; Mark Gongloff, *Bank Shareholders' Executive Pay Revolt No Match for Big Returns*, The Huffington Post (May 7, 2012), www.huffingtonpost.com/2012/05/07/say-on-banker-pay_n_1496133.htmlwww.huffingtonpost.com/2012/05/07/say-on-banker-pay_n_1496133.html.
19. Jessica Silver-Greenberg and Nelson D. Schwartz, *Citigroup's Chief Rebuffed on Pay by Shareholders*, NY Times (April 18, 2012), at 1.
20. Mint Life, *Golden Parachutes: How the Bankers Went Down*, www.mint.com/blog/finance-core/golden-parachutes-how-the-bankers-went-down/.
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29. *City of Westland Police & Fire Retirement System v. Axcelis Technologies, Inc.*, C.A. No. 4473-VCN (Del. Ch. September 28, 2009).
30. *Id.*
31. Citing *Seinfeld v. Verizon Commc'ns, Inc.*, 909 A.2d 117, 120 (Del. Ch. 2006).
32. *Pershing Square, L.P. v. Ceridian Corp.*, Civ. A 2780-CC (Del. Ch. May 11, 2007).
33. No. 3447-CC (Del. Ch. March 13, 2008).

34. We will discuss corporate defenses to takeovers in the chapter on mergers and acquisitions in a subsequent text entitled "Laws and Regulations in Global Financial Markets.
35. 813 A.2d 1118, 1121 (Del. Supr. 2003).
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Chapter 3

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3. www.corporate-governance-code.de/index-e.html.
4. A survey of institutional investors found that the percentage of such investors who said that their laws and practices require corporations to disclose sufficient information to investors ranged from a high of 84 percent in Britain and 82 percent in the United States versus 53 percent in Germany to only 10 percent in Japan. *A Global Vote for U.S. Style of Corporate Openness,* N.Y.T., May 9, 1999, Sections 3 at 4.
5. Commission of the German Corporate Governance Code, http://www.corporate-governance-code.de/index-e.html.
6. Forms of Doing Business in China (Feb. 4, 2010¸ http://cl-co.cn/en/dtshow.asp?id=34.
7. Brian, R. Cheffins, *The History of Corporate Governance* (European Corporate Governance Institute, Working Paper, January 2012).
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13. Rado Bohinc, One or Two-Tier Corporate Governance Systems in Some EU and Non EU Countries, *Megatrend Rev*. (February 18, 2011), www.megatrendreview.com/files/articles/015/RadoBohinc.pdf.
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16. www.ecgi.org/codes/documents/revised_corporate_governance_principles.pdf.
17. Columbia Business School, *Jumpstarting Japanese Boards* (June 12, 2012), http://www4.gsb.columbia.edu/ideasatwork/feature/7228940/Jumpstarting+Japan's+Boards?&layout=cbs_print&top.region=main.
18. COM/2003/0284 final, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52003DC0284:EN:NOT.
19. www.iosco.org/about/.
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"commissions" in their respective context. Thus, the specific acronym will be used to avoid confusion especially when two agencies are discussed in a particular subject.

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5. 15 U.S.C. §77aaa through 15 U.S.C. § 77bbbb.
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