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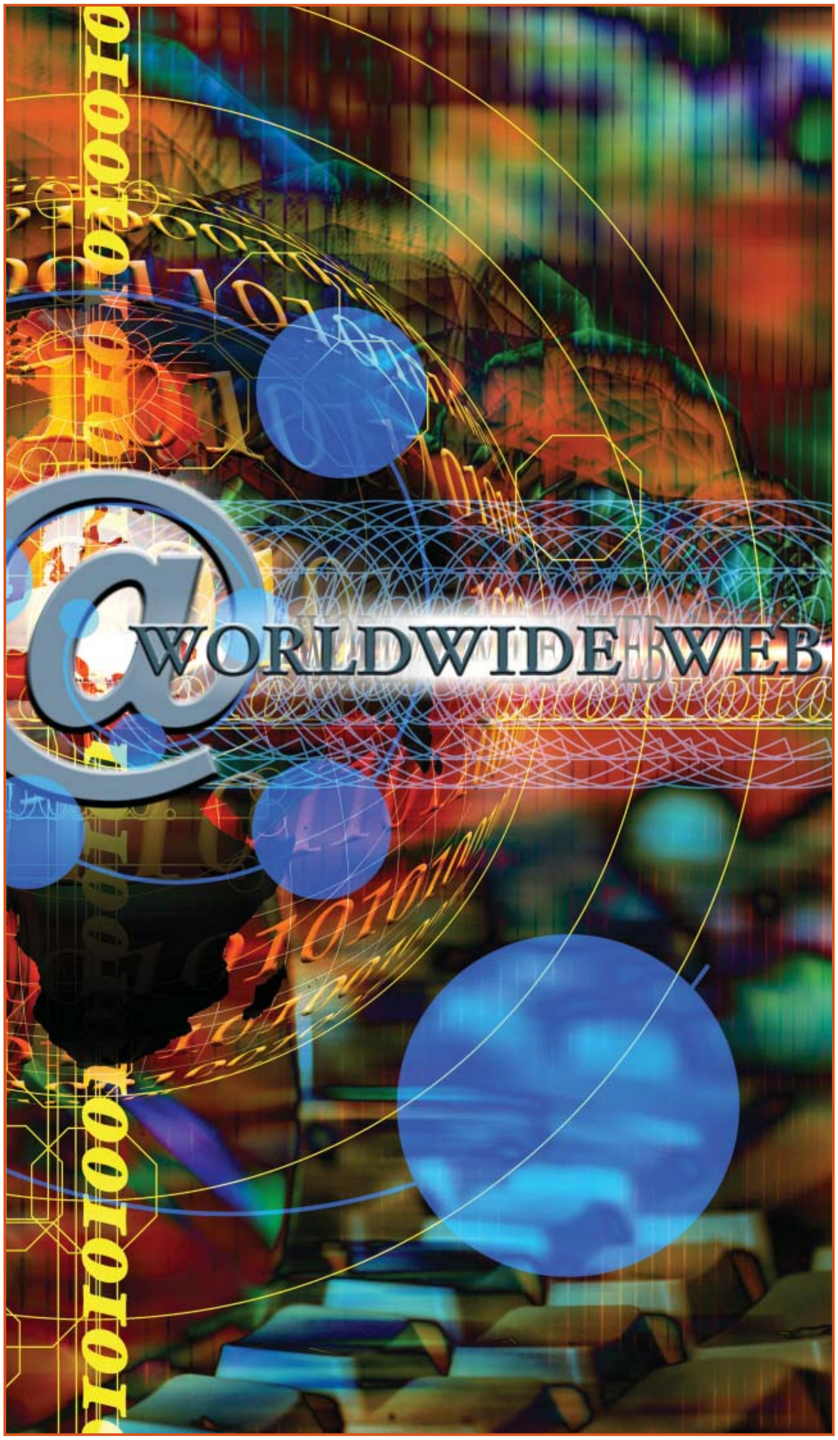
# NY Business Law Journal

A publication of the Business Law Section
of the New York State Bar Association

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NYSBA

**New York State Bar Association**

## Business Law Section

# ANNUAL STUDENT WRITING COMPETITION

The Business Law Section sponsors an annual Student Writing Competition, open to all students who are candidates for the J.D. or LL.M. degree at an accredited law school during the year in which the article is submitted. The student articles submitted in a given year that are judged first and second best, provided they are of publishable quality and otherwise meet the criteria of the Competition, will receive cash prizes of $1,500 and $1,000, respectively. At the discretion of the editors, they also will be published in the NYSBA *NY Business Law Journal*, which is sponsored by the Section in cooperation with New York Law School. Additional cash prizes may be awarded in the discretion of the Section. Entries that do not qualify for cash prizes may also be considered for publication in the *Journal*.

Articles submitted will be judged on the following criteria:

- Relevance to the *Journal*'s audience (New York business lawyers)
- Timeliness of the topic
- Originality
- Quality of research and writing
- Clarity and conciseness

The manuscript should follow Bluebook cite format (using endnotes rather than footnotes) and be a minimum of 3,000 words (there is no maximum). All submissions become the property of the NYSBA and the *NY Business Law Journal*. By submitting an article, the student is deemed to consent to its publication, whether or not a cash prize is awarded.

To enter, the student should submit an original, unpublished manuscript in Word format to David L. Glass, Editor-in-Chief, NYSBA *NY Business Law Journal* (david.glass@macquarie.com). The student should include a brief biography, including law school attended, degree for which the student is a candidate, and expected year of graduation.

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NEW YORK STATE BAR ASSOCIATION

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# NY BUSINESS LAW JOURNAL

# HeadNotes

As this issue was going to press, the U.S. Senate had just passed legislation to reform the financial system. The Senate version ultimately will have to be reconciled with the House version passed in December before a final bill can reach President Obama's desk for signature, so it is still premature to comment definitively. However, in broad outline the legislation is noteworthy for what it does not do as well as what it does. For instance, it does not effect a fundamental overhaul and streamlining of the financial regulatory structure; the existing regulators largely will remain in place with most of their powers intact. But it will effect basic changes in the regulation of consumer financial products, such as mortgages; the ability of regulators to rescue "too big to fail" institutions such as AIG; and perhaps most significantly, the structure and conduct of the over-the-counter (OTC) market for derivatives, such as swaps. How significantly these changes alter the landscape remains to be seen, and will be addressed in future issues of the *NY Business Law Journal.*

Meanwhile, our contributors continue to explore various aspects of the financial crisis and to express their views on causes and solutions. One aspect that has received a great degree of attention is the controversial role of the "nationally recognized statistical rating organizations," or NRSROs—Moody's and Standard & Poor's are the largest and best known. In "Credit Rating Agencies: Their Role in the Financial Crisis and the Regulatory Price That They Must Now Pay," Paul Roberts, a partner with the firm of Bryant Burgher Jaffe & Roberts LLP and a candidate for the LL.M degree at New York Law School's Center on Financial Services Law, explains how the NRSROs contributed to the financial meltdown through inadequate analysis of the underlying risk of certain instruments, especially securities backed by mortgages and other financial assets. Critics have long maintained that the NRSROs have an inherent conflict of interest, in that they are paid by the entity being rated, whether a corporation, governmental unit, or special-purpose issuer, for the ratings they provide on debt issuances. While both new SEC rules and the new legislation address this, the author argues that stronger punitive measures are necessary "to ensure that NRSROs fully respect and understand their role as 'gatekeepers' to the financial markets."

Another aspect that certainly has come to the fore is the role of mortgage brokers and the incentives they have had under existing lax regulation to promote mortgage products that may not be suitable for their customers. In "Mortgage Broker Duties Under New York Law—Are Brokers Fiduciaries?" Mordechai Gross, General Counsel at Xchange Telecom in Brooklyn, NY and formerly an attorney at the New York State Banking Department, discusses recent and proposed changes in New York law that are designed to eliminate or further some existing practices, such as the use of yield spread premiums by banks to compensate brokers. In particular, he discusses whether some of the changes in New York law, by imposing greater duties on mortgage brokers, might not have in effect turned them into fiduciaries for their customers.

Apart from regulatory reform, New York business lawyers have plenty to keep them busy, judging from this issue's lineup. One area that certainly merits closer attention by all business lawyers is the legal implications of web sites, which increasingly are an indispensable tool for any business. In "Web Site Rights and Wrongs: Key Legal Issues in the Creation and Operation of Web Sites," Jessica Friedman, Esq., an experienced New York practitioner specializing in copyright, trademark, and literary property law, outlines the many pitfalls that can arise in establishing and operating a web site. For example, in choosing a name and URL (web address), clients need to consider whether they are infringing on similar names that may be in a different line of business. One good rule of thumb: "If it's infringement offline, it's infringement online." They also need to consider whether U.S. and international trademark registration are required, and what steps are necessary to comply with privacy and defamation laws, especially if the web site is interactive. Ms. Friedman's article is an invaluable primer that every business attorney should read.

Another area of constant change is employment law. James Grasso of Philips Lytle, the *Journal*'s regular Employment Law columnist, contributes another timely and useful update on changes relevant to New York businesses and their attorneys. Reflecting the philosophical change from the Bush to the Obama Administration, recent federal employment law changes include restrictions on the ability of defense contractors and subcontractors to require employees or independent contractors to arbitrate certain employment claims; a new Presidential Order requiring federal contractors and subcontractors to post a government-issued notice at worksites where activities "related to" the contract are performed stating that it is the policy of the United States to encourage collective bargaining (the prior version stated that employees are not required to join a union); and expanding the military caregiver provision to family members of veterans. At the State level, Mr. Grasso notes that recent court decisions have increased the potential liability for employers located in New York State and City under the respective

Human Rights Laws for discrimination affecting employees located outside of the State and City.

Litigation is always a major concern for business lawyers. In "Inside the Courts," their latest installment of the *Journal*'s regular update, attorneys of the Skadden Arps firm provide an extremely useful overview of pending litigation covering the full range of corporate and securities matters. Next up, Evan Stewart of Zuckerman Spaeder, the *Journal*'s legal ethics guru, writes about the latest attack on the attorney work product doctrine, in "Caveat Corporate Litigator: The First Circuit Sets Back the Attorney Work Product Doctrine." Under the Second Circuit's 1998 *Adlman* decision, for purposes of determining whether a document was prepared "in anticipation of litigation," which is the predicate for the work product doctrine, it was sufficient to show that the document was created "because of" the prospect of litigation. However, as the author explains, a narrowly divided First Circuit panel has now held that tax accrual work papers prepared in the normal course for a public company are not covered by the doctrine, because no "experienced litigator" would describe such documents "as case preparation materials"—never mind that having access to these materials would give the IRS a huge advantage in litigation, given "the essential public interest in revenue collection." So, as the author notes, the taxman now "trumps any notions that litigation should be a relatively fair fight."

Recent issues of the *Journal* have been enhanced by some exceptionally fine contributions from law students, and the current issue is no exception, with two excellent and scholarly articles. First, in "The Pendulum Begins to Swing Back: *Kohen v. PIMCO*," David Pepper, a student at New York Law School, focuses on another aspect of business litigation—the criteria for class action certification. The *PIMCO* case involved allegations of market manipulation by PIMCO, the largest manager of fixed income securities, in the market for futures on Treasury issues. As the author explains, Judge Posner of the Seventh Circuit Court of Appeals ruled that for purposes of class certification under Federal Rule 23(b)(3), plaintiffs need not show that every individual in the class was harmed by the defendants' alleged conduct—only that it is plausible that most were. The article provides an education in the sometimes arcane market for Treasury futures as well.

Second, Arielle Katzman, a candidate for the JD degree at Cardozo Law School, explores an arcane but increasingly important aspect of the globalization of financial markets. In "Towards a More Consolidated Universe: Why and How Regulation Must Promote *Essentially* Inevitable Cross-Border Stock Exchange Mergers," Ms. Katzman advocates stock exchange consolidation as the "optimal and essentially inevitable" method of globalizing the marketplace, and explores the attendant regulatory issues. Along the way, she highlights the advantages and disadvantages of consolidation and concerns that have arisen in recent mergers. The article also discusses the current U.S. regulatory scheme and how regulatory barriers discourage cross-border transactions and lead to suboptimal results in executed deals. While acknowledging progressive steps toward harmonization taken by the United States, she argues that these steps have not gone far enough, and analyzes current proposals for facilitating a globalized marketplace. Finally, she compares the main regulatory proposals extant and provides recommendations on regulating cross-border exchanges.

Another aspect of globalization is explored by Guy Lander, a partner of Carter Ledyard & Milburn and past Chair of the NYSBA Business Law Section. In "SEC Initiatives to Make the U.S. Capital Markets More Attractive to Foreign Private Issuers," Mr. Lander outlines the reasons for the secular decline in the use of U.S. markets by foreign issuers. While the growth and development of foreign markets have played a part, aspects unique to the U.S.—the increasing cost of listing, the litigious nature of American society, and the particular burdens posed by the Sarbanes-Oxley Act and other laws—are especially troublesome in terms of promoting future use of the U.S. markets. Mr. Lander discusses the efforts to date by the SEC to reduce regulatory burden—not the least being the elimination of a requirement that foreign private issuers conform to GAAP accounting, if they agree to conform to International Financial Reporting Standards (IFRS).

**David L. Glass**
**Editor-in-Chief**

# Credit Rating Agencies: Their Role in the Financial Crisis and the Regulatory Price That They Must Now Pay

By Paul C. Roberts

## I. Introduction

Nationally Recognized Statistical Rating Organizations ("NRSROs"), commonly referred to as rating agencies, have been among the most vilified during this ongoing financial crisis. The extreme reliance on ratings by market participants and the part that such ratings played in the collapse, have resulted in a resounding clarion call for tougher regulation of NRSROs (some have even called for the elimination of references to credit ratings altogether). The United States Securities and Exchange Commission (the "SEC") and the House Financial Services Committee have been very active over the past several months in proposing tougher and more comprehensive regulatory oversight of NRSROs.

This article will discuss: (i) NRSROs and their role in the credit crisis; (ii) early regulation of NRSROs and the Credit Rating Agency Reform Act of 2006; (iii) recent regulatory initiatives aimed at NRSROs; and (iv) the writer's regulatory proposals for NRSROs.

## II. The Rating Agencies and the Credit Crisis

There are three major NRSROs in the United States: Standard & Poor's Ratings Services, Inc. ("S&P"), Moody's Investor Service, Inc. ("Moody's) and Fitch, Inc. ("Fitch"). The ratings that these agencies assign to any type of financial instrument are, at least in theory, an assessment as to the likelihood of the obligor defaulting.[1] The higher the rating (e.g. "AAA" ), the less likely that a default will occur. The lower the rating (e.g. "CCC"), the more likely that a default will occur.[2] It is not surprising that the proposed regulatory reforms call for increased competition in the NRSRO market as S&P, Moody's and Fitch account for 96% of outstanding structured finance ratings and 98% of all outstanding ratings issued by SEC-recognized agencies.[3]

The credit crisis that began in the summer of 2007 and continues as of the date of this article is extremely complex and widespread. Many commentators on the crisis have pointed to the stratospheric default rates in the subprime mortgage market as the catalyst for the economic meltdown.[4] These massive defaults caused a domino effect in the securitization market in particular and in the financial markets generally. The problem stemmed from the fact that many of the now infamous collateralized debt obligation ("CDO") transactions were backed by residential mortgage-backed securities ("RMBS") which in turn were backed by subprime mortgages. This complex interconnectedness was not realized by most investors in CDO and RMBS transactions and, as a result, they were unaware of the riskiness of their investments.[5] The financial markets, in turn, could not price these securities and this, coupled with financial uncertainty, resulted in a complete contraction of the markets.[6]

Federal and state regulators, "watchdog" groups, market participants, news media and even people on "Main Street," just to name a few, have pointed fingers of blame at those on Wall Street who participated in structuring and selling CDO securities and RMBS, as well as those on the local level, such as fraudulent mortgage loan originators. Among those on Wall Street who have taken considerable criticism are the NRSROs who provided credit ratings for the securities.[7] There has been a general consensus among observers and commentators that the failure of NRSROs to properly rate structured finance securities is due to: (i) conflicts of interest, (ii) lack of independent verification of information and (iii) faulty and inaccurate quantitative models.[8]

The three major rating agencies—S&P, Moody's and Fitch—all have business models that are based on an "issuer pays" concept. That is, the agencies are paid for their ratings by the issuers of the securities and this accounts for approximately 90-95% of their annual revenues.[9]

It is clearly evident that this business model has a glaring conflict of interest issue and this has been a central target of NRSRO critics. This conflict was laid brutally bare in the Congressional testimony of a former executive at Moody's:

> [A] large part of the blame can be placed on the inherent conflicts of interest found in the issuer-pay business model and on rating shopping by issuers of structured securities. A drive to maintain or expand market share made the rating agencies willing participants in this shopping spree.… Originators of structured securities typically chose the agency with the lowest standards, engendering a race to the bottom in terms of rating quality.[10]

The statistical data strongly back up the statements made by the former Moody's executive, as evidenced by the massive downgrades of structured finance securities over the past two years. It is not difficult to conclude that the NRSROs may have allowed their ratings to be compromised (low quality of ratings) due to this conflict of interest.[11]

The NRSROs have also been criticized for their lack of independent verification of information received from third parties where such information was used to issue ratings for structured finance securities. It is normal practice for the NRSROs to rely exclusively on issuers and underwriters with respect to the provision of information regarding the underlying assets of structured finance securities.[12] This type of reliance on "interested" third parties is dangerous as the information source is not independent and thus the information provided could be biased.[13] The NRSROs assert that they do not have an obligation to independently verify information received from issuers and underwriters as they are only providing "opinions" as to the credit quality of the securities.[14]

Lastly, the total reliance by the NRSROs on faulty and inaccurate quantitative models has been a major focal point. The unprecedented growth of CDOs and RMBS led the NRSROs to develop very complex quantitative models that were used to "analyze, evaluate and determine the quality of the underlying assets' cash flows and thus the securities' risk."[15] The fundamental problem is that extreme reliance on "flawed" models results in skewed, unreliable ratings.[16] One of the main flaws in these models was their reliance on historical housing data of mortgage default and foreclosure frequency rates.[17] Other flaws in the models were the assumptions that home prices would increase in value and the failure to "factor in the risk associated with the mortgage originators and their questionable practices on the overall risk of the underlying mortgage pool."[18]

## III. Early Regulation and the Credit Rating Agency Reform Act

The term "NRSRO" first came into use in 1975 when the SEC introduced the concept as part of the amendments to the broker-dealer net capital rule under the Securities Exchange Act of 1934.[19] The net capital rule sets forth the minimum capital requirements for broker-dealers and provides for a determination of asset valuation by broker-dealers in computing regulatory net capital.[20] With the introduction of NRSROs, a system was instituted to distinguish among different types of debt securities, in terms of risk, and thus more accurately value assets (e.g. the more risky the asset, the lower the rating and the higher the discount—resulting in less attribution to capital). This was a very significant point in the history and development of credit ratings as this resulted in an increased reliance by regulators on ratings.[21]

Interestingly, the creation of NRSROs by the SEC did not result in any type of substantive regulation. The SEC did not even adopt a definition of NRSRO.[22] In fact, the only regulation of the credit rating agency market was the NRSRO designation process, which was controlled by the SEC.[23] This process consisted of an application to the SEC by a credit rating agency and if the application was approved, a "no-action letter" would be given and the ratings given by such agency would be accepted as those of an NRSRO.[24] The criteria for NRSRO designation were unclear and the rationale supporting the SEC's decision-making process lacked transparency.[25] Additionally, the time frame for a decision was often very lengthy.[26]

The early 2000s witnessed the implosion of several large, prominent, well-rated companies. Some of the more notable, recognizable names included Enron and WorldCom. The demise of these companies caused Congress to focus on the role of the largely unregulated NRSROs and this resulted in the passage on September 29, 2006 of the Credit Rating Agency Reform Act (the "CRARA").[27] In June 2007, the operative provisions of the CRARA became effective when the SEC adopted implementing rules with respect to the registration and oversight of credit rating agencies that apply for, and are granted, NRSRO status.[28] The primary, overarching purposes of the CRARA were to: (i) increase accountability of NRSROs,[29] (ii) tighten oversight of the NRSROs to prevent such massive company failures in the future[30] and "improve ratings qualities for the protection of investors and in the public interest by fostering accountability, transparency and competition in the credit rating industry."[31]

The passage of the CRARA was a critical step in creating an initial regulatory framework for NRSROs. As discussed above, the prior "no-action letter" process for determining NRSRO status was vague and lacked specificity. Additionally, many of the issues in the credit rating agency market could not be addressed by the SEC as the agency had been limited by a lack of statutory authority.[32] Not only did the CRARA define more clearly the SEC's authority over NRSROs, but it also established a clear, standardized process for achieving NRSRO designation.[33] Furthermore, the CRARA was also designed to minimize the barriers to entry into the market and create more competition among credit rating agencies in what was a very concentrated industry. Prior to the enactment of the CRARA, a major roadblock for new competitors who wanted to enter the industry was the requirement that the rating agency be nationally recognized in order to be granted NRSRO status.[34] Ironically, the argument for increased competition was that performance among the credit rating agencies would improve and that ratings would be more accurate and credible.[35]

In terms of the new application process set forth in the CRARA, an NRSRO applicant must provide performance measurement statistics, procedures and methodologies for deriving its credit ratings, conflicts of interest and policies for managing such conflicts of interest.[36] The applicant must also have been in business for three consecutive years and provide written certifications from at least ten "qualified institutional investors" representing that they have used the applicant's credit ratings for the preceding three years.[37] With respect to conflicts of interest, the CRARA gives the SEC the power to prohibit an NRSRO from issuing ratings for a client who provides more than 10% of its net revenue or an NRSRO downgrading or threatening to downgrade a current security if it does not receive the issuer's business on another transaction.[38]

Although the CRARA provided regulation to a previously unregulated industry, it was blatantly lacking in a number of areas. Under the CRARA, the SEC is granted the authority to ensure that when an NRSRO rates securities, it utilizes only those procedures and criteria that are disclosed either in its application or in other documentation mandated by the SEC.[39] However, the CRARA severely limited the SEC's oversight ability by prohibiting the agency from regulating "the substance of credit ratings or the procedures and methodologies by which any NRSRO determines credit ratings."[40] This appears to be somewhat counterproductive and contradictory as one of the goals of the CRARA was to address challenges to the independence and reliability of credit ratings.[41] The provisions of the CRARA provided some teeth to the SEC's regulatory power, but the effectiveness is negated since the SEC is unable to opine with respect to the substance of the ratings or the substance of the procedures and methodologies. As a result, the SEC cannot determine whether a rating is truly unbiased and independent.[42] Furthermore, the CRARA shields the NRSROs from potential litigation by not providing for any private right of action.[43] Not surprisingly, the rating agencies supported the CRARA because of these limitations.[44] This certainly calls into question the effectiveness of the CRARA in terms of creating a regulatory regime of accountability for the NRSROs.

## IV. Legislative and Regulatory Initiatives

The crisis in the financial markets spurred Congress and the SEC to reexamine the CRARA in an effort to determine where the legislation fell short and come up with solutions to these apparent regulatory failures. On June 16, 2008, the SEC, in the first of three related actions, proposed a series of amendments to the existing NRSRO rules.[45] These proposed amendments were "designed to address concerns about the integrity of [the NRSROs'] credit rating procedures and methodologies in light of the role they played in determining credit ratings for securities collateralized by or linked to subprime residential mortgages."[46] The second action taken by the SEC also occurred on June 16, 2008. This action set forth a proposal for a new rule that would require NRSROs to "distinguish their ratings for structured finance products from other classes of credit ratings by publishing a report with the rating or using a different rating symbol."[47] The third SEC action was a proposal to amend certain rules under the Securities Exchange Act of 1934, Securities Act of 1933 and Investment Company Act of 1940 that would end the use of NRSRO credit ratings in the rules.[48] The proposed rule amendments under this third action were "designed to address concerns that the reference to NRSRO ratings in Commission rules and forms may have contributed to an undue reliance on NRSRO ratings by market participants."[49] These three SEC actions were intended to serve the following purposes: "(i) enhance the disclosure and comparability of credit ratings performance statistics; (ii) increase the disclosure of information about structured finance products; (iii) require more information about the procedures and methodologies used to determine credit ratings for structured finance products; (iv) strengthen internal control processes through reporting requirements; address conflicts of interest arising from the process of rating structured finance products; and reduce undue reliance in the Commission's rules on NRSRO ratings, thereby promoting increased investor due diligence."[50]

On February 2, 2009, the SEC adopted a majority of the rule proposals from the first action (discussed above).[51] According to the SEC release, the new requirements are "intended to increase the transparency of the NRSROs' rating methodologies, strengthen the NRSROs' disclosure of ratings performance, prohibit the NRSROs from engaging in certain practices that create conflicts of interest, and enhance the NRSROs' recordkeeping and reporting obligations to assist the Commission in performing its regulatory and oversight functions."[52] Apparently, these proposed amendments were taken very seriously by market participants as the SEC, according to the release, received 61 comment letters.[53] As a result, there were significant revisions to the proposed rules that are reflected in the amendments. Furthermore, due to the volume of comments, the second and third actions were not finalized in this release and certain of the proposed rules from the first action were left open for additional public comment. In summary, the rule amendments will require an NRSRO to: (i) provide enhanced disclosure of performance measurements statistics and the procedures and methodologies used in determining credit ratings for structured finance products and other debt securities;[54] (ii) make, keep and preserve additional records with respect to credit ratings rationales, changes in credit ratings and external communications in connection with credit ratings; (iii) make publicly available in electronic format a random sample of 10% of the ratings histories of credit ratings paid for by the obligor being rated or by the issuer, underwriter, or sponsor of the security being rated in each class of credit ratings; (iv) furnish the SEC with a new annual report on all credit rating actions in certain credit rating classes; and (v) refrain from issuing or maintaining a credit rating in certain conflict of interest situations.[55]

While all of these amendments are noteworthy and provide greater transparency and regulatory oversight, perhaps the most significant of the amendments are those which address conflicts of interest. The SEC amended paragraph (c) of Rule 17g-5 to prohibit an NRSRO from issuing or maintaining a credit rating where: (i) the NRSRO made recommendations about the corporate or legal structure, assets, liabilities, or activities of the entity being rated or the issuer of the security; and (ii) the fee paid for the rating was negotiated, discussed or arranged by a person within the NRSRO who is involved in the credit rating approval process or the credit rating methodology process.[56]

As mentioned above, the second and third SEC actions, which contained additional rule proposals with respect to changes in the rating symbols for structured finance products and amendments to reduce SEC rule reliance on NRSRO ratings, were not finalized and are still open for public comment. Additionally, as previously mentioned, certain of the rule proposals contained in the first action were not finalized and remain open for public comment. One of these proposals includes a requirement that NRSROs make publicly available the information that was utilized to determine or monitor the rating of a structured security.[57] This proposal would require: (i) the NRSRO to inform other NRSROs that it was rating the security; (ii) the issuer, sponsor or underwriter to represent that it was providing the same information to other NRSROs in order for them to determine a rating; and (iii) NRSROs to annually certify how they are using information they receive from other NRSROs in connection with structured finance products.[58]

Not to be outdone, the Treasury Department also chimed in on the issue of NRSRO regulation by releasing, on July 10, 2009, the proposed "Investor Protection Act of 2009."[59] In its press release, the Treasury Department stated:

> Continuing its push to establish new rules of the road and make the financial system more fair across the board, the Administration today delivered proposed legislation to Capitol Hill to increase transparency, tighten oversight, and reduced reliance on credit rating agencies. The legislation would also work to reduce conflicts of interest at credit rating agencies while strengthening the Securities and Exchange Commission's authority over and supervision of rating agencies. In recent years, investors were overly reliant on credit rating agencies that often failed to accurately describe the risk of rated products. This lack of transparency prevented investors from understanding the full nature of the risks they were taking. The Administration's legislation would tighten oversight of credit rating agencies, protect investors from inappropriate rating agency practices, and bring increased transparency to the credit rating process.[60]

The proposed legislation addresses the issues of: (i) conflicts of interest; (ii) transparency and disclosure; (iii) SEC authority and supervision; (iv) reduction of reliance on NRSROs; and (v) SEC actions on NRSROs.[61] The more significant rules contained in the proposed legislation include: (i) NRSROs would be restricted from providing consulting services to companies for which they provide ratings; (ii) NRSROs would be required to disclose fees paid by issuers (as well as the total amount of fees paid by issuers for the prior two years); (iii) issuers would be required to disclose all preliminary ratings from different NRSROs so that investors, as part of their due diligence, can determine whether any "ratings shopping" has occurred and whether there were any discrepancies with the final rating; (iv) NRSROs would be required to use unique symbols in order to identify structured products; (v) the SEC would establish an office dedicated to NRSRO supervision; and (vi) all credit rating agencies would be subject to mandatory registration.[62] Oddly, one of the most significant pieces of the proposed legislation was omitted from the press release—the requirement that NRSROs issue ratings that are derived using models that are approved by a board of NRSROs.[63]

The SEC followed up its February 2009 release of final rules with an open meeting on September 17, 2009, to discuss ways in which to strengthen regulatory oversight of NRSROs. During the meeting, the SEC voted unanimously to implement final rules that would further strengthen the regulatory framework for NRSROs.[64] The rules approved in the meeting would: (i) enable unsolicited ratings for structured finance products by ensuring access to information for all NRSROs;[65] (ii) require annual compliance reports related to potential conflicts of interest; (iii) amend SEC rules and regulation to remove certain references to NRSROs' credit ratings; (iv) require additional disclosure regarding whether "ratings shopping" occurred; and (v) require NRSROs to publicly disclose, online, their history of ratings actions for any rating that the NRSRO initially made as of June 26, 2007.[66]

Congress finally threw its hat into the NRSRO regulation ring on October 28, 2009. On that date, the House Financial Services Committee passed H.R. 3890, the Accountability and Transparency in Rating Agencies Act (the "ATRAA"), which was introduced by Congressman Paul E. Kanjorski (D-PA), Chairman of the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises. In the House press release, Chairman Kanjorksi stated:

> The Accountability and Transparency in Rating Agencies Act aims to curb the inappropriate and irresponsible actions of credit rating agencies which greatly contributed to our current economic problems. This legislation builds on the Administration's proposal and takes strong steps to reduce conflicts of interest, stem market reliance on credit rating agencies, and impose a liability standard on the agencies. As gatekeepers to our markets, credit rating agencies must be held to higher standards. We need to incentivize them to do their jobs correctly and effectively, and there must be repercussions if they fall short. This bill will take such steps.[67]

The bill, if passed, would require each NRSRO or its parent entity to have one-third of its board of directors be independent directors whose compensation is not tied to or based on the performance of the NRSRO.[68] The independent directors would also be required to oversee (i) the policies and procedures for determining credit ratings; (ii) the policies and procedures with respect to conflicts of interest; and (iii) the internal control system with respect to the policies and procedures for determining credit ratings.[69] The ATRAA would also require SEC rulemaking that would regulate: (i) the use of proper rating methodologies;[70] (ii) provision of information to investors to help them better understand the ratings;[71] (iii) notification to investors and issuers of the models used by the NRSRO and updates or changes in the model versions;[72] and (iv) NRSRO use of credit rating symbols that distinguish credit ratings for structured products from credit ratings for other products.[73] The most far-reaching and drastic proposed change to the current NRSRO regulatory landscape that is contained in the ATRAA is the ability of individuals to bring private actions against the NRSROs.[74] Currently, the NRSROs are effectively protected from lawsuits based on a statutory exemption from liability under Section 11 of the Securities Act of 1933 and limitations on private rights of action in the CRARA.[75] Additionally, there are judicial decisions that have agreed with the NRSROs' claim that their ratings are merely "opinions" which are protected under the First Amendment.[76]

## V. Policy Arguments for Regulation of NRSROs

There have been some critics who have argued that the entire ratings-based system should be blown up and a new, more independent system put in place. Others have opined that the current system, though flawed, can be fixed through regulatory reform. Ratings are such an integral part of not only the U.S. markets, but the global markets, that it would be nearly impossible to get rid of ratings altogether.

There has been significant progress by the SEC and Congress in working towards stronger and more comprehensive regulation of NRSROs; however, it is the belief of this author that the SEC rules and that agency's proposed rules and the ATRAA do not go far enough to fully address the fundamental problems with the current regulatory system in light of the ongoing credit crisis, nor do they provide enough deterrence to incentivize the NRSROs to "do the right thing."

The regulatory system in the United States is based on the theory that disclosure is the best way to protect investors. Thus, it is not surprising that the recent regulatory initiatives have focused primarily on disclosure by the NRSROs in an effort to increase transparency. More disclosure may be beneficial to investors who have an appetite for more plain vanilla, less complex types of securities. However, it is unclear whether increased disclosure will do much, if anything, for investors in the highly complex structured products and derivatives market. One of the threshold issues of this credit crisis is that few, if any, investors truly understood the structured transactions in which they were investing. Indeed, there were people on Wall Street—bankers, lawyers, ratings analysts, etc.—who did not fully understand how these incredibly complex, multi-layered deals worked. The investment banks who were structuring these deals had quantitative analysts with Ph.Ds in Mathematics and Financial Engineering working on models and formulas to be incorporated into the structures, so one can easily imagine how complicated these deals actually were.

The NRSROs also had their own quantitative analysts developing models for the various CDO and other structured finance transactions which were incorporated into their methodologies and ratings criteria. This author has been privy to the methodologies and criteria of one of the major NRSROs and complex does not even begin to describe the problem. Needless to say, disclosure of this information to investors will be all but useless. The concept of disclosure is meaningless if the information disclosed to investors is next to incomprehensible.

Additionally, why should the onus be placed on the investor? The rationale behind the rating agencies is to provide a service to investors so that they can make a reasonable judgment as to whether an investment is safe or not. This is why the issuer-pays business model is inherently flawed. Regardless of the proposed disclosure requirements, it is hard to imagine that there could ever be a truly independent, unbiased rating given by an NRSRO when it is receiving payment for such rating from the issuer. The subscriber-pays/investor-pays model, which is the business model for most of the new NRSROs, gets away from this conflict and thus ratings can be perceived to have more credibility. The purpose of this section, however, is not to discuss business models, but rather to propose ways in which NRSROs could be better regulated.

Regulations need to have "teeth." Not only do they need to have teeth, but they need to be applied and enforced. More than one finger was pointed at the SEC and the various banking regulators for being "asleep at the switch" and thus enabling "bad acts" to take place under their watch which led, in the aggregate, to the financial crisis. The ATRAA does have a few sharp teeth in it (proposals to allow private lawsuits against the NRSROs, for example); however, as stated above, this does not go far enough to incentivize the NRSROs to do a better job with respect to their ratings. There need to be much more serious consequences for the NRSROs if they produce low-quality, inaccurate ratings. The enforcer is already in place as the SEC has recently mandated that a new office within the agency be devoted solely to oversight of NRSROs. Now the enforcer needs a hammer. NRSROs are similar to other service providers (e.g., lawyers) in that reputation matters. A lawyer lives and dies by his/her reputation. So too does an NRSRO. There is a reason why

S&P and Moody's have by far the most dominant positions in the NRSRO market—reputation. The NRSROs have certainly taken a hit and it may be some time before recent transgressions are forgotten. Nevertheless, ratings are still a major part of how the financial markets operate and the ratings of S&P and Moody's will still be valued and respected more than those of any of the other NRSROs. Thus, in order to incentivize these NRSROs to do the best job possible in rating structured finance and derivatives products, the consequences of failure should be suspension of their NRSRO status. For example, if S&P rated 25 CDOs in one month and five of those CDOs have senior tranches that experience some type of default-related issue within a certain time frame (relatively short), then there would be a suspension of S&P's NRSRO status for a certain period of time. For repeat offenders, the time frame would be extended. This type of action could be very detrimental to S&P's bottom line as many institutional investors are required to invest only in securities rated by an NRSRO. Moody's could get a huge windfall in this type of situation.

In addition to suspension of NRSRO status, there should also be monetary fines imposed if shoddy ratings are produced. Fines only work if they hurt. In the heyday of the CDO bonanza, S&P and Moody's were commanding fees of $500,000 per deal. Those days are long gone and as a result, rating agency fees will be more in line with current market conditions. Going back to the example above, for each of the five tranches that experienced distress, S&P should be fined no less than $250,000. The key here is to find a moderate amount. The fine cannot be too modest because then there is no deterrent. However, the fine cannot be too extreme, as this might cause the ratings market to stop operating smoothly.

This author does not have any fundamental problems with the current proposals of Congress and the SEC (some of the proposals may not be very effective), and more comprehensive regulation is needed in light of the role that the NRSROs played in the financial crisis. However, in order to truly deter the type of rampant disregard of their responsibility as "gatekeepers" to the financial markets which the NRSROs have recently shown, reputation-based and monetary sanctions will need to be imposed for ratings that are inaccurate and cause losses in the marketplace.

## VI. Conclusion

It can be argued that the subprime mortgage crisis was the spark that ignited the fiery inferno that consumed the financial markets and caused the ongoing credit crisis. The fact that subprime mortgages were so interconnected and interrelated with structured finance and derivatives products on Wall Street made the crisis exponentially worse. There are many culprits who contributed to the conflagration from which the financial markets are still suffering. NRSROs have been placed high on the "guilty party list" since they issued inaccurate and misguided ratings on these subprime mortgage-backed financial products and, but for these ratings, investors would not have lost billions of dollars when the "house of cards" collapsed.

As a result, there has been a flurry of activity in Washington aimed at providing for stricter regulatory oversight of NRSROs. The SEC has finalized rules and the House Committee on Financial Services has approved pending legislation directed squarely at NRSROs. Although these are necessary measures, based on the "bad acts" committed by NRSROs, the proposals do not provide sufficient deterrence to incentivize NRSROs to refrain from "bad acts" in the future. Strong, punitive measures need to be added to the proposed legislation to ensure that NRSROs fully respect and understand their role as "gatekeepers" to the financial markets.

## Endnotes

1. John Patrick Hunt, *Credit Rating Agencies and the "Worldwide Credit Crisis": The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement*, 2009 Colum. Bus. L. Rev. 109, 114 (2009).
2. It should be noted that the NRSROs state that ratings are merely "opinions" and not guarantees. See Deryn Darcy*, Survey, Credit Rating Agencies and the Credit Crisis: How the "Issuer Pays" Conflict Contributed and What Regulators Might Do About It*, 2009 Colum. Bus. L. Rev. 605, 611 (2009) ("…a higher rating reflects the [NRSRO's] belief that an instrument is of a higher credit quality than a lower rated instrument, but even a AAA rating is not intended as a guarantee that the instrument will not default; the rating only reflects that the [NRSRO] believes that it is less likely to default than an instrument with a lower rating.").
3. Hunt, *supra* note 1, at 115.
4. *Id.* at 121.
5. Timothy E. Lynch, *Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment*, 59 Case W. Res. L. Rev. 232-33 (2009).
6. *Id*. at 233.
7. Darcy, *supra* note 2, at 607. "…many observers have accused the agencies of doing a poor job assessing the risks inherent in securities backed by subprime mortgages."; Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective*, Council of Institutional Investors, April 2009, at 3. "Until recently, the NRSROs maintained triple-A ratings on thousands of nearly worthless subprime-related investments."; Lynch, *supra* note 5, at 234. "Each of [S&P, Moody's and Fitch] appear to have been recklessly, if not knowingly, rating [RMBS] and related securities as less than risky than they actually were and, consequently, to have fed investor appetites for [RMBS] and other U.S. real estate financial products."
8. *See generally* Lois R. Lupica, *Credit Rating Agencies, Structured Securities, and the Way Out of the Abyss,* 28 Rev. Banking Fin. L. 639, 656-663; Darcy, *supra* note 2, at 616-20; Office of the Special Inspector General for the Troubled Asset Relief Program, Quarterly Report to Congress, Oct. 21, 2009, at 136-37 [hereinafter SIGTARP].
9. Darcy, *supra* note 2, at 622.
10. SIGTARP, *supra* note 8, at 136 (quoting Jerome S. Fons, Former Managing Director of Credit Policy, Moody's Investor Services, Testimony to Congress, U.S. House of Representatives, Committee on Oversight and Government Reform, Hearing: Credit Rating Agencies and the Financial Crisis, 10/23/2008).
11. Darcy, *supra* note 2, at 620.
12. Lupica, *supra* note 8, at 656.
13. *Id*. at 656-57 ("There is little short-term incentive for issuers to completely disclose information about all aspects of the underlying

assets because selectively choosing which information to provide may well increase an issuer's credit rating.").

14. Darcy, *supra* note 2, at 617-18. "…but their decision not to [perform their own due diligence] may also stem from a lack of sufficient resources given the volume of issuances the [NRSROs] rate or concern over legal liability."
15. Lupica, *supra* note 8, at 657.
16. *Id.* at 649-51. "In the absence of a precise understanding and valuation of securitized assets, the exercise in arbitrage fails, and the credit rating becomes based on a misunderstanding that in turn determines the faulty [CDO and RMBS] pricing."
17. SIGTARP, *supra* note 8 at 136. The data were typically based on the years 1992-2000 and mortgage loans made during 2001-2007 were very different and far more risky.
18. *Id*. at 136-37. *See also* Lupica, *supra* note 8, at 660-61. "Overreliance on "math" to the exclusion of consideration of subjective factors impacting credit quality such as the issuer's management quality, competitive market position, financial policy, capital structure, cash flow protection, accounting practices, and the general economic environment led to inaccurate conclusions about levels of risk."
19. Adoption of Amendments to Rule 15c3-1 and Adoption of Alternative Net Capital Requirement for Certain Brokers and Dealers, Rel. No. 34-11497, June 26, 1975, 40 Fed. Reg. 29,795 (July 16, 1975).
20. SIGTARP, *supra* note 8, at 122; *See also* John T. Bostelman, The Sarbanes-Oxley Deskbook § 21:1.3, at 21-5 (2008).
21. *Id*. *See also* Partnoy, *supra* note 7, at 4.
22. Bostelman, *supra* note 20, at 21-5 to 21-6.
23. Darcy, *supra* note 2, at 630.
24. *Id.*
25. Hunt, *supra* note 1, at 133; *See also* Darcy, *supra* note 2, at 630.
26. Hunt, *supra* note 1, at 133.
27. 15 U.S.C. § 78o-7 (2006).
28. Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34,55857 (June 5, 2007), 72 FR 33564 (June 18, 2007) (hereinafter *Oversight of CRAs*).
29. Darcy, *supra* note 2, at 630.
30. Lynch, *supra* note 5, at 267-68; *see also* SIGTARP, *supra* note 8, at 127.
31. Proposed Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-57967 (June 16, 2008) (hereinafter *Proposed Rules for NRSROs*).
32. Bostelman, *supra* note 20, at 21-6 to 21-7.
33. Darcy, *supra* note 2, at 630.
34. SIGTARP, *supra* note 8, at 127.
35. Lynch, *supra* note 5, at 268.
36. 15 U.S.C. § 78o-7(a)(2)(B)(vi) (2006).
37. 15 U.S.C. § 78o-7(a)(1)(B)(ii) (2006).
38. SIGTARP, *supra* note 8, at 127.
39. 15 U.S.C. § 78o-7(c) (2006).
40. 15 U.S.C. § 78o-7(c)(2) (2006).
41. SIGTARP, *supra* note 8, at 127.
42. Lynch, *supra* note 5, n.194.
43. 15 U.S.C. § 78o-7(m) (2006).
44. Partnoy, *supra* note 7, at 6.
45. Oversight of CRAs, *supra* note 28.
46. Proposed Rules for NRSROs, *supra* note 31.
47. *Id*.
48. References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 58070 (July 1, 2008), 73 FR 40088 (July 11, 2008).
49. *Id*. The Release also stated the SEC's concern as to "whether the inclusion of requirements related to ratings in its rules and forms has, in effect, placed an 'official seal of approval' on ratings that could adversely affect the quality of due diligence and investment analysis."
50. Proposed Rules for NRSROs, *supra* note 31.
51. Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 59342 (February 2, 2009) (hereinafter *Amendments*).
52. *Id*.
53. *Id*.
54. Lupica, *supra* note 8, at 668. "…NRSROs are prohibited from issuing a rating on a structured product unless information about the underlying assets is made available."
55. *Id*.
56. *Id*. The paragraph was also amended to prohibit an NRSRO from issuing or maintaining a credit rating where a credit analyst involved in determining or monitoring the credit rating, or another person involved in the credit rating approval process, received gifts from the entity being rated or the issuer, underwriter or sponsor of the securities being rated.
57. Lupica, *supra* note 8, at 668.
58. Lupica, *supra* note 8, at 668-69.
59. H.R. 3817, 111th Cong. (2009).
60. U.S. Treasury Dep't Press Release (July 21, 2009).
61. *Id*.
62. *Id*.
63. H.R. 3817, 111th Cong. (2009).
64. SIGTARP, *supra* note 8, at 144.
65. Darcy, *supra* note 2, at 650. "NRSROs seeking to access this information would need to certify to the SEC that they intend to use this information only to provide credit ratings and that they will produce a minimum number of ratings based on the information."
66. SIGTARP, *supra* note 8, at 144.
67. H. Comm. on Financial Services Press Release (Oct. 28, 2009).
68. H.R. 3890, 111th Cong. (2009).
69. *Id*.
70. *Id*.
71. *Id*.
72. *Id*.
73. *Id*.
74. *Id*.
75. Partnoy, *supra* note 7, at 5-6.
76. *Id*. at 6.

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# Mortgage Broker Duties Under New York Law—Are Brokers Fiduciaries?

By Mordy Gross

## I. Introduction

The financial crisis of the past few years has been called the worst since the Great Depression.[1] Industry-wide finger pointing has ensued. A root cause of this crisis was the improvident granting of mortgages, both to people who should have not been placed in a mortgage at all, and to people who were placed in a mortgage that was not in their best interests.[2] Diverse incentives caused and encouraged this behavior of improperly placing borrowers. Eliminating the incentives for such behavior has become a legislative goal across the country.

One of the incentives for this bad behavior is mortgage broker compensation. Although the borrower most often pays a mortgage broker, the fee is often shifted from being paid up front to being paid at the time of the closing.[3] Thus, the mortgage broker often receives his compensation directly from the bank—whether the compensation takes the form of a fee paid at the closing from the mortgage proceeds or as a direct payment from the bank. Banks often use the practice of paying a "yield spread premium" ("YSPs"), or compensation to the broker for the difference between the interest rate on a par loan and the interest rate on an above par loan.[4] YSPs are particularly effective in allowing borrowers with little available cash or remaining loan-to-value to obtain financing. This, of course, incentivizes brokers to encourage borrowers into above par loans rather than steering their borrowers into the best loans for them, in order to maximize their own compensation.[5]

The YSP itself is not innately evil.[6] It is a legitimate method of shifting an upfront fee paid from the borrower to his broker.[7] However, this argument inherently must mean that the broker would otherwise work for and be paid by the borrower if the broker would otherwise look for compensation from the borrower. Thus, the problem in such fees is in the expectation of the borrower—the borrower thinks that the broker is working for him—to obtain the best loan for the borrower, when in fact the broker is working for himself (and, by proxy, the bank)—to obtain the best loan for the bank and maximize his compensation.[8]

Adding to the problem of this misunderstanding is that former regulations did not, in practice, encourage full disclosure of fees. Although the regulations *require* full disclosure, numerous ways abound to render such disclosure meaningless. In New York, the requirement under the regulation is merely that the *maximum* amount of broker compensation be disclosed.[9] Thus, a broker can disclose an absurd maximum that will not be exceeded, thus rendering ineffectual the goal of the regulation. Moreover, the forms promulgated by the New York State Banking Department have not encouraged meaningful disclosure by requiring a standardized format. For instance, use of the "Pre-application Disclosure and Fee Agreement for Use by New York Registered Mortgage Brokers"[10] is optional. Additionally, the fact that the actual compensation is based on factors not in the borrower's best interest need not be disclosed.

In light of this reality, legislatures across the nation have proposed laws to align borrowers' expectations to reality. These laws require a combination of disclosure and creation of duties by the broker to the borrower.[11]

In New York, the Governor's Program Bill to address this issue, S. 8143,[12] enacted several changes to the relationship between a broker and a borrower in certain loans and changed the disclosure requirements for the loan transaction. Specifically, § 4 of the bill revised Banking Law § 6-l (2) regarding high-cost loans, and § 5 of the bill added a new § 6-m (2) regarding subprime loans. These subdivisions provide for disclosure of the exact broker compensation. Additionally, Section 6 of S. 8143 added a new § 590-b to the Banking Law. This section requires or establishes specific duties that run from the broker to the borrower and establishes a duty to disclose all compensation. Section 590-b allows a cause of action for actual damages and attorney's fees by the borrower for violation of the section.[13]

Similarly, the federal government has enacted new requirements for the Good Faith Estimate[14] and HUD-1[15] disclosures under RESPA.[16] The requirements prohibit deviation from certain terms disclosed in the Good Faith Estimate, and prohibit deviation from other terms within a tolerance level of 10%, in the absence of a new estimate. The Good Faith Estimate must conform to a template provided by the Department of Housing and Urban Development ("HUD").

This article will examine the new requirements and duties of the Governor's Program Bill. It will first examine the new duties under § 590-b and whether the duties impose a fiduciary duty upon the broker. It will then examine the disclosure requirements of S. 8143. Finally, it will examine the practical implications of the new sections.

## II. New Section 590-b—Do the New Duties Impose a Fiduciary Relationship on Brokers?

New Section 590-b requires mortgage brokers to act in the borrower's interest; act with reasonable skill, care and diligence; act in good faith and with fair dealing; clearly disclose compensation and all other material information; and diligently work to present the borrower with a range of loan products for which the borrower likely qualifies and which are appropriate to the borrower's existing circumstances, based on information known by, or obtained in good faith by, the broker. Because these duties mirror in large part the duties that a fiduciary owes its principal, the new statute necessitates questioning whether, indeed, a mortgage broker is now a fiduciary of the borrower, with all the rights, privileges and responsibilities appertaining thereto.

### A. What Is a Fiduciary Relationship and How Does It Affect Mortgage Brokers?

The first thing to keep in mind when considering fiduciary duties is the distinction between the legal definition of a fiduciary and the common conception of what a fiduciary is. In common nomenclature, a fiduciary is often limited to the realm of trusts. However, the legal use of the word fiduciary is not so limited, and arises from the contours of a relationship.[17]

A fiduciary relationship arises generally under two circumstances. First, the parties may, by contract, agree to the relationship, a relationship known as agency. Agency/principal relationships arise in all contexts, where the parties manifest the proper state of mind. Additionally, the relationship may be implied by law by the acts of the parties or circumstances surrounding their actions, even though no formal agency agreement is made.[18] Fiduciary relationships implied by law often arise in the context of trustee and beneficiary, guardian and ward, attorney and client, and agent and principal.[19] Where the circumstances show that a party, the principal, is entitled to rely upon another party, the fiduciary, a fiduciary relationship will result.[20]

Recognizing the existence of a fiduciary relationship is important because it imposes a series of duties on the party that is a fiduciary. In brief, the fiduciary relationship imposes the following duties: duty of loyalty, duty of good faith, duty of due care and duty of disclosure.[21] A fiduciary breaches these duties where he acts in his own interests.[22]

Traditionally, a broker is distinguished from an agent in that the broker's purpose is to unite the two parties in a transaction, whereas an agent's purpose is to consummate the transaction on behalf of one of the parties. Because the primary purpose of the relationship was to unite the parties, the broker would normally not owe fiduciary duties to any one party.[23] Courts have generally held under previous New York law that a typical mortgage broker-borrower relationship is not that of a fiduciary.[24] However, the nature of the agreement between the parties, the reasonable expectations of the parties, and duties imposed by statute can make what is termed a broker relationship into an agency relationship with ensuing rights and remedies.[25] Courts have found such a relationship where the broker took control of the application process,[26] or assumed a special advisory role, even though the typical relationship would be arm's-length.[27] Similarly, courts in other contexts have found agency or fiduciary duties where statutes or regulations impose a heightened standard of duty on the putative agent.[28] Therefore, arguably, a broker should not assume that a court would view his relationship with a borrower as an arm's-length transaction. It is quite likely that a fiduciary relationship will be found.

### B. Parties' Expectations and Responsibilities Under the Old Law

#### 1. Parties' Expectations in a Mortgage Broker Relationship

The finding of a fiduciary duty between the broker and the borrower, taking the average parties' expectation in a mortgage transaction, is quite likely. In the typical mortgage scenario, a borrower contacts a mortgage broker to find a mortgage. The borrower, absent clear notification otherwise, assumes that the broker is working for the borrower. Thus, the typical contract will allow the broker to be a dual agent, working for both the borrower and the lender. However, a threshold issue is whether the borrower ever really understands the legal distinction. What often results is a scenario where the borrower believes that the only interest being looked out for is the best interest of the borrower; however, the reality is that the broker is looking out for his own and the lender's interests as well—the borrower having waived his right to expect such a duty in signing the contract.[29] This disconnect between the expectation of the borrower and the realities of the transaction often leads to the borrower accepting a non-advantageous mortgage product.[30]

The broker, however, expects to be treated as an independent contractor working for himself. The broker assumes that the contracts signed make this position clear and that he is not assuming any fiduciary duties. Again, whether or not the assumption made by the broker is in line with the reality of the law depends on whether the borrower is actually informed, and what duties the law imposes. However, it is clear that there is a disconnect between the borrower's expectations and the broker's expectations.

#### 2. Common Law Fiduciary Duties of Broker-Agents

Before this article examines the new law and discusses whether it imposes a fiduciary duty, it is helpful to discuss the common law ramifications of a finding of a fiduciary relationship or agency between the borrower and the broker.

If a mortgage broker is in the position of agent of the borrower, a fiduciary relationship exists between the agent and the principal.[31] The agent is then bound to exercise the utmost good faith and undivided loyalty toward the principal throughout the relationship, and must act in accordance with the highest principles of morality, fidelity, loyalty, and fair dealing. The principal is entitled to rely completely upon the agent to represent him with undivided loyalty.[32] Thus, where a breach of duty occurs, the agent is liable to the principal for damages caused by the breach.[33] Moreover, it is the duty of the agent to disclose to his principal all material facts that come to the agent's knowledge relating to the subject of the agency.[34] Lastly, an agent is prohibited from acting in any manner inconsistent with his agency. If he does so act, he can be liable for fraud.[35] This last duty imposes its own duty of disclosure of any conflicting interests.[36] This, obviously, is not in line with the expectation of the average mortgage broker.

Thus, even if the parties are *not* in a fiduciary relationship by law, the borrower certainly expects such a relationship. In light of this reality, laws have been proposed to create such duties. One such law is § 590-b.

### C. New Section 590-b

Section 6 of S. 8143 added a new § 590-b to the Banking Law. Subsection (1) of § 590-b provides new requirements for brokers:

> Each mortgage broker shall, in addition to the duties imposed by otherwise applicable provisions of state and federal law, with respect to any transaction, including any practice, or course of business in connection with the transaction, in which the mortgage broker solicits, processes, places or negotiates a home loan:
>
> (a) act in the borrower's interest;
>
> (b) act with reasonable skill, care and diligence;
>
> (c) act in good faith and with fair dealing;
>
> (d) not accept, give, or charge any undisclosed compensation, directly or indirectly, that inures to the benefit of the mortgage broker, whether or not characterized as an expenditure made for the borrower;
>
> (e) clearly disclose to the borrower, not later than three days after receipt of the loan application, all material information as specified by the superintendent that might reasonably affect the rights, interests, or ability of the borrower to receive the borrower's intended benefit from the home loan, including total compensation that the broker would receive from any of the loan options that the lender or mortgage broker presents to the borrower; and
>
> (f) diligently work to present the borrower with a range of loan products for which the borrower likely qualifies and which are appropriate to the borrower's existing circumstances, based on information known by, or obtained in good faith by, the broker.

This article will examine the new duties imposed individually. Because of the scarcity of case law interpreting the statutes, parallels will have to be drawn from similar statutes in order to draw a reasonable picture of the scope of the statutory obligations. Many, if not all, of the new duties imposed have parallels in agency law. As much as prior case law and convention insist that a mortgage broker is not an agent in a fiduciary relationship with the borrower, one must consider that § 590-b changes everything—"If it looks like a duck, and quacks like a duck, we have at least to consider the possibility that we have a small aquatic bird of the family Anatidae on our hands."[37]

#### 1. Duty to Act in the Borrower's Interest

Section 590-b (1) (a) imposes a duty on a mortgage broker to act in the borrower's interest. Unique to New York law, this section parallels the common law duty of an agent not to act adversely to the principal's interest.[38] The question, of course, is whether this section codifies the common law duty of an agent to act only in the principal's interest, or if it imposes some lesser duty on a broker.

If the section is construed as codifying the common law agency duty of a mortgage broker, a unique burden would be placed on the broker-borrower relationship. Because most broker-borrower relationships are inherently in conflict with the broker-lender relationship, it is almost certain that every broker relationship would be adverse to the borrower's interest. Borrowers and lenders want different things. Simply put, the borrower wants to pay less, and the lender wants to get more. Additionally, the broker wants to maximize his compensation—an interest which often runs contrary to the interest of the borrower. Thus, a broker would be acting adversely to the borrower's interest, where, for example, the mortgage that the broker is effectuating is one in the broker's and not the borrower's interest. A breach of this common law duty normally gives rise to an action for fraud.

A subsidiary question is whether a borrower can waive this duty. Under agency law, a principal can waive conflicts only after receiving full disclosure.[39] Full disclosure requires that the principal be fully informed as to every material fact.[40] Thus, if this provision parallels the agency rule, it would be waivable with such full disclosure but only if such waiver is freely given after full disclosure. However, it is worth bearing in mind that the disclosure under this section must be higher than and independent of that of subsection (e), which requires disclosure of the compensation of the broker, in order not to render that subsection a nullity. If, as seems plausible, the disclosure must parallel that which is required under agency law to disclose a conflict, a broker would be advised to make a disclosure more akin to the disclosure required of an attorney prior to accepting dual clients, which requires informed consent confirmed in writing.[41] Moreover, continuing the parallel to attorney-informed consent, where the attorney himself stands to benefit from a business transaction, he must, aside from obtaining consent, advise the client in writing and give the client enough time to obtain independent legal advice.[42] Thus, under such a standard, since a broker most often stands to benefit from the specific mortgage that the borrower chooses, the broker would have to advise the borrower to seek independent financial advice from a competent advisor.

### 2. Duty to Act with Reasonable Care, Skill and Diligence

Section 590-b (1) (b) imposes a duty on a mortgage broker to act "with reasonable care, skill and diligence." Similar duties have been enacted in other states.[43] This duty is similar to the common law duty of an agent to perform his duties with care, competence, and diligence.[44] This duty generally requires the agent to exercise such skill as is ordinarily possessed by persons of common capacity engaged in the same business.[45] In the agency law context, courts have found such a breach where an agent failed to properly investigate and determine the availability of a promised product,[46] or to provide a product which satisfied the requested needs.[47] It would not be a far stretch for a court to determine that a mortgage broker breached this duty by not providing the borrower with the proper mortgage product.

However, the required care, skill and diligence can be set by clear benchmarks in a well-drafted contract between the agent and principal.[48] Thus, a broker can avoid liability if the contract is sufficiently clear in delineating the care, skill and diligence that the broker will use. A broker is forewarned to take care in promising or seeming to promise to obtain a certain mortgage product; such promises can set a benchmark for the broker's services which is higher than the average and which would allow the principal to rely on such heightened promises.[49]

### 3. Duty of Good Faith and Fair Dealing

Section 590-b (1) (c) imposes on all brokers a duty of good faith and fair dealing. This duty is not a new one; it is found in both the agency context and in the contract context. An agent has a similar duty "to be loyal to his principal and is prohibited from acting in any manner inconsistent with his agency or trust and is at all times bound to exercise the utmost good faith and loyalty in the performance of his duties."[50] Contracts impose on the contracting parties a duty of good faith, fair dealing and cooperation.[51] The question, of course, is what is considered good faith. In the context of contracts governed by the UCC, good faith is defined as "honesty in fact in the conduct or transaction concerned."[52] In New York, the implied covenant of good faith and fair dealing embraces a pledge that neither party will do anything having the effect of destroying or injuring the right of the other party to receive the fruits of the contract.[53] "Subterfuges and evasions violate the obligation of good faith in performance even though the actor believes his conduct to be justified. But the obligation goes further: bad faith may be overt or may consist of inaction, and fair dealing may require more than honesty. A complete catalogue of types of bad faith is impossible, but the following types are among those which have been recognized in judicial decisions: evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance."[54] Under New York law, while a party to a contract is not prohibited from pursuing other contracts, and may even incidentally affect or otherwise lessen the other party's interests, there comes a point where the actions taken by the party will so manifestly harm the other party's interest as to constitute a breach of the duty of good faith.[55] Thus, care must be taken by the broker to insure that any deal made with the lender is not manifestly adverse to the borrower's interest.

Since every contract includes a duty of good faith and fair dealing, one must ask why the legislature felt a need to import such a duty into the broker-borrower relationship. A reasonable explanation would be that this duty, unlike the duty of good faith in the typical contractual setting, cannot be modified, nor may its standards be set, by contractual terms.[56] Until the courts rule on the scope of this statutory duty, a broker is well advised to assume the worst—that the terms of the contract setting the standards of good faith do not govern.

### 4. Duty to Disclose Compensation and Other Material Information and Not Accept Undisclosed Compensation

Section 590-b (1) (d) prohibits a mortgage broker from accepting, giving, or charging "any undisclosed compensation, directly or indirectly, that inures to the benefit of the mortgage broker, whether or not characterized as an expenditure made for the borrower." This prohibition complements § 590-b (1) (e)'s requirement to "clearly disclose to the borrower, not later than three days after receipt of the loan application, all material information as specified by the superintendent that might reasonably affect the rights, interests, or ability of the borrower to receive the borrower's intended benefit from the home loan, including total compensation that the broker would receive from any of the loan options that the lender or mortgage broker presents to the borrower." A broker can avoid liability under these two sections with clear disclosure of any and all compensation that the broker will receive under each proposed loan.

Under previous New York law, the disclosure of an accurate description of broker compensation was optional, because regulations only required disclosure of the *maximum* compensation.[57] This, obviously, is not satisfactory under § 590-b; the broker must now disclose the exact compensation under each proposed mortgage option within three days. Moreover, the words "total compensation," although undefined, will probably be construed to include any compensation inuring to the benefit of the broker from the borrower or from the bank, including YSPs.[58]

This disclosure supplements the disclosure requirements under federal law. Under federal law, a mortgage broker must provide a good-faith estimate (GFE) within 3 days of the loan application or receipt of information sufficient to complete the loan application.[59] The actual amounts of the loan and fees cannot be exceeded regarding origination charges, interest rate charge and adjusted origination charge while the rate is locked, and transfer taxes. Lender-required settlement services, lender-required title services and insurance, and government recording charges cannot exceed 10% of the amount in the GFE.[60] Changes require issuance of a new GFE.[61] A form and instructions are provided in Appendix C. The form sets forth the type of disclosure that would be acceptable under federal law, and because it requires brokers to report their total compensation, it would satisfy the requirements of § 590-b (1) (e).

Additionally, under federal law, if a lender violates RESPA, the lender can cure its violation by refunding the overage at settlement or within 30 days. Section 590-b does not provide such an ability to cure; however, recovery is limited under § 590-b to actual damages.[62] Thus, if the broker or lender refunds any overage as provided under federal law, there will be no actual damages.

### 5. Duty to Diligently Work to Present the Borrower with a Range of Products

Section 590-b (1) (f) requires the broker to "diligently work to present the borrower with a range of loan products for which the borrower likely qualifies and which are appropriate to the borrower's existing circumstances, based on information known by, or obtained in good faith by, the broker." Several states have enacted similar requirements.[63] Diligence is subjective, and most likely will be interpreted as it is under agency law—requiring such skill as is ordinarily possessed by persons of common capacity engaged in the same business.[64] Unlike the previous discussion of the duty of good faith and fair dealing, the benchmark here is set by the statute. As long as the broker makes a good faith effort to present "a range" of loan products for which the borrower likely qualifies, he satisfies the burden imposed by this section.

Some unanswered questions may arise as to what is considered proper presentment under the statute. Is the burden satisfied where a broker presents several products, but steers the borrower to one specific product? It would be prudent for a broker to keep records of the searches of loan options made, all communications regarding the several loan products, and the reasoning behind the recommendations in case of future problems.

In sum, the duties imposed by § 590-b parallel many of the duties of fiduciaries. Even though not stating so much in words, one must ask if the legislature intended to impose a fiduciary relationship on a broker by enacting the servitudes of such a relationship. What is clear is that § 590-b's heightened duties are not to be lightly viewed.

## III. Broker Compensation and Yield Spread Premium Disclosures

Subsections (s) and (n) of Banking Law 6-l(2) and 6-m(2), respectively, both provide new disclosure requirements for compensation for high-cost and subprime loans, in addition to the requirements of § 590-b. Subsection (s) provides:

> No abusive yield spread premiums. In arranging a high-cost home loan, the mortgage broker shall, at the time of application, disclose the exact amount and methodology of total compensation that the broker will receive. Such amount may be paid as direct compensation from the lender, direct compensation from the borrower, or a combination of the two. The provisions of this paragraph shall not restrict the ability of a borrower to utilize a yield spread premium in order to offset any up front costs by accepting a higher interest rate. If the borrower chooses this option, any compensation from the lender which exceeds the exact amount of total compensation owed to the broker must be credited to the borrower. The superintendent shall prescribe the form that such disclosure shall take. This provision shall not restrict a broker from accepting a lesser amount.

Subsection (n) contains substantially the same requirements for subprime loans. Similar statutes enacted in other states provide variations on the amount and time of disclosure.[65] The original draft of the bill banned all yield spread premiums.[66] Subsequent drafts changed the bill from an outright ban to "no *abusive* yield spread premiums."[67] The legislature saw the value in such premiums but sought to ensure better disclosure. Thus, the basic requirement is fuller disclosure than what was required under previous regulations. In other words, any combination of compensation will still be allowed. It appears as though what is crucial is ensuring that the consumer receives the appropriate disclosure as prescribed by the superintendent.

The disclosure requirements of these sections are more onerous compared to the requirements under new section 590-b and federal law. Section 590-b allows three days from the application for the disclosure to take place.[68] RESPA likewise provides for three days from the application for disclosure.[69] Subsections (s) and (n) require disclosure contemporaneous with the application. Secondly, § 590-b only requires that the broker disclose the "total compensation that the broker would receive from any of the loan options that the lender or mortgage broker presents to the borrower." A broker who discloses the total amount of compensation without disclosing his methodology at arriving at the compensation would satisfy this requirement. Likewise, under current New York regulations, there is no requirement to disclose the methodology used to arrive at a calculation.[70] Subsections (s) and (n), however, require disclosure of "the *exact amount and methodology* of total compensation that the broker will receive." A broker thus would not satisfy his subsection (s) or (n) requirement without disclosing both the exact amount *and* the methodology of arriving at that amount. Thus, as applied to high-value loans, and subprime loans, even when not used with a yield spread premium, the broker has a greater burden in making a contemporaneous disclosure and showing how he arrived at the disclosed figures.

Under this section, as pointed out above, a broker must disclose "the exact amount" of "total compensation." The statute defines total compensation as including both the compensation paid by the bank and by the borrower. Compensation, in this context, likely would be interpreted to include any remuneration and other benefits received in return for the broker's arranging the mortgage.[71] This, again, is consistent with § 590-b (1) (d)'s prohibition against undisclosed indirect compensation. Thus, it behooves the broker to disclose any form of compensation he may be receiving for originating the mortgage, monetary or otherwise.

Lastly, subsections (s) and (n) require that the broker credit the borrower who agrees to a yield spread premium loan any excess compensation over the amount originally agreed upon.

## IV. Practical Implications of the New Sections

### A. Practical Implications for Brokers

As the previous sections have made clear, full disclosure of the exact amount of broker compensation, regardless of type, is now required, at the appropriate time. Moreover, the broker now has multiple duties paralleling those of fiduciaries. A violation of a fiduciary duty may give rise to an action for fraud. Additionally, § 590-b provides for its own cause of action to enforce its sections.

Section 590-b (3) provides for a non-exclusive cause of action for actual damages caused by any broker found by a preponderance of the evidence to have violated a duty under § 590-b (1), as enumerated above.[72] A borrower can be granted equitable relief to enforce the section, and, in a foreclosure action, may receive reasonable attorney fees. Equitable relief can include mortgage rescission, among other remedies.[73] While the limitation on damages provides some measure of relief to brokers, the best remedy is prevention.

Pursuant to Section 590-a (3) of the Banking Law, mortgage brokers are required to obtain surety bonds. Regulations require that the bond be made available to satisfy unpaid broker obligations in the event of insolvency or surrender of license.[74] This would include obligations under the duties imposed by § 590-b.

### B. Practical Implications for Attorneys Representing Homeowners

Because § 590-b creates greater disclosure requirements, an attorney engaged to defend against a foreclosure action that does not ensure that his client was properly informed by the broker of the agreement is remiss. Whether disclosure was properly given may be of use in defending a foreclosure action. Moreover, the attorney should also bear in mind that § 590-b includes a cause of action for violations of the broker's duties which would allow for the recovery of actual damages or for the imposition of equitable remedies.[75] Additionally, the attorney should be aware that he is entitled to reasonable attorney fees.[76]

In conclusion, Section 590-b, 6-l(s) and 6-m(n) present new challenges to mortgage brokers. They require heightened disclosure, made immediately or close to the time of the proposed mortgage. They impose heightened duties arising out of what is essentially a fiduciary relationship between the borrower and broker. Finally, they allow for a cause of action for failure to properly adhere to the requirements of the statute. A broker is advised to take heed of the strictures of these sections.

## Endnotes

1. *See, e.g., Business Highlights,* The Associated Press, June 17, 2009, *Anger at Fed could heat up*; Don Lee, *Calls to curb the bank are likely to intensify at Ben Bernanke's confirmation hearing*, Los Angeles Times, Dec. 3, 2009, at B1.
2. *See, e.g.*, Bill Sponsor's Memo to S. 8143, 2007 Legis. Bill Hist. N.Y. S.B. 8143 (May 6, 2008); *see also* N.Y. Banking Law § 589 (Declaration of policy).
3. This is due to the lack of up front cash often available to homeowners and buyers. Real Estate Settlement Procedures Act Statement of Policy 2001-1, 66 Fed. Reg. 53052, 53053 (Oct. 18, 2001) (to be codified at C.F.R. pt. 3500). Borrowers may choose to pay the fees out of pocket, or to pay the origination fees, and possibly all the closing fees, by adding the amount of such fees to the principal balance of their mortgage loan. The latter approach, however, is not available to those whose loan-to-value ratio has already reached the maximum permitted by the lender. *Id.* at 53054.
4. Federal Trade Commission, *The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment*, Bureau of Economics Staff Report, Jan. 2004, at 2-4. ("A YSP received from the lender is part of the compensation that a broker receives for originating the loan. The broker also may receive other compensation from the lender for the performance of various services, and compensation directly from the borrower in the form of borrower-paid origination charges. Congressional testimony by Olson (2002) indicates that 45 percent of broker income comes from YSPs and 55 percent from origination charges paid directly by the borrower.") ("FTC report"). *See also* Real Estate Settlement Procedures Act Statement of Policy 2001-1, 66 Fed. Reg. at 53054 ("Yield spread premiums permit homebuyers to pay some or all of the up front settlement costs over the life of the mortgage through a higher interest rate. Because the mortgage carries a higher interest rate, the lender is able to sell it to an investor at a higher price. In turn, the lender pays the broker an amount reflective of this price difference. The payment allows the broker to recoup the up-front costs incurred on the borrower's behalf in originating the loan. Payments from lenders to brokers based on the rates of borrowers' loans are characterized as 'indirect' fees and are referred to as yield spread premiums."). Although the legality of YSPs has been questioned under RESPA, *see Culpepper v. Inland Mortgage Corp.*, 132 F.3d 692 (11th Cir. 1998), more recent court pronouncements have upheld YSPs as authorized by HUD in 2001. *See Glover v. Standard Fed. Bank*, 283 F.3d 953 (8th Cir. 2002); *Schuetz v. Banc One Mortgage Corp.*, 292 F.3d 1004 (9th Cir. 2002).

5. Wayne Barrett, *Andrew Cuomo and Fannie and Freddie; How the youngest Housing and Urban Development secretary in history gave birth to the mortgage crisis*, The Village Voice, Aug. 5, 2008; Cassandra Jones Havard, *"Goin' Round in Circles"…and Letting the Bad Loans Win: When Subprime Lending Fails Borrowers: The Need for Uniform Broker Regulation*, 86 Neb. L. Rev. 737, 754 (2008).
6. As pointed out in section III, *infra*, the legislature considered banning yield spread premiums, but ultimately rejected the ban in favor of disclosure, partially because it recognized the value in yield spread premiums.
7. FTC Rep. 3. The Department of Housing and Urban Development has stated that "the yield spread premium [] can be a legitimate tool to assist the borrower. The availability of this option fosters homeownership." Real Estate Settlement Procedures Act Statement of Policy 2001-1, 66 Fed. Reg. at 53054.
8. *See* Siddhartha Venkatesan, *Abrogating the Holder in Due Course Doctrine in Subprime Mortgage Transactions to More Effectively Police Predatory Lending*, 7 N.Y.U. J. Legis. & Pub. Pol'y 177, 185 (2003) (noting that the lack of fiduciary duty encourages mortgage brokers to recommend subprime and predatory loans to borrowers). The point is not to suggest that the broker is an employee or fiduciary of the bank; rather, the broker is more incentivized by the bank's interest than the borrower's interest.
9. N.Y. Comp. Codes R. & Regs. 3 tit. § 38.3 (a) (2) (iv).
10. Promulgated by the Banking Department under Part 38.3 (a) of the General Regulations of the Banking Board. 3 N.Y.C.R.R. § 38.3 (a).
11. *See* Melissa LaVenia, *Developments in Banking and Financial Law: 2006-2007: The Subprime Mortgage Crisis: XII. Predatory Lending's Role in The Subprime Mortgage Crisis*, 27 Rev. Banking & Fin. L. 101, 102 (2008).
12. L. 2008, ch. 472, (eff. Aug 5, 2008).
13. N.Y. Banking Law § 590-b (3), (6).
14. 24 C.F.R. § 3500.7.
15. *Id.* § 3500.8.
16. 12 U.S.C. §§ 2601 *et seq*.
17. Fiduciary is defined by Merriam-Webster's Dictionary of Law as "one often in a position of authority who obligates himself or herself to act on behalf on another (as in managing money or property) and assumes a duty to act in good faith and with care, candor and loyalty in fulfilling the obligation." Dictionary of Law 193 (1996). Thus, the fact that previous proposed laws expressly called a mortgage broker a fiduciary but the enacted version of 590-b does not, is not itself proof of the kind of duties owed by the broker. The change may be mere semantics—but the duties are the same.
18. *See* Restatement (Third) of Agency § 1.01 (2006); Restatement (Second) of Trusts § 2 cmt b (1959).
19. Restatement (Second) of Trusts § 2 cmt b (1959).
20. 2a N.Y. Jur. 2d *Agency* § 20 ("The names which the parties give to the relationship is not determinative of the existence of an agency. The facts in each case must be considered in determining whether or not it is understood that the primary obligation of one party is to act for the benefit of the other.").
21. 2a N.Y. Jur. 2d *Agency* §§ 204-215.
22. Restatement (Third) of Agency, § 8.01 (2006).
23. *See* 2a N.Y. Jur. 2d *Agency* § 7.
24. *See, e.g., Shovak v. Long Island Commercial Bank*, 50 A.D.3d 1118, 1120 (N.Y. App. Div. 2d Dep't 2008); *Lum v. New Century Mortgage Corp.*, 19 A.D.3d 558, 559 (N.Y. App. Div. 2d Dep't 2005); *Iannuzzi v. Wash. Mut. Bank*, No 07-CV-964 (JFB) (WDW), 2008 U.S. Dist. LEXIS 65541, at *27 (E.D.N.Y. Aug. 21, 2008); *but see Joseph v. Northwood Group, LLC*, 08 Civ. 3644 (NRB), 2009 U.S. Dist. LEXIS 64741, at *11 n.8 (S.D.N.Y. July 22, 2009) (quoting *Langer v. Haber Mortgages, Ltd.*, N.Y.L.J. p. 26 col. 4 (Sup. Ct. N.Y. County Aug. 2, 1995) as stating that "by their very nature, contracts between mortgage brokers and their clients generally create a fiduciary duty"). Other states differ. *See, e.g., Gardner v. Randall Mortgage Servs.*, No.: 2:06-cv-0612, 2009 U.S. Dist. LEXIS 105093 (D. Ohio 2009).
25. *See Iannuzzi v. Wash. Mut.*, 2008 U.S. Dist. LEXIS 65541 at *29; 12 Am. Jur. 2d Brokers § 106; *see e.g. Weissman v. Mertz*, 128 A.D.2d 609, 610 (N.Y. App. Div. 2d Dep't 1987) (real estate "broker" is a fiduciary).
26. *E.g. Iannuzzi v. Wash. Mut. Bank*, 2008 U.S. Dist. LEXIS 65541, at *31.
27. *E.g. EBC I, Inc. v. Goldman Sachs & Co.*, 5 N.Y.3d 11, 22 (2005).
28. *E.g.* R.U.P.A. § 301(1) (imposing agency on partners); *Select Constr. Corp. v. 502 Old Country Rd. LLC*, 819 N.Y.S.2d 851 (Sup. Ct. Nassau County 2006). *See also* 2a N.Y. Jur. 2d *Agency* § 25 ("An agency is created if relations exist which will constitute an agency, regardless of whether the parties understood the exact nature of the relations.").
29. *See* Craig Steven Delsack, Note, *The Mortgage Contingency Clause: A Trap For The Residential Real Estate Purchaser Using A Mortgage Broker*, 17 Cardozo L. Rev. 299, 311-315 (1995) (arguing that the reality of the transaction makes most mortgage brokers into dual agents of the borrower and the bank); *see also "Goin' Round in Circles"…and Letting the Bad Loans Win: When Subprime Lending Fails Borrowers: The Need for Uniform Broker Regulation*, 86 Neb. L. Rev. at 752, 778 (same).
30. *See* Havard *supra* note 5, at 781.
31. 3 Am. Jur. 2d *Agency* § 204.
32. *Id.* § 205; Restatement (Third) of Agency § 8.01 (2006).
33. 2a N.Y. Jur. 2d *Agency* § 217, 218; Restatement (Second) of Torts § 874 (1977).
34. 2a N.Y. Jur. 2d *Agency* § 225.
35. *Id.* § 228.
36. *Id.* § 228; Restatement (Third) of Agency § 8.12 (2006).
37. Douglas Adams, Dirk Gently's Holistic Detective Agency (1987). Alternatively, "What's in a name? that which we call a rose, By any other name would smell as sweet." William Shakespeare, Romeo and Juliet, act 2, Sc. 2.
38. A U.S. Senate bill that would impose a similar duty on mortgage brokers, 110 S. 2452, died in committee. It provided, in relevant part, "Each mortgage broker shall with respect to each home mortgage loan be deemed to have a fiduciary relationship with the borrower, and…act in the best interest of the borrower and in the utmost good faith toward the borrower, and refrain from compromising the rights or interests of the borrower in favor of the rights or interests of another, including a right or interest of the mortgage broker; and clearly disclose to the borrower…all material information that might reasonably affect the rights, interests, or ability of the borrower to receive the borrower's intended benefit from the home mortgage loan, including total compensation that the broker would receive from any of the loan options that the broker presents to the borrower." S. 2452, 110th Cong. § 301 (b); *see also* 153 Cong. Rec. S15235, 15236 (2007). The language of § 590-b arguably was derived from this proposal, and thus, can be read as imposing such fiduciary duties on the mortgage broker.
39. 2a N.Y. Jur. 2d *Agency* § 215; 11 N.Y. Jur.. 2d *Brokers* § 30.
40. *TPL Assocs. v. Helmsley-Spear, Inc.*, 146 A.D.2d 468, 471 (App. Div. 1st Dep't 1989).
41. Model Rules of Prof'l Conduct, R. 1.7 (1983), 22 N.Y.C.R.R. § 1200.7 (b)(4).
42. Model Rules of Prof'l Conduct, R. 1.8 (1983), 22 N.Y.C.R.R.§ 1200.8 (a).
43. *E.g.* N.C. Gen. Stat. § 53-243.10 (a) (3)); Ark. Code Ann. § 23-39-510 (a) (3); 9-A Me. Rev. Stat. § 10-303-A; Ohio Rev. Code 1322.081 (A) (3); Va. Code Ann. § 6.1-422 (B) (6).
44. *See* Restatement (Third) of Agency § 8.08 (2006).

45. 2a N.Y. Jur. 2d *Agency* § 206. This is normally a fact-intensive inquiry decided by the jury. *Heinemann v. Heard*, 50 N.Y. 27, 35 (1872).

46. *See, e.g.*, *Pellegrini v. Landmark Travel Group*, 628 N.Y.S.2d 1003, 1007 (City Ct. 1995) (citing cases).

47. *See Port Clyde Foods, Inc. v. Holiday Syrups, Inc.*, 563 F.Supp. 893, 897 (S.D.N.Y. 1982) (citing cases in the insurance agent context holding that the agent breaches the duty of care where he fails to provide adequate coverage).

48. Restatement (Third) of Agency § 8.08 cmt b (2006).

49. *See, e.g.*, *Cristallina S. A. v. Christie, Manson & Woods Int'l*, 117 A.D.2d 284, 294-295 (N.Y. App. Div. 1st Dep't 1986) (auctioneer held to higher standard because he was selected for his special skill, and he represented that he could get a specific price for the auctioned goods); *see also*, Restatement (Third) of Agency § 8.08 (2006). ("If an agent claims to possess special skills or knowledge, the agent has a duty to the principal to act with the care, competence, and diligence normally exercised by agents with such skills or knowledge."); *id. cmt c* ("An agent's level of skill or knowledge may exceed the norm for similarly situated agents. Alternatively, an agent may falsely represent that this is so. An agent's performance should be evaluated consistently with the agent's claimed level of skill or knowledge unless the agent establishes that the principal knew the agent's claim to be false. The agent's professed level of skill or knowledge becomes the standard against which the agent's performance should be assessed.").

50. *Sokoloff v. Harriman Estates Dev. Corp.*, 96 N.Y.2d 409, 416 (2001) (internal citations and quotations omitted).

51. 22 N.Y. Jur. 2d *Contracts* § 227; Restatement (Second) of Contracts § 205 (1981).

52. N.Y. U.C.C. § 1-201 (19). This has been described as a purely subjective standard that can be satisfied by someone with a pure heart but empty head. *See* 3 Duesenburg & King, *Bender's Uniform Commercial Code Service: Sales & Bulk Transfers* § 4.08[3] (1997).

53. *Rooney v. Slomowitz*, 11 A.D.3d 864, 867 (N.Y. App. Div. 3d Dep't 2004) (citing cases).

54. Restatement (Second) of Contracts § 205 *cmt d* (1981). *See also* Robert S. Summers, *Good Faith in General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 Va. L. Rev. 195, 199-207 (1968) (describing good-faith requirements as an "excluder," excluding bad faith more than requiring good-faith action).

55. *Van Valkenburgh, Nooger & Neville, Inc. v. Hayden Publishing Co.*, 30 N.Y.2d 34, 45-46 (1972). Thus, a publisher, while not obligated to stop publishing competing books that could lessen the royalties to the author, could be held liable for a breach of the duty of good faith if it failed to uphold its obligations to advertise the works of its original author. *Id.; see also American Assurance Underwriters Group, Inc. v. MetLife General Ins. Agency, Inc.*, 154 A.D.2d 206 (N.Y. App. Div. 1st Dep't 1990) (holding that AAUG breached its covenant of good faith in contract with MetLife because it unduly influenced the employees of MetLife overseeing the enforcement of the contract).

56. In the context of the U.C.C., the parameters of what is considered good faith may be set by the contract terms. U.C.C. § 1-302 (b); N.Y. U.C.C. 1-102 (3). It is reasonable that absent such statutory authority to modify an express duty of good faith required under N.Y. U.C.C. § 1-201 (19), such duties would be unmodifiable.

57. 3 N.Y.C.R.R. § 38.3 (a) (1) (iv) requires only that the broker disclose "the specific maximum amount of such consideration to be received."

58. *See* N.Y. Banking Law §§ 6-l (2) (s) and 6-m (2) (n) (defining total compensation as being "paid as direct compensation from the lender, direct compensation from the borrower, or a combination of the two").

59. 24 C.F.R. § 3500.7 (b).

60. *Id.* § 3500.7 (e).

61. *Id.* § 3500.7 (f).

62. N.Y. Banking Law § 590-b (4).

63. Cal. Fin. Code § 22063 (b) (E); Me. Rev. Stat. Ann. tit. 9-A § 10-303-A (1) (E); N.C. Gen. Stat. § 53-244.109 (5).

64. 2a N.Y. Jur. 2d *Agency* § 206. This is normally a fact-intensive inquiry decided by the jury. *Heinemann v. Heard*, 50 N.Y. 27, 35 (1872).

65. *See, e.g.*, Cal. Bus. & Prof. Code § 10166.07 (a) (8); La. Rev. Stat. 6:1096 (f); N.H. Rev. Stat. Ann. 397-A:15 (prohibiting YSPs in reverse mortgages); N.M. Stat. Ann. § 58-21-31 (requiring two-day disclosure of YSPs and other fees); S.C. Code Ann. § 37-23-45 (requiring detailed disclosure of YSPs before closing for high-cost loans); S.C. Code Ann. § 37-23-75 (same for consumer loans); Wash. Rev. Code § 19.144.020 (requiring disclosure of YSPs "as a dollar amount").

66. 2007 Bill Text N.Y. S.B. 8143 (May 2, 2008). The FDIC proposed the same, but the Department of HUD rejected its proposal. Real Estate Settlement Procedures Act, 73 Fed. Reg. 68204, 68225 (Nov. 17, 2008) (to be codified at C.F.R. pts. 203 & 3500).

67. 2007 Bill Text N.Y. S.B. 8143 (June 21, 2008).

68. N.Y. Banking Law § 590-b (1) (e).

69. 24 C.F.R. § 3500.7 (b).

70. 3 N.Y.C.R.R. § 38.3 (a) (1) (iv), (vii) requires only the maximum amount to be disclosed, but does not require the disclosure of the methodology.

71. Black's Law Dictionary 301 (8th ed. 2004) ("Remuneration and other benefits received in return for services rendered; esp., salary or wages.").

72. *See also*, N.Y. Banking Law § 590-b (8) (providing that the remedies granted under § 590-b are not exclusive).

73. 13 Am. Jur. 2d *Cancellation of Instruments* § 2 (1964); *Symphony Space v. Pergola Props.*, 88 N.Y.2d 466, 485 (1996); *Rudman v. Cowles Communications, Inc.*, 30 N.Y.2d 1, 14 (1972) (rescission an equitable remedy and thus discretionary; should only be granted where damages are inadequate). It is worth noting that since an action at law would be limited in this case to actual damages and not exemplary damages, where the court decides that actual damages are inadequate, it would be forced to consider an equitable remedy instead.

74. 3 N.Y.C.R.R. § 410.14 (3) ("Such bond…shall contain substantially the following language: "In the event of the insolvency, liquidation or bankruptcy of [the broker]…the proceeds of this bond shall constitute a trust fund to be used…to pay…other obligations of the registrant.'").

75. N.Y. Banking Law § 590-b (3), (5).

76. N.Y. Banking Law § 590-b (6).

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# Web Site Rights and Wrongs: Key Legal Issues in the Creation and Operation of Web Sites

By Jessica R. Friedman

With the tools available these days, anyone can put up a Web site. But creating and operating a Web site requires more than a good business model, nice graphics, and catchy text. Your clients need to know what consequences may result from their failure to comply with various laws and regulations that apply to their Web site operations. For example, if a company does not take appropriate care in choosing its URL, it may end up having to change its name and lose brand recognition that it worked hard to build. If a Web site operator does not respond appropriately to a notice that it is infringing someone else's copyright, its Internet service provider may shut the site down. If one of your clients posts certain kinds of material online, he or she may be violating someone's right of privacy or right of publicity. If a client collects personal information on its site, that client needs to post a privacy policy that meets certain requirements. The fact that the Internet transcends international boundaries raises a whole host of separate issues.

The goal of this article is to enable you to spot certain issues that may be problematic for your clients and put you in a position to try to reduce your clients' risk of liability for trademark infringement, copyright infringement, defamation, right of privacy, right of publicity, and certain violations of privacy laws, and by drafting appropriate terms of use.[1]

## Choosing a Name: Avoiding U.S. Trademark Infringement

When your client Anne says she wants to choose a domain name for a new Web site, most likely she is talking about picking a name that will identify the goods or services that she will provide through the Web site, whether or not she uses the top-level domain (such as ".com" or ".net") as part of the mark in advertising. Amazon.com, for example, is not just a URL: it identifies the services that that company provides.[2] So, in picking a domain name, Anne will be choosing a trademark (for goods) or a service mark (for services). This means that in addition to the challenge of just finding a good domain name that is not already taken, Anne needs to make sure that her use of that mark will not infringe anyone else's rights.

Anne's mark will infringe a mark that is being used by someone else—the "senior user"—if people are likely to be confused into thinking that (i) Anne's products or services come from the owner of the other mark; (ii) the owner of the other mark endorses Anne's products or services; or (iii) there is just some connection or affiliation between Anne's products or services and those offered under the other mark.[3] For one mark to infringe another mark, the two do not have to be identical. If Anne started an online retail store named Amazons.com or Amazonian.com, clearly she would be infringing on the Amazon.com service mark. She also would be well advised not to start an online retail service called "Amaze" at www.amaze.com, since that mark is visually very close to "Amazon." Nor do the services have to be identical. If Anne wants to sell secondhand clothes on her site and the name she wants is taken by or very similar to the name of a site that sells secondhand records, or new clothes, she is also potentially liable for infringement. The top-level domain makes no difference in this analysis.[4] So if Anne wants to use Anne.com for her secondhand clothing site, and someone else is using Anne.net for the same or similar services, Anne should use another mark.

These are just some simple examples of the scenarios that might present themselves as Anne chooses a mark for her Web site. Other criteria that need to be taken into account when you consider whether Anne's mark will infringe another mark in the United States include the strength of the other mark, the channels of marketing and distribution (which obviously will overlap if both parties are selling over the Internet), the sophistication of the target buyers, the likelihood that the senior user will expand its business into the business that Anne wants to start, and Anne's intent in choosing her mark (i.e., was she out to divert business from the senior user?).[5] Anne has a legal duty to choose a mark that is not likely to be confused with someone else's mark.

What does Anne need to do to ascertain whether the mark she wants to use will infringe someone else's trademark or service mark in the United States? Acquiring the domain name and incorporating under the name are not enough. The domain name registrars will sell any name that is not already registered, and the state divisions of corporations will permit the formation of a company under any name that is not already registered, even if that name differs by only one letter from another name in its registry. A Google search is not enough, because even in this day and age, not everyone has a Web site, and also because Anne needs to consider marks whose spelling varies from the spelling of her own mark. Simply searching the database of the U.S. Patent and Trademark Office (PTO) is not enough either, because in the United States, the first person to use a mark can sue an infringer even without a federal registration, so that database is only the tip of the iceberg of possible problems. Unless a preliminary search of the PTO reveals a clear "knockout," Anne needs to do a full search, which includes federal registrations and applications, state registrations, common law marks, domain names and Web site usage, and even articles that mention company and product names.[6]

Whoever formulates the full search must be familiar with the kinds of goods and services that may be considered to be related to one another. Whoever *reviews* the search must be able to understand the range of marks that may be deemed to be "confusingly similar" to the mark being searched; the full range of goods and services that may be deemed to be related; the significance of the data that appear in the federal registration listings (e.g., the difference between a principal registration and a supplemental one or where a potentially problematic application stands in the application process); how intent-to-use applications work and what rights they confer, or do not confer, on an applicant; and what kind of Internet usage is relevant. Another question is whether, even if there is no mark with which Anne's mark is likely to be confused, Anne's mark will "dilute" someone else's mark. Dilution, as opposed to infringement, occurs when one uses a mark that someone else is using for entirely different goods or services, but the second user's use of the mark tends to weaken the mark's distinctive cachet or tarnish the goodwill of the mark.[7] Under federal law, one cannot bring a claim for dilution unless the mark is "famous," which means "nationally known," although many state dilution laws do not have that requirement.

If the search report reveals any potential conflicts, Anne needs to make a business judgment about whether to proceed with the mark or start over with a new one.

## Applying for a Federal Registration

If Anne does decide to use the mark, she should apply to register the mark in the PTO. A registration on the federal Principal Register creates a prima facie presumption that Anne has the exclusive right to use the mark in the United States for her goods and services and reasonably related goods and services. If Anne has not yet sold or offered for sale any goods or services using the mark, she may file an intent-to-use application on the basis of a good-faith intent to use the mark for her particular goods or services. If she goes that route, before she will actually receive a registration, she will have to show the Trademark Office that she is actually using the mark. Although it is possible for anyone to file a trademark or service-mark application online, there are many pitfalls in the application process that can trap the unwary client or the inexperienced lawyer, starting with the choice of application forms that the PTO offers.

The Trademark Office may raise objections to Anne's application. Among other things, the examining attorney may assert that (i) the mark is likely to be confused with another mark that is registered or is the subject of a pending application;[8] (ii) the description of the goods or services in the application is not sufficiently clear; or (iii) the mark is "merely descriptive," "primarily merely a surname," or "primarily deceptively geographically misdescriptive." These are just a few examples of certain common objections. To overcome such objections, Anne would have to submit evidence and arguments.

Even if the Trademark Office does not object to Anne's application, or, if it does and she is able to overcome the objections and the examining attorney authorizes publication of the mark in the *Official Gazette*, a third party may oppose the application.[9] Even if she obtains a registration, a third party may petition to cancel it.

## International Trademark Clearance and Registration

Many smaller Web site operators, if they do any clearance at all, clear trademark rights only in the United States. Clearing just those rights can cost several thousand dollars. International rights clearance can cost tens or hundreds of thousands of dollars or more, as can international registration. A comprehensive discussion of the complexities of international clearance and registration is well beyond the scope of this article, save for a few very general points. As is the case with U.S. searches, the formulation of a search will determine its utility in revealing potential conflicts, and its interpretation by experienced counsel is crucial. The search companies offer international searches of individual countries as well as of different regions, although many trademark practitioners prefer to retain their own foreign counsel, whom they know, to conduct such searches. Once the search process is completed, Anne will need to decide where to apply to register her mark. Depending on her budget, Anne probably will want to register first in the countries where her mark is being used and where it is likely to be used in the foreseeable future; then, in countries where she thinks infringing activity is likely to occur; and last, in jurisdictions that are known for the unauthorized registration of trademarks. When Anne has decided where she needs to register, she has to decide among the different available filing options. She can file in individual countries; she can register in the 27 countries of the European Union through a single Community Trade-Mark application;[10] and she can file an application under the Madrid Protocol that can cover dozens of countries all over the world.[11] Each route has very specific procedural and substantive advantages and disadvantages.

## Avoiding Copyright Infringement (Under U.S. Law)

Anne also will need to take care to avoid copyright infringement. Under the Copyright Act of 1976, which governs all copyright interests and claims in the United States, the owner of the copyright in a work has five exclusive rights: to reproduce the work; to create derivative works (adaptations) based on the work; to distribute copies of the work; to publicly perform the work; and to publicly display the work.[12] If the work in question is a sound recording, the copyright owner also has the exclusive right to perform it publicly by means of digital audio transmission. Doing any of those things without the copyright owner's permission constitutes infringement. In the Web site context, such activities include uploading, transmitting, or digitally modifying someone else's article, image, musical composition, or other work.

While copyright cases are fact-specific, here are some basic rules to help Anne avoid infringement:

- If it's infringement offline, it's infringement online. If Anne would not physically cut and paste someone else's photo into her news article or report, she should not do it digitally.
- The fact that material is posted online does not mean Anne can use it without permission.
- The fact that Anne has a license to use a work in print does not mean that she has the right to use that work online. If she does have such a contract but it is not clear whether that contract gives her the right to use that material in electronic media, the contract needs to be reviewed in reference to certain established criteria.[13]
- If Anne obtains permission to use someone else's work, the permission she gets must include the rights she needs to do what she wants to do with the material (display only? display and download? incorporate into an article or collage? in which formats?). A permission or license that says only that Anne can "use" the material will not be helpful if she has to prove that she has the right to make particular uses of the work.
- Permission needs to come from someone who has the right to give it. The owner of a physical work, such as a painting, is not necessarily the owner of the copyright in the work. A licensee may not have the right to grant any further rights. Permission from that licensee is useless. Someone who created a work for another person as "work made for hire"[14] also does not own the copyright in the work.
- If Anne is having Web site development work done by someone outside her company, she should make sure that in the development agreement, the developer promises (i) not to incorporate anything into her Web site that belongs to someone else, and (ii) to get all ownership rights from any subcontractor that it uses.
- Anne needs to know and adhere to the terms of any license that she enters into. It is important to read even standardized licenses carefully. For example, there are several kinds of stock art licenses, and each kind grants specific rights. A "royalty-free" stock license might be appealing, but there are restrictions on how many people can access the images and whether they can be loaded on a central server, and if Anne sells her business, that license probably cannot be transferred to the buyer.

Just determining whether a work is subject to copyright protection in the first place can be tricky. A work that appears to be in the public domain may not be. The term of the U.S. copyright in a work created on or after January 1, 1978 is the life of the author plus 90 years, with some variations if the work was created by more than one person or if it was created by a corporation.[15] A work whose U.S. copyright has expired may be in copyright in another country. A foreign work that was in the public domain here may have come back into copyright under the Copyright Restoration Act of 1994.[16] Even if one version of a work is in the public domain, there may be another version that Anne's work would infringe. For example, although Nathaniel Hawthorne's *The Scarlet Letter* is in the public domain, a movie based on that book might infringe the movie that was made several years ago.

Even if Anne herself scrupulously avoids infringing anyone's copyright, she may be liable for vicarious or contributory infringement on account of infringement committed by her site's users. Vicarious infringement means the right and ability to supervise the infringing activity combined with a direct financial interest in that activity.[17] Anne does not have to charge a fee to have a "direct financial interest" in an infringing activity to be a vicarious infringer. It may be enough if the infringing material acts as a draw that feeds other sections of the Web site from which Anne does benefit.[18] Google has been charged with vicarious infringement by virtue of its operation of YouTube.[19] Contributory infringement occurs when one has (i) actual or constructive knowledge of the infringing activity, and (ii) induces, causes, or materially contributes to the infringing conduct. What these terms mean depends on the facts. In the famous *Napster* case, Napster's role in enabling the sharing of online music files was held to constitute contributory infringement.[20]

What is the financial risk of copyright infringement under U.S. law? A successful copyright plaintiff can recover its damages and the defendant's profits.[21] If the infringed work was registered for copyright before the infringement occurred, or the infringement commenced after an initial publication of the work and within three months of registration,[22] the plaintiff may choose instead to recover "statutory damages," which are damages that the court is permitted to award within a certain range set by the Copyright Act,[23] and the plaintiff may recover its attorney's fees as the court deems reasonable.[24] Injunctive relief is also available for copyright infringement, but it is rarely sought in the Internet context.

There are some circumstances under which conduct that otherwise would be infringing under U.S. law is excused. These excuses are affirmative defenses to infringement, so if Anne relies on one of these defenses and loses, she will be liable for infringement.

One such defense is "fair use." Many people think of fair use as a free pass to use certain amounts of material. (Many musicians, for example, believe that they can use six bars of a musical composition without liability.) This is not correct. Under Section 107 of the Copyright Act, there are four factors that must be considered to ascertain whether a particular use is "fair": (i) the purpose and character of the defendant's use;[25] (ii) the nature of the copyrighted work;[26] (iii) the amount and substantiality of the portion taken in relation to the work as a whole;[27] and (iv) the effect of the defendant's use on the actual or potential market for the work.[28] The statute characterizes these factors as non-exclusive, which means that the court can also take into account whatever else the court considers relevant.

Infringement also will be excused under U.S. copyright law if Anne has an "implied license" to use the work, i.e., if Anne asked someone to create a work for her, either in writing or orally,[29] and that person delivered it to her knowing that she was going to reproduce or distribute copies of it,[30] or if her use can be characterized as "de minimis," which refers to the use of a tiny amount or a work or its use for an insignificant amount of time.[31]

The section of the Copyright Act known as the Digital Millennium Copyright Act (DMCA), which comprises Section 512 of the Copyright Act, offers additional protection. The DMCA creates four "safe harbors" that limit Anne's liability as a Web site operator, if she meets certain conditions in operating her Web site. Some of the safe harbors are relevant to Anne only if she is operating an Internet service provider. Generally, such operators will not be liable for infringement if material is transmitted through an automatic technical process and the material is not made available, and the transmission is not initiated, by the service provider.[32]

The safe harbor that will help Anne the most is Section 512(c), which limits a Web site operator's liability for information that people post on the site. To be eligible for this safe harbor, Anne must file with the Copyright Office a designation of an agent, including the name of a particular person and that person's snail mail address, e-mail address and phone number. Anne must post this same information in her terms of use, and she must actually have someone monitoring that address.

In addition, if an infringement claim comes in, Anne must show that she had no actual knowledge that any content was infringing. She may also show that she had no constructive knowledge, or no reason to know, of the infringing activity, meaning she was not aware of facts or circumstances from which the infringing activity was apparent.[33] What does this mean? In *Io Group v. Veoh Networks,* the California district court interpreted this language to mean that for a plaintiff to show that a defendant *was* aware of such facts or circumstances, it would have to show that the Web site operator "deliberately proceeded in the face of blatant factors of which it was aware"—the so-called "red flag" test.[34] If Anne learns that infringing activity is occurring or becomes aware that activity that she thought was non-infringing in fact is infringing, she must remove or disable access to the infringing material.[35]

The next requirement to qualify for immunity under Section 512(c) in the face of a claim is that if Anne has the right and ability to control the infringing activity in question, she does not receive a financial benefit that is directly attributable to the material at issue (e.g., she cannot be charging an extra fee for subscribers specifically to access this material).[36] The *Io Group* court noted that the requirements of this section "grew out of," and should be interpreted consistently with, "the common law standard for vicarious liability" (discussed above), and for which it cited to *Metro-Goldwyn-Mayer Studios, Inc. v. Grokster, Ltd.,* 545 U.S. 913, 930, 125 S.Ct.2764, 2766 (2005).[37] The *Io Group* court interpreted the phrase "right to control" very strictly to mean nothing less than being able to prevent the initial uploading of any infringing material. Yet the court also held that a Web site operator cannot be *required* to pre-screen everything.[38] This conclusion makes sense because most Web sites or online services that are based on the sharing of user content would have to shut down if they had to pre-screen everything. The *Io Group* court also opined that, for a Web site operator to have the "*ability* to control" infringing activity, the operator would have to be able to identify infringing material without even getting a notice from the copyright holder. This decision set a very high standard for a copyright owner-plaintiff to meet in order to prove that a Web site operator is liable for vicarious infringement; but unless and until other opinions come along, *Io Group* may serve as the standard.

If Anne has received a DMCA-compliant notice, she must move quickly to take the infringing material down or disable access to it.[39] A DMCA-compliant notice is a notice that is signed by the copyright owner that specifies the infringing material and where it appears on the site. As long as the notice gives Anne this information, or if Anne can tell from the notice what material the notice is talking about, Anne is obligated to take down the material quickly; but she also has to notify whoever posted the material that she has removed or blocked that material. If that person submits a "counter-notification" that says the removal was wrong, she must send that notice to the person who sent her the original notice.[40] If that person does not notify Anne in 10-14 days that he or she has filed an infringement suit against the subscriber, Anne has to put the material back up.

If Anne finds herself deluged with takedown notices, the recent decision out of the Northern District of California in *Lenz v. Universal Music Corp*. may help her.[41] That case arose out of Section 512(f) of the DMCA, which imposes liability on anyone who knowingly materially misrepresents that material on a Web site is infringing. In that case, a mother posted on YouTube a video of her two children dancing to a song by the Artist Formerly Known as Prince. Universal Music, which owns the copyright in the song, sent YouTube a DMCA notice. The mother sent a counter-notification to YouTube to have her video restored, and then sued Universal for misrepresenting that the video infringed Universal's copyright, on the ground that her use of the song was fair use. She also sought a declaratory judgment that the video was not infringing. The mother claimed that Universal had sent the notice in bad faith[42] because Universal had failed to engage in a fair use analysis before sending it. The court agreed. It denied Universal's motion to dismiss, holding that "in order for a copyright owner to proceed under the DMCA with 'a good faith belief that use of the material in the manner complained of is not authorized by the copyright owner, its agent, or the law,' the owner must evaluate whether the material makes fair use of the copyright."[43] While the application of this requirement going forward will make it harder for copyright owners to allege infringement, Anne should nevertheless police her site at least to prevent people from re-posting material that has already been identified as infringing.

## International Copyright Implications

So far, we have been talking only about U.S. copyright law. But, even if Anne's conduct meets all the requirements of U.S. law, Anne may be infringing copyright laws of other jurisdictions. In 2007, a Hamburg (Germany) Regional Court held that Google was infringing the copyrights of a photographer, Michael Bernhard, and a comic artist, Thomas Horn, by displaying their works as low-resolution thumbnails.[44] These decisions directly contradict the Ninth Circuit's decision in *Perfect 10 v. Amazon.com,* 508 F.3d 1146 (9th Cir. 2007), which rejected a lower court's determination that Google's use of thumbnails was likely infringing. Also in 2007, a French court held that Viewfinder, the owner of a Web site that posts photographs from fashion shows, was liable for copyright infringement under French law for displaying on the Web site photos from two French fashion houses, because while U.S. copyright law does not recognize a copyright in fashion designs, French law does.[45] Viewfinder never actually defended the lawsuit. It defaulted.

The fact that Viewfinder's conduct violated French copyright law even though it did not violate U.S. copyright law is not the end of the story. When Viewfinder was sued in France, it defaulted, which enabled the French plaintiffs not just to win on liability, but to obtain a judgment against Viewfinder that they sought to enforce in district court here. The district court held that it could not enforce the judgment because under U.S. law, Viewfinder had a First Amendment right to publish photos of newsworthy events. But on the plaintiffs' appeal, the Second Circuit remanded the case to the district court to look more carefully at whether French law provides protections similar to the First Amendment (and also because a First Amendment defense is not absolute). In so doing, the Second Circuit made clear that "public policy…rarely results in refusal to enforce a judgment [meaning a foreign judgment] unless it is inherently vicious, wicked or immoral, and shocking to the prevailing moral sense."[46]

The bottom line is that if someone sues Anne in another country for copyright infringement (or any other tort), even if Anne thinks the claims against her are governed by U.S. law, she should consult a lawyer, preferably a lawyer in that country, to explore what defenses may be available to her there and to make sure that she does not default and make her business into a sitting duck.

## Defamation, Privacy, and the Communications Decency Act

Another legal violation that can arise out of operating a Web site, especially a site where users can post comments and other material freely, is defamation.[47] Each state has its own definition of defamation, but very generally speaking, a defamatory statement is (i) a statement of fact, (ii) about a living person, (iii) that is "of and concerning" the subject, meaning the subject can be identified from the statement to a group of people even if the subject is not named, (iv) and that "tends to expose [the subject] to hatred, contempt or aversion, or to induce an evil or unsavory opinion of him in the minds of a substantial number of people in the community.…"[48]

Although there is no substitute for professional expertise in this area, here are a few things that you and Anne should know about defamation before she starts up a Web site that permits user postings:

- A company can be defamed as well as a person.[49]
- Liability for republication of a defamatory statement is the same as for the original publication. In other words, the fact that another publication or Web site published the material first is no defense.

- Certain kinds of statements are defamatory "per se," and thus are actionable without allegation or proof of special damages. These include a statement that falsely charges the subject with having committed, been indicted for, convicted for, or punished for a crime; suggests that the subject has an infectious, contagious, or loathsome disease; tends directly to injure the subject professionally; or suggests that the subject is impotent or unchaste.
- It is possible to defame someone without making a direct statement about the person. For example, if Anne posts an article about organized crime with the caption, "Many members of the Mafia just hang out on the street," with a photo of a man standing on the sidewalk, that man may have a claim against Anne for suggesting, by the placement of the photo next to the article, that he is a member of the Mafia.[50]
- An opinion may still constitute a potentially defamatory statement if it includes assertions about factual matters. Prefacing the statement, "X is a crook," with "I think" or "It is my opinion that," does not magically convert the factual assertion to a protected opinion.
- The concept of "public figure" is a complex one and includes a distinction between a "general purpose" public figure and a "limited purpose" public figure.

If Anne's site permits users to post personal comments or stories about other people, she also needs to be concerned about claims for invasion of privacy. In some states, including New York, this is a statutory tort; in other states, it is a matter of common law. Although this tort, like defamation, is defined differently in different states, it generally refers to publishing private facts whose publication is likely to embarrass someone. A Web site that encourages users to post stories about their worst sexual experiences, or about why they got divorced, runs the risk of invasion of privacy claims (as well as defamation claims) by the former partners of the people posting the stories. On other sites, the risk may be less obvious but still high, such as a site on which people post their experiences with certain products or stores.[51]

Does Anne have any statutory protection against claims for defamation or invasion of privacy that arise out of user postings? The Communications Decency Act of 1996 (CDA) gives immunity to interactive service providers, which includes Web site operators, against liability arising out of content created by third parties on their sites. That statute says, "No provider or user of an interactive computer service shall be treated as the publisher or speaker of any information provided by another information content provider," as long as it is not "responsible in whole or in part for the creation or development of the offending content."[52]

What does it mean to be responsible "in part" for the creation or development of offending content? Some guidance comes from the *en banc* decision in *Fair Housing Council of San Fernando Valley v. Roommates.com*.[53] The Roommates.com site required each subscriber to create a profile that listed his or her basic contact information, including gender, sexual orientation, and whether he or she would bring children to a household. The subscribers were also encouraged to fill in an "additional comments" section. The Fair Housing Councils of the San Fernando Valley and San Diego sued, claiming that the profile requirement violated the federal Fair Housing Act and California housing discrimination laws by making it possible for potential roommates to discriminate against people based on the contents of their profiles. Roommates.com argued that it had immunity under the CDA from any claims arising out of content posted by subscribers. The Ninth Circuit disagreed: "By requiring subscribers to provide the information as a condition of accessing its service…[Roomates.com] becomes much more than a passive transmitter of information provided by others; it becomes the developer at least in part of the information."[54] The court distinguished this case from *Stratton Oakmont, Inc. v. Prodigy Services, Co.*,[55] in which Prodigy was found to be liable for defamatory content posted on its service. Unlike Prodigy, Roommates.com was not "removing some harmful messages while failing to remove others; instead, it is being sued for the predictable consequences of creating a website designed to solicit and enforce housing preferences that are alleged to be illegal." The Ninth Circuit offered a simple rule of conduct: "If you don't encourage illegal content, or design your website to require users to input illegal content, you will be immune." Besides heeding the Ninth Circuit's warning, Anne can protect herself to some extent in her terms of use, which I will discuss below.

## Right of Publicity

Using someone else's name, image or likeness or voice without permission for purposes of advertising or trade without permission may violate that person's "right of publicity." Like defamation and right of privacy, this is a state law claim. In New York, it arises under Sections 50-52 of the Civil Rights Act.[56] An example would be using a photo of a celebrity to advertise services being offered on a Web site, e.g., "Madonna does exercises just like these," or simply publishing an ad for someone else's products or services that makes such a claim. If Anne posts a third-party ad that is held to violate someone's right of publicity, she may be held liable for damages. Moreover, in some states, including California and Tennessee, the right of publicity survives death. New York has been considering a new law that would have right of publicity surviving death.

It is not clear whether right of publicity claims fall under the CDA and whether Web site operators can claim the benefit of that statute in defending against such claims. Two interpretations of the CDA that have been expressed so far suggest that they can. First, the CDA itself says that the CDA shall not "be construed to limit or expand any law pertaining to intellectual property." The Ninth Circuit has construed this provision as applying only to *federal* intellectual property laws (such as the Copyright Act), which would mean that the CDA could protect a Web site operator from a right of publicity claim even if such protection arguably expanded the *state* intellectual property law under which the claim is being made.[57] The CDA also specifically states that Web site operators cannot be held liable under state or local laws that are inconsistent with the CDA.[58] At least one court has intimated that the only kind of law that would be consistent with the CDA would be a law that makes a Web site operator liable for "statements actually authored, not for the statements of others."[59]

## Terms of Use

Anne also may be able to protect herself from liability by posting terms of use that are binding on users of her site. The words "binding on users of her site" are important. Like any contract, terms of use are not binding unless both parties agree to them. The simplest way to do this is to require users to click "I agree" or "I accept."[60] Even someone who clicks "I agree" may turn around and sue in violation of the terms of use, but Anne will have a very strong defense if she can prove that the person agreed to them. Can Anne get away with a statement such as, "By using this site, you agree to our terms of use," which appears on many sites? If that notice is conspicuous enough so that no one could miss it and clear enough so that no one reasonably could misunderstand it, then the notice may be deemed binding.[61] But if the notice appears at the very bottom of a very long screen in tiny print, the chances of its being binding are slim.

We have already seen that for Anne to qualify for the DMCA safe harbor, her terms of use need to include information about an agent to receive DMCA notices as well as a statement that the accounts of any repeat infringers will be terminated. In addition, Anne's terms of use:

- Need to make clear to users that if they post anything on the site that is defamatory or violates anyone's right of privacy or publicity or infringes anyone's copyright or trademark, and Anne is sued as a result, they have to pay her legal fees and any damages.
- Need to say that she (or her company, if she has one) has the right, but not the obligation, to monitor what is posted on the Web site. If Anne says that she will review every item posted—if that is even possible—she is undertaking to exercise the kind of control over the content that could lead a court to find that she is more than just a distributor of information.
- Should include a waiver of any claims against Anne for problems that a user may encounter as a result of using the site.
- Need to include choice of law and forum, which is especially important for potential foreign claims.
- Need to include a warning that activities on the site may not be legal in other jurisdictions.
- If she is selling products, she needs to put the terms of sales and purchases, including her shipping and refund policies.[62]

Beyond these general guidelines, there is no "one size fits all." Anne needs to tailor the terms to the nature of her site. If she is encouraging people to send in material, the terms of use need to provide that Anne has the right to use all submissions without payment. If she is operating a porn site or a site about victims of violence with graphic photos, she needs to provide a notice that the site is not for minors. If she is providing information about how to do something that people will rely on, her terms of use need to tell users that she will not be liable for anything that goes wrong. If she is connecting people with each other for business purposes and leaving them to deal with each other without her being involved, her terms of use need to state clearly that she is not responsible for what happens between them and that she does not guarantee any results. For example, if she is providing a database of healthcare professionals that people who are looking for doctors can search, the terms of use should say that she does not guarantee that any user will find a doctor who can solve his or her problem.

All this needs to be in concise, precise, clear language that anyone can understand. Although most people, including many of the lawyers who draft terms of use for a living, do not read terms of use, if Anne ever has to resort to her terms of use to prove that someone agreed to them, she will be in a much stronger position if they are clear.

## Errors and Omissions Insurance

Another important way for Anne to protect her company from any copyright, privacy, advertising and other content-related claims is errors and omissions (E&O) insurance, which is also known as "media perils" insurance. This is not the same as professional general liability insurance. If Anne gets this kind of policy, she needs to know exactly what kinds of claims are covered and what the deductible is.[63]

## Online Privacy Policy

Besides needing to be sure she does not violate anyone's right of privacy by publishing private facts, Anne needs to have a "consumer-facing" privacy policy, meaning a policy that is posted on her Web site.[64] The criteria for this kind of privacy policy are set out in the Federal Trade Commission's Fair Information Practice Principles.[65] The basic premise of these principles is that a consumer should be given notice of an entity's information practices before providing any personal information, so that the consumer can make an informed decision as to whether and to what extent to disclose his or her personal information. Accordingly, Anne's policy should:

- State clearly and specifically just what personal information she collects (e.g., e-mail addresses, phone numbers).[66]
- Say just how she uses that information (e.g., to process orders, to renew subscriptions, to send e-mails on behalf of her company and trusted partners) and how and with whom it might be shared (e.g., with a fulfillment house).
- Tell users how they can request changes to any of that information, including how to opt out of particular uses of that information.
- How the information is kept secure; and
- Identify when the policy was last changed.

She also needs to comply with her own policy, which means communicating the policy to people in her company who handle and use personal information that is collected on the site and making sure that they do not use such information in a way that contradicts the policy. This may seem self-evident, but once the policy is drafted and posted, it is all too easy for a circulation department, for example, to forget that personal information collected under a privacy policy that promises that the names won't be shared cannot be included on lists that the company rents out, or for a company selling the assets of a division or subsidiary to sell the e-mail addresses as a separate asset despite a promise in the policy that this would not happen.

## Conclusion

Perhaps the biggest challenge facing you as Anne's attorney is simply persuading her that the risks of not taking these legal issues into account are real and significant. When I give a presentation about these issues, at least one member of the audience is likely to point out that "everyone does" all the things I have just spent an hour telling them not to do and that "they haven't been sued," whoever "they" are. It is tempting to say that with millions of Web sites in operation, no one is likely to sue Anne unless she is doing something truly egregious and depriving someone else of lots of income. But the case of Ms. Lenz, the mother whose home video of her children attracted the attention of Universal, shows that it is impossible to predict when or why someone might notice and object to someone else's online activities, even if those activities seem completely above-board. While there is no guaranteed way for Anne to avoid legal claims related to her Web site operations, she can best protect her investment in her business by taking at least some of the steps described above.

## Endnotes

1. This article will not cover other issues that relate more to affirmatively protecting your client's own Web site assets, such as what to do when someone infringes on your client's Web site material, registering Web sites for copyright, domain name disputes, compliance with e-mail laws, and compliance with state privacy statutes.
2. If your client sells products and its Web site name will be the brand name for products that your client sells, your client's site name is your client's trademark. If your client will be using the Web site to provide services under your client's domain name, your client's name will be a service mark. For example, providing information online is a service. This article uses the term "mark" to mean either one.
3. In the likelihood of confusion analysis, confusion does not refer only to confusion that lasts through a purchase. Let's say that Anne does use Amazons.com, and someone looking for Amazon.com comes to her site by mistake. When he gets there, he realizes that he is not on Amazon.com, but he decides to look around anyway, and eventually he buys something. This kind of confusion is known as initial interest confusion. If Anne had not used a name similar to Amazon.com, that person would never have come to her Web site in the first place. Anne's use of a name similar to Amazon.com is analogous to her falsifying a résumé to get in the door for a job interview: she may get the job because of the interview, but without having falsified the résumé, she would not have had the interview in the first place. *See, e.g., Anlin Indus., Inc. v. Burgess*, No. 1:05cv1317 DLB, 2009 WL 1884364 (E.D. Cal. June 26, 2009) (manufacturer used anlin.com; competitor registered anlinwindows.com; court rejected defendant's summary judgment motion, holding that a disclaimer posted on site did not necessarily preclude an initial interest confusion finding).
4. *See, e.g., Omega S.A. v. Omega Engineering, Inc.*, 228 F. Supp. 2d 112, 126 (D. Conn. 2002).
5. In *Polaroid v. Polarad Elecs. Corp.*, 287 F.2d 492 (2d Cir. 1961), the Second Circuit identified eight factors as relevant to determine whether there is a likelihood of confusion between two marks: "the strength of the mark, the degree of similarity between the two marks, the proximity of the products, the likelihood that the prior owner will bridge the gap, actual confusion, and the reciprocal of defendant's good faith in adopting its own mark, the quality of defendant's product, and the sophistication of the buyers. Even this extensive catalogue does not exhaust the possibilities—the court may have to take still other variables into account." The Second Circuit reaffirmed these factors in *Virgin Enters. v. Nawab*, 335 F.3d 141 (2d Cir. 2003). *See also, e.g., Streetwise Maps, Inc. v. Vandam, Inc.*, 159 F.3d 739, 743-46 (2d Cir. 1998); *Arrow Fastener Co. v. Stanley Works*, 59 F.3d 384, 391-99 (2d Cir. 1995); and *Mobil Oil Corp. v. Pegasus Petroleum Corp.*, 818 F.2d 254, 256-60 (2d Cir. 1987).
6. A full search is conducted by a company such as CT-Corsearch or Thomson & Thomson.
7. For example, widespread use of the mark TIFFANY'S for a low-rent pizza chain would dilute the famous TIFFANY'S mark for

jewelry, even though no one would think that the high-end jewelry store had anything to do with the pizza chain.

8. It is to be hoped that the person who reviews the search report will have identified and anticipated any such objections, although sometimes an examiner will raise an objection that reasonably could not have been anticipated.

9. Again, it is to be hoped that whoever reviews the search has identified all parties who reasonably might be expected to oppose the application and that Anne has taken this possibility into account in her decision to proceed. It is also possible, however, that the search did not reveal a particular potential conflict.

10. The members include Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, and the United Kingdom.

11. The Madrid Protocol, to which over 65 countries, including the EU and China, Japan and Australia are parties, allows a Web site owner to register a trademark in member countries without appointing a local agent in each individual country. The term of registration under the Madrid Protocol is 10 years from the date the request was filed with the office of origin. For the implementing rules, *see* http://www.madridprotocol.info/implementedrulesus.html.

12. 17 U.S.C. § 106.

13. These include: Did online technology exist, or was it even anticipated, when the contract was made? Did the contract specifically grant the right to exploit a work by "any means now or hereafter known?" Is there a clause reserving to the licensor all rights not expressly granted to the licensee? How sophisticated was the licensor (author)? All such ambiguities will be construed against the drafter.

14. The Copyright Act defines a "work made for hire" as: "(1) a work prepared by an employee within the scope of his or her employment; or (2) a work specially ordered or commissioned for use as a contribution to a collective work, as a part of a motion picture or other audiovisual work, as a translation, as a supplementary work, as a compilation, as an instructional text, as a test, as answer material for a test, or as an atlas, if the parties expressly agree in a written instrument signed by them that the work shall be considered a work made for hire." *Id.* § 101.

15. *See id.* § 302.

16. *Id.* § 104A.

17. *Shapiro, Bernstein & Co. v. H. L. Green Co.*, 316 F.2d 304, 307 (2d Cir. 1963). *See also* 3 Melville B. Nimmer & David Nimmer, Nimmer on Copyright § 12.04(A) [1] 1270-72 (1995).

18. *See A&M Records v. Napster*, 239 F.3d 1004, 1023 (9th Cir. 2001) (availability of infringing media on a peer-to-peer file sharing service "increase[d its] user base"); *Fonovisa, Inc., v. Cherry Auction, Inc.*, 76 F.3d 259, 263 (9th Cir. 1996) (sale of infringing records by vendors at swap meet attracted customers paying admission fees and incidental payments for parking, food, and other services).

19. *See* Miguel Helft & Geraldine Fabrikant, *WhoseTube? Viacom Sues Google Over Video Clips*, N.Y. Times, Mar. 14, 2007, at C1, *available at* http://www.nytimes.com/2007/03/14/technology/14viacom.html. As of February 2010, the parties were still awaiting a ruling on cross motions for summary judgment. *See* Peter Kafka, *Is the YouTube Case Finally Ready to Start Moving Again?*, All Things Digital, Jan. 7, 2010, *available at* http://mediamemo.allthingsd.com/20100107/is-the-youtube-case-finally-ready-to-start-moving-again.

20. In *A&M Records v. Napster*, 239 F.3d 1004 (9th Cir. 2001), Napster executives were held to have knowledge of infringing uses by Napster users on account of, *inter alia*, their having enforced intellectual property rights in other instances and having themselves downloaded copyrighted songs from the system, and the Napster system was held to have contributed materially to infringing activity by providing the site and facilities for direct infringement. In *Perfect 10, Inc., v. Cybernet Ventures, Inc.*, 213 F. Supp. 2d 1146 (C.D. Cal. 2002), the court granted a preliminary injunction based on the fact that (1) Cybernet, which hosted links to non-Cybernet-owned sites containing allegedly infringing images, had received over 2000 emails alleging infringement and had employees regularly reviewing linked-to sites; and (2) Cybernet paid the infringing sites to advertise Cybernet's own services, and paid a commission to a site whenever someone registered for Cybernet's services through that particular site.

21. 17 U.S.C. § 504(b).

22. *Id.* § 412.

23. *Id.* § 504(c). Statutory damages generally are between $750 and $30,000, unless the plaintiff proves "willful" infringement, in which case the court may award damages up to $150,000 or the defendant proves that it was not aware and had no reason to believe that its acts constituted infringement, in which case the court may award damages as low as $200. *Id.* (This is the only context in U.S. copyright law in which there is a distinction between "willful" infringement and "innocent" infringement. In all other contexts, copyright infringement is a matter of strict liability.).

24. *Id.* § 505.

25. The fact that the defendant's use of a work is "commercial" does not preclude the use from being fair. But under the current judicial standard, the defendant must be making a "transformative" use, which means she must be using the work for a "different" or "further" purpose.

26. Unpublished works receive more protection than published works; creative works receive more protection than factual works.

27. In other words, did the defendant take more than it needed to make its point?

28. One question courts often ask is, if everyone did what you did, would the copyright owner lose money?

29. While Section 204(a) of the Copyright Act requires that transfers of copyright be in writing, under Section 101 a "transfer of copyright" does not include a nonexclusive license. "By negative implication, nonexclusive licenses may therefore be granted orally, or may even be implied from conduct." 3 Melville B. Nimmer & David Nimmer, Nimmer on Copyright § 10.03[A][7] (1995).

30. "An implied non-exclusive license has been granted when (1) the licensee requests the creation of a work; (2) the licensor creates the work and delivers it to the licensee who asked for it; and (3) the licensor intends that the licensee copy and distribute the work." *Effects Assocs., Inc. v. Cohen*, 908 F.2d 555, 557 (9th Cir. 1990), *cert. denied*, 498 U.S. 1103 (1991).

31. *See, e.g.*, *Sandoval v. New Line Cinema Corp.*, 147 F.3d 215 (2d Cir. 1998) (display of photographs during a movie, at a distance and out of focus, constituted *de minimis* use); *but see Ringgold v. Black Entertainment Television, Inc.*, 126 F.3d 70, 77 (2d Cir. 1997) (copyrighted artwork used as set dressing found to be "clearly visible" and "recognizable…with sufficient detail for the 'average lay observer'" to discern the artist's identifiable style); *Gottlieb Dev. LLC v. Paramount Pictures Corp.*, 590 F. Supp. 2d 625 (S.D.N.Y. 2008) (incidental background appearance of pinball machine in "What Women Want" film found to be *de minimis* use).

32. *See* 17 U.S.C. §§ 512(a)-(b), 1201-1205.

33. *Id.* § 512(c)(1)(A)(ii).

34. *Io Group v. Veoh Networks*, 586 F. Supp. 2d 1132, 1148 (N.D. Cal. 2008) (quoting 3 Melville B. Nimmer & David Nimmer, Nimmer on Copyright, § 12B.04[A][1] 12B-49 (1995)).

35. 17 U.S.C. § 512(c)(1)(A)(iii).

36. *Id.* § 512(c)(1)(B).

37. *Io Group*, 586 F. Supp. 2d at 1150.

38. *Id.* at 1145. ("[S]ection 512(i) does not require service providers to track users in a particular way to [sic] or affirmatively police users for evidence of repeat infringement.").

39. 17 U.S.C. § 512(c)(1)(C).

40. *Id.* § 512(g).

41. *Lenz v. Universal Music Corp.*, 572 F. Supp. 2d 1150 (N.D. Cal. 2008).

42. In contravention of 17 U.S.C. § 512(c)(3)(A)(v), which requires, as part of the DMCA takedown notice, "[a] statement that the complaining party has a good faith belief that use of the material in the manner complained of is not authorized by the copyright owner, its agent, or the law."

43. *Lenz*, 572 F. Supp. 2d at 1154.

44. Hamburg Regional Court, reference numbers 308 O 42/06 and 308 O 248/07.

45. *Sarl Louis Feraud Int'l v. Viewfinder, Inc.*, 489 F.3d 474 (2d Cir. 2007).

46. *Id.* at 479.

47. Defamation encompasses oral statements (slander) and written statements (libel).

48. *Tracy v. Newsday, Inc.*, 155 N.E.2d 853, 854 (1959).

49. In a famous example, Procter & Gamble successfully sued four retail distributors for spreading false rumors that the company was associated with Satanism. *See Procter & Gamble Wins $19 Million in Satanism Suit,* N.Y. Times, *Mar. 20, 2007, available at* http://www.nytimes.com/2007/03/20/business/worldbusiness/20iht-satan.4966053.html.

50. *Lefa Siciliana Social Club, Inc. v. St. Germaine*, 825 A.2d 827 (Conn. App. 2003).

51. There also may be risks under foreign law. The week before this article was submitted for publication in March 2010, an Italian court convicted three Google executives of violation of Italian privacy law by having allowed the posting of a video of students bullying an autistic teenager to air on the Google Video site (which is no longer in operation), although it rejected claims of defamation.

52. 47 U.S.C. § 230(f)(3).

53. *Fair Housing Council of San Fernando Valley v. Roommates.com*, 521 F.3d 1157 (9th Cir. 2008) (en banc).

54. *Id.* at 1166.

55. *Stratton Oakmont Inc. v. Prodigy Services Co.*, 1995 WL 323710 (N.Y. Sup. Ct. 1995).

56. *See, e.g.,* N.Y. Civ. Rights §§ 50-52.

57. *Perfect 10, Inc. v. CCBill LLC*, 488 F.3d 1102, 1118 n.5 (9th Cir. 2007), *cert. denied*, 128 S. Ct. 709 (2007); *contra Atl. Recording Corp. v. Project Playlist, Inc.*, 603 F. Supp. 2d 690 (S.D.N.Y. 2009).

58. 47 U.S.C. § 230(e)(3).

59. *Cisneros v. Sanchez*, 403 F. Supp. 2d 588, 592 (S.D. Tex. 2005).

60. *Register.com, Inc. v. Verio, Inc.*, 356 F.3d 393 (2d Cir. 2004) (user agreed to terms of use by submitting search query); *ProCD v. Zeidenberg*, 86 F.3d 1447 (7th Cir. 1996) (customer consented to terms by installed software); *Hotmail Corp. v. Van$ Money Pie*, No. 98-20064, 1998 WL 388389, at *6 (N.D. Cal. Apr. 16, 1998) (e-mail service terms of use enforceable).

61. *Id.*

62. Cal. Bus. & Prof. Code § 17538(d)(1). In *Daniels v. True*, 47 Ohio Misc. 2d 8, 547 N.E.2d 425 (Muni.Ct. Hamilton County 1988), an Ohio court held that a seller who accepts a deposit without giving notice of its refund policy was guilty of deceptive practices.

63. Two companies that offer this kind of policy are Axis Pro (<http://www.mediaprof.com>) and One Beacon (<http://www.onebeaconpro.com>). I have not worked with either one.

64. "Privacy policy" is also used to describe an internal information management and security policy that covers all of a company's operations, not just its Web site, including where the company stores personal information that it collects from any source, who has access to it, how the company handles personal information on handheld devices, and what steps the company takes to protect personal information used in e-mails. The term also usually encompasses an incident response plan, which covers what happens if someone hacks into the company's site, or if a laptop or other handheld device that contains personal information gets lost or stolen, including whom the company has to notify, who is on the incident response team, and what each person is responsible for.

65. Fair Information Practice Principles, http://www.ftc.gov/reports/privacy3/fairinfo.shtm (last visited Apr. 18, 2010).

66. If Anne is going to send out e-mail blasts, she will need to comply with the federal CAN-SPAM law. That law, which pre-empts all state laws and this is the only statute that governs e-mails, requires that any commercial e-mail include certain information and give the recipient the opportunity to opt out from all future e-mails from the "sender." Although this is less burdensome than the federal and most state fax laws, which prohibit sending unsolicited commercial faxes to anyone who has not already opted *in*, complying with the CAN-SPAM opt-out requirement can be trickier than it seems, because the "sender" is the person or company on whose behalf the e-mails are being sent out, not the entity that is actually sending them out. Also, the law prohibits sending e-mails to any *wireless* device without "express prior authorization."

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# Employment Law Update

By James R. Grasso

## New Law Restricts Employment Arbitration for Defense Contractors

President Obama signed into law the Department of Defense Appropriations Act for Fiscal Year 2010 on December 21, 2009. Section 8816 of the Act significantly restricts the ability of defense contractors and subcontractors to require employees or independent contractors to arbitrate certain employment claims.

Under § 8816, any defense contractor that receives funds of over $1 million appropriated under the Act, for a contract awarded more than 60 days after December 19, 2009, must agree not to:

1. enter into any agreement with any of its employees or independent contractors that requires, as a condition of employment, that the employee or independent contractor agree to resolve through arbitration any claim under Title VII of the Civil Rights Act of 1964 or any tort related to or arising out of sexual assault or harassment, including assault and battery, intentional infliction of emotional distress, false imprisonment, or negligent hiring, supervision or retention; or
2. take any action to enforce any provision of an existing agreement with an employee or independent contractor that mandates that the employee or independent contractor resolve such claims through arbitration.

The Act also provides that all prime defense contractors that receive covered contract awards must certify that their subcontractors have agreed to the arbitration restrictions in the Act. This certification requirement, which takes effect for all contracts awarded more than 180 days after December 19, 2009, applies to all subcontractors that have subcontracts in excess of $1 million. The Act applies to all of the employees and contract workers of a defense prime contractor. However, for defense subcontractors, the Act only covers persons working on a covered subcontract.

While this law applies only to defense contractors, it is consistent with current proposed Congressional legislation which would prohibit pre-dispute arbitration agreements in all employment, consumer, franchise or civil rights disputes.

## Federal Contractors Required to Notify Employees of Their Rights Under Federal Labor Law

On January 30, 2009, President Obama signed Executive Order 13496, entitled "Notification of Employee Rights under Federal Labor Laws" (Order). The Order rescinds a prior Executive Order signed by former President Bush that had required contractors to post a "Beck" notification informing workers that they did not have to join a union or pay union dues to keep their jobs. Under the new Order, federal contractors and subcontractors must post a government-issued notice at worksites where activities "related to" the contract are performed.

The proposed version of the notice states that it is the policy of the United States to encourage collective bargaining and lists activities that are illegal under the National Labor Relations Act. It also informs employees of their right to file a complaint for violations of their rights to association, self-organization, and designation of representatives for the purpose of negotiating terms and conditions of employment. Certain contracts are exempt from the notice posting requirement, including collective bargaining agreements, federal contracts below the simplified acquisition threshold of $100,000, and contracts issued by agencies or departments that the Secretary of Labor chooses to exempt. It also appears that receipt of Medicare or Medicaid payments does not constitute a government contract.

The Department of Labor (DOL) issued proposed regulations to implement the Order on August 3, 2009. Once the proposed regulations are finalized, the DOL will publish a poster that contractors must post in a conspicuous place at their facilities. The DOL anticipates that final regulations and the required poster will be issued in June 2010. Two separate agencies are involved in enforcing the Order. The Office of Federal Contract Compliance Programs will be responsible for investigating and conciliating complaints and will refer violations to the Office of Labor-Management Standards for enforcement. Contractors who do not comply with the posting requirements face penalties and sanctions, including debarment.

## FMLA Amendment Expands Military Family Leave

On October 28, 2009, President Obama signed the National Defense Authorization Act for Fiscal Year 2010 (NDAA) into law, expanding Family and Medical Leave Act (FMLA) military family leave benefits. The NDAA extends FMLA qualifying exigency leave coverage to family members of active duty members of the Armed Forces and expands the military caregiver provision to family members of veterans.

### Qualifying Exigency Leave

Prior to this amendment, a covered employee could take up to 12 weeks of FMLA leave because of any "qualifying exigency" related to the employee's spouse, child or parent being on active duty or called to active duty in the National Guard or as a reservist in support of a military "contingency operation." Qualifying exigencies include issues related to short-notice deployment, military events and related activities, childcare and school activities, financial and legal arrangements, counseling, rest and recuperation, and post-deployment activities. Employees were not previously eligible to take leave for a qualifying exigency if the family member was a member of the regular Armed Forces. Under the NDAA amendments to the FMLA, that distinction has been eliminated and covered employees are now eligible to take leave for a qualifying exigency related to the deployment of a spouse, child or parent who is a member of any regular component of the Armed Forces. Also, the right to take qualifying exigency leave is no longer restricted to the service member being on active duty or called to active duty in support of a military "contingency operation." Instead, an eligible employee whose spouse, child or parent is a member of the regular or reserve components of the Armed Forces may take FMLA qualifying exigency leave when the service member is deployed to any foreign country.

## Military Caregiver Leave

Under the 2008 FMLA amendments, covered family members were allowed 26 weeks of leave during a single 12-month period to care for an injured service member. A covered service member under the 2008 amendments was limited to a current member of the Armed Forces, including a member of the National Guard or Reserves, with a serious injury or illness incurred in the line of duty while on active duty. As a result, the 2008 amendments failed to address an employee's need to take leave to care for a veteran whose service-related injury manifested itself after discharge. Under the NDAA, the definition of "covered service member" for purposes of caregiver leave has been expanded to include a veteran who is undergoing medical treatment, recuperation or therapy for a serious injury or illness that was incurred or aggravated while on active duty, whether or not the illness or injury manifested itself before or after the member became a veteran, and who was a member of the Armed Forces, including the National Guard or Reserves, at any time during the five-year period before he or she began treatment, recuperation or therapy. As a result, the FMLA now allows an eligible caregiver to take up to 26 weeks of leave to care for a veteran for up to five years after the service member leaves military service.

In response to these changes, employers should update their FMLA policies and forms and educate managers and supervisors about the additional situations under which FMLA leave may be taken.

## Federal Court Restricts Professional Overtime Exemption

In its recent decision, Young v. Cooper Cameron Corp., the Second Circuit Court of Appeals significantly restricted the circumstances under which an employee may qualify as exempt from overtime under the professional exemption. Under the Fair Labor Standards Act (FLSA) regulations, an employee is considered to be a professional and exempt from overtime if his or her primary duty requires "knowledge of an advanced type in a field of science or learning customarily acquired by a prolonged course of specialized intellectual instruction." Lawyers, doctors and architects are some of the representative professions that meet this standard. Many employers also apply the professional exemption to employees who do not hold an advanced degree in their field but have obtained their expertise, such as in engineering, as the result of experience and on-the-job training. However, the court's decision in Young now makes it clear that if an employee is not required to have an advanced educational degree to perform his or her duties, the employee is not an exempt professional under the advanced knowledge provision.

In Young, the plaintiff worked as a Product Design Specialist and had 20 years of engineering-type experience. His work involved complicated technical expertise and responsibility. Like all of the other persons in his position, the plaintiff lacked any formal education beyond a high school diploma. Nonetheless, the employer considered the plaintiff and his co-workers to be professionals under the FLSA because their positions required them to use the technical expertise they had acquired through many years of experience. In 2004, the plaintiff was terminated in a reduction-in-force and sued the employer, alleging that he had been wrongly classified as a professional and denied overtime in violation of the FLSA while employed. The lower court ruled in the plaintiff's favor and the employer appealed.

The Court of Appeals affirmed the lower court's decision. The Court of Appeals reviewed the regulations and concluded that "if a job does not require knowledge customarily acquired by an advanced educational degree—as for example when many employees in the position have no more than a high school diploma—then, regardless of the duties performed, the employee is not an exempt professional under the FLSA."

The Young decision is likely to impact how employers classify their employees for overtime purposes. Under the Young decision, if a job does not customarily require an advanced educational degree, then the employees in that job will not qualify as professionals regardless of the fact that they possess advanced technical knowledge and expertise as a result of experience and training. The types of jobs that will likely be most affected include those such as non-degreed engineers—employees who perform engineering support and related duties but do not have an engineering degree—and employees in other technical areas.

Employers should review the classification status of the employees they now classify as professionals in light of the Young decision and make any necessary changes.

### New-Hire Wage Notice Update

As of October 26, 2009, New York Labor Law § 195 requires employers to notify all new hires in writing of their rate of pay and regular pay day. If the employee is eligible for overtime, the notice must also include the employee's regular hourly rate and overtime pay rate. Employers must also obtain a written acknowledgment from each new hire confirming that the employee received the notice. In October 2009, the New York State Department of Labor (DOL) issued what it then described as a "mandatory" form for use by New York State employers for hourly employees. The DOL has changed its position on its form being "mandatory" and its website now states that no particular form is required.

In December of 2009, the DOL issued detailed guidelines, instructions and model notices for employers to comply with these requirements. The guidelines are available on the following website: http://www.labor.state.ny.us/formsdocs/wp/LS52.pdf. The instructions are available on the following website: http://www.labor.state.ny.us/formsdocs/wp/LS53.pdf.

The instructions provide that employers may create their own notices as long as the relevant information is included, the employee receives a copy and the employee signs an acknowledgment of receipt, which must be retained for six years.

The model notices address several issues that arose as employers attempted to comply with this new law. There are now separate model forms available for the following situations:

1. One hourly rate—http://www.labor.state.ny.us/formsdocs/wp/LS54.pdf;
2. Multiple hourly rates—http://www.labor.state.ny.us/formsdocs/wp/LS55.pdf;
3. A weekly rate for a fixed number of hours less than 40—http://www.labor.state.ny.us/formsdocs/wp/LS56.pdf;
4. A salary for varying hours, day rate, piece rate, flat rate, or other non-hourly basis—http://www.labor.state.ny.us/formsdocs/wp/LS57.pdf;
5. Pay rates for prevailing wage jobs and other jobs—http://www.labor.state.ny.us/formsdocs/wp/LS58.pdf.

There is also a form for exempt employees—http://www.labor.state.ny.us/formsdocs/wp/LS59.pdf. Although the statute contains no such requirement, the instructions for this form indicate that employers should identify the specific overtime exemption that applies to an exempt employee. Employers should review each exempt status carefully.

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# Inside the Courts: An Update on Securities Litigation

By Jay B. Kasner, Matthew J. Matule, Edward B. Micheletti and Peter B. Morrison

## Antitrust Preemption

### S.D.N.Y Dismisses Antitrust Claims in Auction Rate Securities Matter

***Mayor of Baltimore, Md. v. Citigroup Inc.*, No. 08 Civ. 7746 (BSJ) (S.D.N.Y. Jan. 26, 2010)**

On preemption grounds, Judge Barbara S. Jones of the U.S. District Court for the Southern District of New York dismissed claims that broker-dealers underwriting auction rate securities (ARS) violated Section 1 of the Sherman Antitrust Act by allegedly acting collectively to withdraw support from the ARS market. The broker-dealers had been intervening in the ARS auctions to prevent auction failures until the second largest ARS underwriter disclosed it was no longer intervening in ARS auctions, a policy "[v]irtually every other major broker-dealer" followed. Applying the four factors in the U.S. Supreme Court's 2007 decision in *Credit Suisse Securities (USA) LLC v. Billing*, the court concluded that the Sherman Antitrust Act was preempted by federal securities laws. First, the ARS market is "squarely within" the heartland of securities regulation, as ARS are a form of debt securities. Second, the SEC has "clear and adequate" authority to regulate the ARS market under Sections 10(b) and 15(c) of the Securities Exchange Act by prohibiting broker-dealers from using fraudulent devices to induce securities transactions. Third, the SEC has actively exercised that authority to regulate the ARS market, including by investigating broker-dealer practices to influence the ARS market and the broker-dealers' apparently collective decision to stop supporting ARS auctions. That investigation led to new rules for ARS broker-dealers and settlements requiring some broker-dealers to purchase ARS held by their clients at par value. Fourth, there is a "serious conflict" between federal antitrust law and federal securities laws, because the SEC has permitted or encouraged the broker-dealers to interact, for example, to jointly underwrite ARS offerings and auctions. Consequently, the SEC might permit further collective action to restore liquidity to the ARS market. Further, applying the Second Circuit's 2009 decision in *Electronic Trading Group, LLC v. Banc of America Securities LLC* (discussed next), Judge Jones recognized that it would be unreasonable to expect the broker-dealers to determine the fine line between the communications permitted by federal securities laws and the SEC and those prohibited by federal antitrust law. Finally, the SEC has "thoroughly" regulated the ARS market and dozens of securities lawsuits have been brought against the broker-dealers, demonstrating "an 'unusually small' need for antitrust enforcement in the ARS market."

## Second Circuit Affirms Dismissal of Claims That Prime Brokers Violated Sherman Act

***Elec. Trading Group, LLC. v. Banc of Am. Sec LLC*, No. 08-0420-cv (2d Cir. Dec. 3, 2009)**

The U.S. Court of Appeals for the Second Circuit affirmed the district court's order dismissing claims that prime brokers in short sale transactions violated Section 1 of the Sherman Antitrust Act by designating certain securities as hard-to-borrow and fixing the price of borrowing those securities. The court determined that each of the four factors in the U.S. Supreme Court's 2007 decision in *Credit Suisse Securities (USA) LLC v. Billing* weighed in favor of a finding, based on the pleading particularity standards applied in that decision, that the federal securities laws impliedly precluded application of the Sherman Antitrust Act. As for the first factor, the court determined that short selling—the underlying market activity at issue—is "squarely within the heartland of securities regulations." As for the second factor, the SEC has the authority under Sections 6 and 10(a) of the Securities Exchange Act to regulate the role of prime brokers in short selling, as well as the borrowing fees they charge. As for the third factor, the SEC regulates the role of prime brokers in short sales in an active and ongoing manner via Regulation SHO. As for the fourth factor (whether there is conflict between securities and antitrust laws), the court focused on the alleged anticompetitive conduct and not on the broader regulatory framework. The court recognized that there was an actual conflict between securities and antitrust laws, because the very communications permitted by Regulation SHO to allow prime brokers to determine if securities (for short sales) are available would "by reasonable but contradictory inferences" be evidence of conduct that violates the Sherman Antitrust Act. Similarly, there was the potential for future conflict between securities and antitrust laws if the SEC decided to regulate the fees set for borrowing hard-to-borrow securities in short sales.

## Appointment of Lead Plaintiff and Counsel

### Tenth Circuit Rejects Challenge to Lead Plaintiff Selection in Quest Securities Class Action

***In re Bard Assocs., Inc.*, No. 09-6243 (10th Cir. Dec. 2, 2009)**

In a *per curiam* opinion, the U.S. Court of Appeals for the Tenth Circuit denied the request for a writ of mandamus of the investment advisory firm Bard Associates, which challenged the district court's denial under the PSLRA of its motion to serve as lead plaintiff in a putative securities class action brought against Quest Resource Corp. The district court had denied Bard's bid to serve as lead plaintiff, despite the fact that Bard "indisputably… holds the largest financial stake in the outcome of th[e] litigation." The district court based its rejection on Bard's failure to demonstrate its clients' financial interest before the deadline to submit a motion to serve as lead plaintiff, which is "not later than 60 days after the date on which [ ] notice is published." 15 U.S.C. Section 78u-4(a)(3)(A)(i)(II). In denying Bard's request for a writ, the court held that the district court did not abuse its discretion in requiring Bard to submit evidence of its clients' financial interest and of its Article III standing at the time of its motion to serve as lead plaintiff, rather than at the time of filing the complaint. The court held that, although Article III standing is ordinarily measured no earlier than the time the complaint is filed, a court does not abuse its discretion in cases under the PSLRA by requiring a prospective lead plaintiff to demonstrate its Article III standing when lead plaintiff motions are due.

### Ninth Circuit Vacates District Court's Selection of Class Counsel in NVIDIA Securities Class Action

***Cohen v. U.S. Dist. Court*, No. 09-70378 (9th Cir. Nov. 5, 2009)**

The U.S. Court of Appeals for the Ninth Circuit granted, in part, co-lead plaintiff Roberto Cohen's request for a writ of mandamus vacating the district court's selection under the PSLRA of co-lead counsel in a putative securities class action brought against NVIDIA Corp. Cohen argued that the district court acted contrary to the PSLRA—which provides that the lead plaintiff "'shall, subject to the approval of the court, select and retain counsel to represent the class'" 15 U.S.C. Section 78u-4(a)(3)(B)(v)—by selecting as co-lead counsel Girard Gibbs LLP, a law firm that had not been nominated by either of the two co-lead plaintiffs. (Girard Gibbs LLP had been nominated by a purported class member who was not selected as lead plaintiff.) The court vacated the district court's selection of Girard Gibbs LLP as co-lead counsel because, "[a]lthough it cannot be contested that the district court had the authority to reject Cohen's choice of lead counsel, it does not follow that having done so it had the authority to select lead counsel of its own choosing." The court concluded that "the PSLRA unambiguously assigns this authority [to select lead counsel] to the lead plaintiff" and remanded the matter to the district court either to approve or reject Cohen's proposed class counsel. Notably, the court also suggested in a footnote that the district court may have further erred by appointing multiple lead plaintiffs—so-called "co-lead plaintiffs"—which, although it is "a practice occasionally employed by district courts," may run afoul of the PSLRA.

## Appraisal

### Court of Chancery Rejects Petitioners' Demand for Appraisal

***DiRienzo v. Steel Partners Holdings L.P.*, No. 4506-CC (Del. Ch. Dec. 8, 2009)**

The petitioners, the beneficial holders of shares in WebFinancial Corp., brought an action pursuant to Delaware General Corporation Law Section 262 for appraisal of their shares. Specifically, the petitioners had instructed their broker to demand appraisal from WebFinancial, even though they were not the record holders of the shares. The Delaware Court of Chancery concluded that the petitioners were not entitled to appraisal because they did not comply with the express provision of Section 262(a), which requires a record holder to demand appraisal. In addition, the court found that WebFinancial had not waived its right to object to the petitioners' failures to comply with Section 262. The court held that three communications from WebFinancial to the petitioners did not constitute the kind of unequivocal and unambiguous conduct required to waive the company's right to object to a defective appraisal demand. The court held that, even though Sections 262(d)(1) and (e) required WebFinancial to send certain correspondence to stockholders who had properly perfected their appraisal rights, those sections "cannot be read to have required [the] respondent to immediately determine the insufficiency of [the] petitioners' demands and refrain from sending them the letters or risk waiving the right to later object to the insufficiencies in a formal appraisal proceeding." The court concluded that "nothing in Section 262 requires a company to notify dissenting stockholders prior to the filing of an appraisal petition that they failed to comply with Section 262.… Thus, it is perfectly appropriate for a company to wait until a petition is filed to begin analyzing and objecting to insufficient appraisal demands so long as the company makes no express or implied waiver in its correspondence with stockholders that it will not later object to their demands." The court also rejected the petitioners' argument that they could proceed in the appraisal action because the company's alleged disclosure violations estopped it from objecting to their insufficient demand. The court held that "[i]f fiduciary duties were breached due to inadequate disclosure," the petitioners are still not relieved of the "obligation to comply with Section 262 in seeking appraisal." Rather, the court explained that if petitioners wish to assert that disclosure violations occurred, they must do so in a separate action for breach of fiduciary duty, because "an appraisal action is not the appropriate channel of relief through which to vindicate inadequate disclosure claims." The court ultimately granted WebFinancial's motion for summary judgment.

## Auditor Liability

### S.D.N.Y. Dismisses Securities Claims Related to Auditor's Approval of Financial Statements

***Amorosa v. Ernst & Young LLP*, No. 03 Civ. 3902 (CM) (S.D.N.Y. Nov. 30, 2009)**

Judge Colleen McMahon of the U.S. District Court for the Southern District of New York dismissed claims alleging that Ernst & Young violated Section 11 of the Securities Act and Sections 10(b) and 14(a) of the Securities Exchange Act in connection with its approval of four AOL and AOL Time Warner financial statements. In addition, because the complaint was nearly identical to other actions preempted by SLUSA, with which the plaintiff took every opportunity to informally coordinate his action, the complaint's state law claims were preempted by SLUSA. Because the complaint alleged that Ernst & Young violated securities laws, under the U.S. Supreme Court's 1975 decision in *Blue Chip Stamps v. Manor Drug Stores* the plaintiff could only assert claims against Ernst & Young's statements that he could have relied upon in connection with buying or selling AOL or AOL Time Warner stock. Consequently, he could not challenge Ernst & Young's statements after his last transaction. As to the Section 10(b) and 14(a) claims, the court determined that loss causation was not adequately pled, because the complaint did not claim that Ernst & Young's alleged misstatements were subject to a corrective disclosure. Although the complaint pointed to AOL Time Warner's restatement and to an article suggesting that the type of transaction at issue might not comply with GAAP, that restatement occurred after the action was filed and the article did not mention AOL and made clear that the transactions were not "necessarily illegal." As to the Section 11 claim, the court determined that the plaintiff had not alleged he had suffered any losses as a result of the alleged fraud because the price of AOL Time Warner's stock had increased. Judge McMahon applied the ruling of the court addressing the other nearly identical actions to set the date of the earliest possible disclosure of the alleged fraud. Between that earliest possible disclosure and when the action was filed, the price of AOL Time Warner's stock had increased, and the plaintiff's alleged losses all occurred before that disclosure. If, however, the alleged fraud was disclosed when the plaintiff alleged it had happened, then the Section 11 claim was barred by the one-year limitations period.

## Damages

### Court of Chancery Allows Claims for Damages to Proceed in Failed Acquisition

***NACCO Indus., Inc. v. Applica Inc.*, No. 2541-VCL (Del. Ch. Dec. 22, 2009)**

In this case, the Delaware Court of Chancery denied, in part, a motion to dismiss on claims brought by NACCO Industries, Inc. seeking damages in connection with its failed acquisition attempt and a terminated merger agreement with Applica Inc. Specifically, Applica entered into a merger agreement with NACCO and agreed to a standstill provision that limited its ability to act unilaterally to acquire Applica. Applica subsequently terminated the merger agreement with NACCO and agreed to be acquired at a higher price by affiliates of the hedge fund Harbinger Capital Partners. NACCO brought suit alleging, among other things, that while it was restricted under the standstill agreement, Harbinger had, under the cover of allegedly false Schedule 13 disclosures, accumulated a large block of Applica stock and eventually bid against NACCO to acquire Applica. NACCO sought damages arising out of its defeated acquisition attempt and brought a number of claims, alleging that Applica violated a nondisclosure agreement and breached the no-shop provision in the merger agreement by engaging in discussions with Harbinger and tipping Harbinger on the confidential NACCO merger discussions to assist it in its acquisition of Applica. NAACO alleged that Applica's senior management feared they would lose their jobs following a strategic deal with NACCO, and they favored Harbinger as a financial buyer that needed a management team and would likely retain them. NACCO also claimed that Harbinger committed fraud by making false misrepresentations in its Schedule 13 disclosures by failing to disclose its intentions to control Applica. The court dismissed the claims for breach of the implied covenant of good faith and fair dealing, aiding and abetting a breach of fiduciary duty, and equitable fraud. However, the court allowed to proceed to trial claims for breach of contract, tortious interference with contract, fraud (in connection with Harbinger's alleged faulty disclosures in its SEC filings) and civil conspiracy.

The court made a number of findings in this case. First, in allowing the claims for breach of the merger agreement to withstand a motion to dismiss, the court observed that the communications between Applica and Harbinger involved highly confidential information and took place at a time when the NACCO-Applica agreement prevented those types of communications. Second, the court rejected the defendant's argument that NACCO had not sufficiently pled damages because it subsequently engaged in a bidding war with Harbinger for Applica and lost. The court observed that "[i]f embraced as grounds for a pleadings-stage dismissal, the defendants' theory would have serious and adverse ramifications for merger and acquisitions practice and for our capital markets." The court explained that "[p]arties bargain for provisions in acquisition agreements because those provisions mean something. Bidders in particular secure rights under acquisition agreements to protect themselves against being used as a stalking horse and as consideration for making target-specific investments of time and resources in particular acquisitions. Target entities secure important rights as well. It is critical to our law that those bargained-for rights are enforced, both through equitable remedies such as injunctive relief and specific performance, and, in the appropriate case, through monetary remedies including awards of damages." The court explained that, although NAACO received a bargained-for termination fee, the right to terminate the agreement by Applica without further liability was dependant upon Applica complying with its other obligations under the agreement.

Third, the court permitted NAACO's fraud claim to proceed; this fraud claim arose exclusively on statements that Harbinger made in its Schedule 13 filings. Critically, the court made clear that the Delaware state courts can provide a common law fraud remedy for false statements made by a Delaware company in an Exchange Act filing. The court held that a claim for fraud based on false statements in federal securities filings could be litigated independently in the Court of Chancery, explaining that "[i]f a Delaware entity engages in fraud or is used as part of a fraudulent scheme, that entity should expect that it can be held to account in the Delaware courts." Thus, the court held that NACCO's fraud claim could go forward in the court because it had pled sufficiently that Harbinger's statements regarding its investment intent in its Schedule 13G and 13D filings were false. The court concluded by emphasizing that this is a "pleadings-stage decision" and whether NACCO "ultimately prevails and obtains a remedy will depend on the evidence presented, any defenses, and the ultimate equities of the case."

## Directors and Directors' Duties: *Demand Futility*

### Ninth Circuit Affirms Dismissal of Derivative Action Against Hewlett-Packard for Failure to Allege Demand Futility

***Ind. Elec. Workers Pension Trust Fund, IBEW v. Dunn*, No. 08-15877 (9th Cir. Nov. 3, 2009)**

In an unpublished opinion, the U.S. Court of Appeals for the Ninth Circuit affirmed the dismissal of a derivative action that challenged the Hewlett-Packard (HP) board's decision to make a $21.4 million payment to former HP CEO Carleton S. Fiorina as part of a post-termination settlement agreement. The court affirmed the district court's order that plaintiffs failed to show demand futility because they did not allege "particularized facts giving rise to a reasonable doubt that the challenged transaction… was the product of a valid exercise of business judgment." Emphasizing the "well-recognized presumption 'that in making a business decision the directors of a corporation act[] on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company,'" the court blessed the HP board's decision to enter the settlement without shareholder approval, which would have been required if the entire settlement were a "severance" payment. The court found that the $21.4 million was not a "severance" payment (and thus not subject to shareholder approval), despite an "offhand comment by one Board member and the broad description of the entire payment as 'severance' in a proxy statement." The court also found that payments to Fiorina classified as long-term performance cash were permissible as part of the settlement. Although not generally available for involuntarily terminated HP employees (such as Fiorina), the court found that HP company policy provided the board with discretion to make such long-term performance cash payments. Accordingly, the court concluded that there was no basis to challenge the board's decision and, as a result, no grounds to allege demand futility.

The court also affirmed the district court's finding that all of the plaintiffs' claims were derivative, and not direct claims, which would not require a showing of demand futility. In so holding, the court explained that to state a direct claim against the board, the shareholders needed to show that they, as opposed to the company, were harmed by the board action. The court concluded that plaintiffs could only proceed through a derivative action because they could not make such a showing.

## Derivative Suits

### Second Circuit Affirms Dismissal of Derivative Suit for Failure to Make Presuit Demand

***Bader v. Blankfein*, No. 09-0309-cv (2d Cir. Dec. 14, 2009)**

In a *per curiam* summary order signed by the clerk, the U.S. Court of Appeals for the Second Circuit affirmed the dismissal of a derivative suit against the directors of Goldman Sachs Group because the plaintiff failed to make a presuit demand on the board. The plaintiff alleged that the board made a misstatement in Goldman Sachs' proxy statement about the value of stock options granted to officers, thereby violating Section 14 of the Securities Exchange Act. The court explained that, under the applicable SEC regulations, the board could either disclose the value of stock options using their potential realizable value or using their present value (using any pricing model). Accordingly, because the board must use valid business judgment to meet its obligations under Section 14 regarding how to disclose the value of awarded stock options, a presuit demand was required under Delaware law. Further, the court adopted the district court's view that demand was not excused because the complaint did not create a reasonable doubt that a majority of Goldman Sachs' board was disinterested and independent.

## Section 225

### Chancery Court Explains Range of Claims Allowable in Section 225 Summary Proceeding

***Levinhar v. MDG Med., Inc.*, No. 4301-VCS (Del. Ch. Nov. 24, 2009)**

The Delaware Court of Chancery explained the wide range of claims allowable in a summary proceeding pursuant to Section 225 of the Delaware General Corporation

Law (DGCL). The plaintiffs, the founders of MDG Medical, Inc., originally brought an action pursuant to DGCL Section 225, arguing that the defendants, investors in MDG who controlled the voting power of MDG, wrongfully ousted the founders from MDG's board. The founders settled their Section 225 action by agreeing to dismiss the case with prejudice in exchange for the new investors' agreement to pay certain of the founders' attorneys' fees. Then, a couple of months later, the founders brought this action seeking appraisal of their shares in the merged entity, and also alleging that the defendants breached their fiduciary duties and the terms of a stockholders' agreement by depriving them of the right to select two board members. The defendants moved for judgment on the pleadings, arguing that the plaintiffs' claims, except for their appraisal claims, were barred by *res judicata*.

The Court of Chancery agreed with the defendants, holding that those claims were precluded by *res judicata*, because the founders "could and therefore should have" brought their claims as part of the settled Section 225 action. The court held that *res judicata* applied because the same transaction and series of activities formed the basis for both the Section 225 action and present claim—namely, the defendants' "single overarching scheme" to eliminate the founders' rights to designate directors to the board. Furthermore, the court found that the founders could have brought their present claims related to the MDG board composition and the breach of the stockholders' agreement in the Section 225 action. The court held, "[a]lthough Section 225 actions are summary proceedings, claims that bear on the appropriate composition of the board of directors may be brought in connection with a Section 225 action." Moreover, "it is common in Section 225 cases for this court to address the consequences that stockholder voting agreements have on the outcome of director elections or removal efforts." Ultimately, the court barred the founders from litigating their claims about their removal as directors because "[f]or them to now seek to revive those arguments and to inject them into this case implicates all the key policy reasons *res judicata* exists as a doctrine."

## Discovery

### S.D.N.Y. Determines Plaintiffs Negligent in Failing to Preserve Relevant Information Related to Liquidated BVI Hedge Funds

***Pension Comm. of the Univ. of Montreal Pension Plan v. Banc of Am. Sec., LLC*, No. 05 Civ. 9016 (SAS) (S.D.N.Y. Jan. 11, 2010)**

In a ruling titled "*Zubulake* Revisited: Six Years Later," Judge Shira A. Scheindlin of the U.S. District Court for the Southern District of New York determined that 13 plaintiffs in a multidistrict litigation resulting from the 2004 liquidation of two British Virgin Islands hedge funds had failed to preserve and produce all relevant, requested documents. As background, the court explained that a party is negligent if it fails to preserve relevant information (including electronically stored information) or fails to obtain records from all employees, and a party is grossly negligent if it fails to adhere to contemporary standards on discovery. The court also explained that it would be grossly negligent for a party to fail to (1) issue a written litigation hold, (2) identify key players and ensure their electronic and paper records are preserved, (3) preserve former employees' records in the party's possession, and (4) preserve backup tapes if they are the sole source of relevant information or relate to key players after July 2004 (when the final opinion in *Zubulake v. UBS Warburg LLC* was issued). Similarly, it is gross negligence or willfulness to fail to collect records from key players or to destroy e-mails and backup tapes after the duty to preserve attaches (which happens when "a party reasonably anticipates litigation"). The court also explained that severe sanctions (*e.g.*, dismissal, preclusion or an adverse-inference instruction) may be imposed if the innocent party shows that the destroyed evidence was responsive and helpful to proving its claims or defenses (which is presumed where there is willfulness or gross negligence) and that the spoliating party had a culpable state of mind, which the spoliating party may rebut. The court determined that six plaintiffs were grossly negligent (because they disregarded their duty to preserve relevant documents until 2007, including by destroying electronic documents, and did not search key players' documents), entitling the defendants to a spoliation instruction and monetary sanctions, and that the other seven plaintiffs were merely negligent (because their searches were incomplete, although they did search the key players' documents), entitling the defendants to monetary sanctions.

### Chancery Court Denies Motion to Expedite Discovery in Stockholders' Acquisition Challenge

***In re 3Com S'holders Litig.*, No. 5067-CC (Del. Ch. Dec. 18, 2009)**

The Delaware Court of Chancery denied stockholder plaintiffs' motion to expedite discovery in a putative class action challenging the announced $2.7 billion acquisition by Hewlett-Packard of 3Com Corp., "[b]ecause plaintiffs have failed to state colorable disclosure claims or claims for breach of fiduciary duty, and because an adequate remedy (appraisal) exists for any purported fiduciary breach." Specifically, the court rejected the plaintiffs' contention that the proxy contained a number of material omissions and inadequate disclosures regarding, among other things, the analysis performed and projections used by 3Com's investment banker, Goldman Sachs. The court made a number of findings in rejecting all of the plaintiffs' disclosure claims, including that: (1) a proxy only needs to disclose an "adequate and fair summary of the financial advisor's work," and the plaintiffs "failed to assert a colorable reason as to why management should be required to provide full versions of the projections underlying the already disclosed summaries"; (2) management's failure to explain why a revised management plan was used to evaluate the merger did not state a disclosure violation, because the court was "aware of no rule that precludes management or its financial advisor from using alternative sets of financial projections in evaluating the advisability and fairness of a merger"; (3) management was not required to disclose information about the value of 3Com's three distinct operating segments, because there is "no rule that requires financial advisors to perform [a sum-of-the-parts] analysis in preparing a fairness opinion"; (4) failure to inform stockholders of other strategic initiatives "is not a disclosure violation," because "Delaware law does not require management 'to discuss the panoply of possible alternatives to the course of action it is proposing'"(citation omitted); and (5) no disclosure violation occurred where Goldman Sachs' fairness opinion deviated from conventional practice. Furthermore, the court observed that "[t]here is no rule that requires a financial advisor to follow the same protocol every time it renders a fairness opinion." The court also rejected the plaintiffs' fiduciary claims challenging no-solicitation, matching-rights and 4 percent termination-fee provisions, stating that "[t]he provisions [in the merger agreement] that [the] plaintiffs attack have been repeatedly upheld by this Court."

#### S.D.N.Y. Denies Request to Lift PSLRA Discovery Stay in Lawsuit Against Freddie Mac

***Kuriakose v. Fed. Home Loan Mortgage Co.*, No. 08-cv-7281 (JFK) (S.D.N.Y. Dec. 7, 2009)**

Judge John F. Keenan of the U.S. District Court for the Southern District of New York denied the plaintiff's request to lift the PSLRA discovery stay in a lawsuit alleging Freddie Mac and several of its officers and directors violated Section 10(b) of the Securities Exchange Act arising from the 2008 decline in the consumer housing and subprime mortgage markets. Although a committee in the House of Representatives, two U.S. attorneys and the SEC also have investigated Freddie Mac in connection with those events, the fact that documents sought by the plaintiff already had been produced to those investigators was an insufficient reason to lift the discovery stay. Additionally, the plaintiff was not unduly prejudiced by the lack of those documents regarding planning litigation strategy or potential settlement negotiations, insofar as there were no ongoing settlement negotiations and no criminal or civil enforcement actions, and Freddie Mac had not declared bankruptcy. Importantly, Judge Keenan suggested that the Nov. 16, 2009, decision in *In re Bank of America Corp. Sec., Derivative & ERISA Litig.* (summarized below) may have misapplied the law of the Second Circuit to the extent it lifted the PSLRA discovery stay simply because discovery was proceeding in other cases not subject to the PSLRA discovery stay.

### S.D.N.Y. Lifts PSLRA Discovery Stay in Actions Concerning Bank of America/Merrill Lynch Merger

***In re Bank of Am. Corp. Sec., Derivative & ERISA Litig.*, No. 09 MDL 2058 (DC) (S.D.N.Y. Nov. 16, 2009)**

Upon application of the lead plaintiffs, Judge Denny Chin of the U.S. District Court for the Southern District of New York lifted the PSLRA discovery stay in the consolidated securities actions concerning Bank of America's merger with Merrill Lynch in late 2008. The lead plaintiffs requested the documents produced to the various government agencies investigating the merger (*e.g.*, the SEC and the U.S. Congress) and copies of the transcripts of any testimony given in connection with those investigations. Courts consider all facts and weigh the burden of the defendants' cost to produce the documents against the plaintiffs' need for early review of the documents, but may consider other factors as well (*e.g.*, the defendants' financial state and settlement negotiations). The court held that the lead plaintiffs would be unduly prejudiced if the stay remained, because discovery was continuing in actions brought by the SEC and state attorneys general against Bank of America and in the Delaware Chancery Court derivative action against Bank of America, and so the lead plaintiffs would be less able to make decisions about litigation strategy. In addition, Judge Chin recognized that the lead plaintiffs were seeking only documents which the defendants already had produced in those other actions, so their burden in producing those documents in the consolidated securities action would be "slight." Finally, the securities actions were consolidated with derivative and ERISA litigation against Bank of America, and those actions were not subject to the PSLRA discovery stay.

### Limited Liability Companies

#### Delaware Supreme Court Rules That Statute of Frauds Applies to Oral LLC Agreement

***Olson v. Halvorsen*, No. 338, 2009 (Del. Dec. 15, 2009)**

In an issue of first impression, the Delaware Supreme Court affirmed the Delaware Court of Chancery's 2008 holding that the statute of frauds applied to an oral LLC agreement. One of Viking LLC's founders, Brian Olson, sued Viking in the Court of Chancery for, among other things, breach of contract, arguing he was entitled to an earn-out under a draft agreement that was never signed. The Court of Chancery had held below (1) that the statute of frauds applied to LLC operating agreements, and therefore prevented enforcement of oral LLC agreements requiring more than one year to complete; (2) because the draft earn-out agreement could not be calculated until after one year following the draft agreement, the agreement fell within the statute of frauds and was unenforceable; and (3) Olson did not satisfy the multiple-writing exception to the statute of frauds. The Court of Chancery granted summary judgment in favor of Viking on Olson's breach of contract claim, and Olson appealed.

The Delaware Supreme Court affirmed the Court of Chancery's decision. Applying principles of statutory interpretation, the court found that it could construe the Delaware LLC Act and the statute of frauds harmoniously, and the statute of frauds thus applied to LLC agreements. The court held that the "LLC Act's explicit recognition of oral and implied LLC agreements does not preclude the statute of frauds. Rather, such legislative recognition indicates that an LLC agreement operates like any other oral, written or implied contract, *i.e.*, it requires compliance with the statute of frauds." Thus, the statute of frauds did not contradict the legislature's policy of giving "maximum effect" to LLC agreements. The court concluded that "[i]f the General Assembly intends to limit the application of the statute of frauds by removing LLC agreements from its scope, the General Assembly must say so explicitly." The court ultimately held that "the Delaware LLC Act does not preclude application of the statute of frauds to LLC agreements. Therefore, the statute of frauds applies to LLC agreements, and the Vice Chancellor correctly so held."

## Loss Causation

### Circuit Split Develops Over Whether *Dura* Loss Causation Principles Apply to Sentencing Enhancements for Criminal Securities Fraud

***United States v. Berger*, No. 08-50171 (9th Cir. Nov. 30, 2009)**

The U.S. Court of Appeals for the Ninth Circuit declined to follow the lead of the Fifth and Second Circuits in applying loss causation principles enunciated by the U.S. Supreme Court in *Dura Pharmaceuticals, Inc. v. Broudo* to the sentencing of a defendant in a criminal prosecution for securities fraud. The district court concluded that it did not need to apply *Dura* in determining the appropriate sentence of Richard I. Berger—the former CEO of Craig Consumer Electronics, Inc. who was convicted for securities violations in March 2003. Instead, the district court, in evaluating shareholder loss from the fraud, adopted the government's "modified market capitalization theory," which extrapolates based on the changes in stock value of other, unaffiliated companies after accounting irregularities were disclosed to the market about those companies.

The Ninth Circuit agreed with the district court that *Dura* does not apply to criminal sentencing, but nonetheless held that the district court erred in adopting the government's "modified market capitalization theory" in enhancing Berger's sentence. In refusing to extend *Dura* to criminal sentencing, the Ninth Circuit found that the policies for demonstrating loss in the civil context (where the focus is on loss to plaintiff) are different than those present in the criminal context (where the focus is on loss to society). The court also found that the federal sentencing guidelines themselves support a measure for loss in the criminal context that is less stringent than *Dura*. The Ninth Circuit, nonetheless, reversed and remanded because it found "troubl[ing]" the government's "modified market capitalization theory," which extrapolated from unrelated companies that, different from the case at bar, actually disclosed the fraud. While rejecting the government's theory, the court did suggest that, unlike in the civil context, the government may show "loss" in the criminal context even if the defendant never discloses the fraud to the market, so long as there is evidence that the stock was overvalued "because of the fraud."

### D.C. Federal Court Dismisses Section 10(b) Claims Relating to Fraud Involving a Company's Subsidiary

***Ross v. Walton*, No. 1:07-CV-00402 (D.D.C. Nov. 4, 2009)**

Senior Judge Jack D. Shanstrom of the U.S. District Court for the District of Columbia dismissed purported class claims that Allied Capital Corp., its chairman and CEO, its CFO and its COO (who also was a director) violated Section 10(b) of the Securities Exchange Act by failing to disclose that Allied Capital's finances were inflated by a fraud involving one of its subsidiaries. An executive at that subsidiary had been indicted for fraudulently originating Small Business Administration loans. That executive pled guilty, was unable to implicate senior managers at the subsidiary and was ordered to pay $30 million in restitution to the subsidiary. Allied Capital had disclosed the indictment after it was unsealed. The court applied Rule 9(b)'s and the PSLRA's heightened pleading standards and determined that the complaint did not provide compelling evidence that the defendants knew of the fraud, that the executive's inability to identify senior managers who knew of the fraud weighed against scienter and that the $30 million restitution order indicated that the subsidiary was the "primary victim" of the executive's fraud. In addition, even if the complaint adequately pled scienter, Judge Shanstrom also determined that the complaint did not plead loss causation under the aforementioned *Dura* case. The court recognized that, although the plaintiffs were not obligated to have sold their holdings in Allied Capital to demonstrate loss causation, the plaintiffs were obligated to show that the corrective disclosure—Allied Capital's disclosure of the indictment—caused a decline in the stock price. Because the stock price was higher than the price plaintiffs paid to purchase the stock shortly after the end of the class period, the plaintiffs had not suffered the "actual economic loss" contemplated by *Dura*. Moreover, because the PSLRA did not create the presumption of a causal connection between a corrective disclosure and the decline in the stock price, the plaintiffs did not "overpa[y]" for Allied Capital's stock because of the fraud if—following the fraud's disclosure—the stock price was subsequently greater than their purchase price.

## Materiality

### Ninth Circuit Affirms Dismissal of Action Against FoxHollow Technologies for Failure to Identify a Material Falsehood

***In re FoxHollow Techs., Inc. Sec. Litig.*, No. 08-16469 (9th Cir. Dec. 4, 2009)**

In an unpublished opinion, the U.S. Court of Appeals for the Ninth Circuit affirmed the dismissal of a putative class action brought against FoxHollow Technologies, Inc. alleging violations of Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder based on various purported misrepresentations relating to FoxHollow's personnel philosophy and plans. Plaintiffs alleged that FoxHollow violated Rule 10b-5 by failing to update its prior statements about its general personnel plans (which purportedly indicated that FoxHollow would not fire its executives) and by allegedly misleading the public into believing that its former CEO resigned voluntarily for personal reasons. Without deciding whether the Ninth Circuit imposes a duty to update statements that were true when made upon a change in circumstances, the court concluded that the defendants had no such duty to update, even if one existed, because FoxHollow's earlier statements "did not contain any clear, factual, forward-looking representation that all senior management would be left in place." Nor could plaintiffs base a claim on FoxHollow's alleged material misstatements about the reasons for its former CEO's resignation because "[*p*]*ro forma* claims that an executive is leaving a company for personal reasons are ubiquitous and transparent," with reasonable people "usually…not mak[ing] investment decisions in reliance on them."

### Illinois District Court Grants Summary Judgment Disposing of Class Action Relating to the Sears-Kmart Merger

***Levie v. Sears Roebuck & Co.*, No. 04 C 7643 (N.D. Ill. Dec. 18, 2009)**

After having denied defendants' motion to dismiss and having certified a class of investors, Judge Robert W. Gettleman of the U.S. District Court for the Northern District of Illinois granted summary judgment in favor of Sears Roebuck & Co. and its CEO Alan Lacy (the Sears defendants), disposing of Securities Exchange Act claims relating to the Sears defendants' purported failure to disclose Sears' merger negotiations with Kmart before and during the class period. In so holding, the court observed that "there is no general duty to disclose merger negotiations," and, accordingly, plaintiffs could only proceed with their Securities Exchange Act claims if the Sears defendants needed "to disclose the merger negotiations in order to make the statements made during the class period non-misleading." The court held that the Sears defendants never made any public statements during the negotiations that triggered such a duty to disclose. As for their statements prior to the merger negotiations, the court found that "these statements could not create a duty to disclose something that had yet to occur." With regard to their statements during the merger negotiations approving of Vornado Realty Trust's acquisition of 4.3 percent of Sears' shares (the Response), the court found that the Sears defendants' alleged failure not to mention the merger negotiations in the Response did not violate the Securities Exchange Act because the merger negotiations did not "relate directly to" nor were they "sufficiently linked to the express statements made [in the Response] so as to render them inaccurate or misleading." The court also found that the merger negotiations were still preliminary and, as a result, had not become sufficiently material to require disclosure at the time of the Response. Finally, the court held that Sears was not obligated to mention the merger negotiations in the Management, Discussion and Analysis of Financial Condition (MD&A) section of its Form 10-Q because, among other things, the SEC expressly exempts companies from disclosing such merger negotiations in an MD&A "where, in the registrant's view, inclusion of such information would jeopardize completion of the transaction."

### Texas District Court Dismisses Putative Class Action Against Cano Petroleum Without Leave to Amend

***Truk Int'l Fund L.P. v. Wehlmann*, No. 4:09-CV-308-A (N.D. Tex. Dec. 3, 2009)**

Judge John McBryde of the U.S. District Court for the Northern District of Texas dismissed a putative class action brought against, among others, Cano Petroleum, Inc., alleging that defendants violated Sections 11, 12 and 15 of the Securities Act by making material misrepresentations and misstatements of fact in Cano's offering documents. Specifically, plaintiff alleged that Cano violated the Securities Act by misstating its estimated "proved reserves," *i.e.*, its estimated quantities of reasonably recoverable oil and gas in mineral properties. The plaintiff alleged that, upon Cano's revision of its estimated proved reserves, Cano's shares (which were offered at $8 to the public roughly one month earlier) fell "sharply and immediately" to $3.73.

The court held that the plaintiff failed to allege any material misstatement adequately. Central to its holding, the court found that the "cautionary statements in the Offering Documents made clear that the proved-reserve numbers stated in the documents were estimates as of June 30, 2007, and that a large number of factors could cause the estimates to be lower if recalculated as of the date of the offering." The court additionally rejected, both as a matter of fact and law, the plaintiff's argument that Cano's alleged misstatements about its proved reserves must have been material because Cano's stock price purportedly fell "sharply and immediately" to $3.73 following Cano's revision of its estimates. The court, taking judicial notice of publicly reported stock prices and broader market and economic conditions, found that Cano's stock price did not tumble "sharply and immediately" from $8 to $3.73, as the complaint implied, but rather had already dropped to $5.40 before Cano's revised estimates and "more likely" continued to drop to $3.73 after the revision because of "falling oil prices at the time or the faltering economy" (and not because of Cano's revision of its estimated proved reserves). Observing that a "two-day decline of only $1.67 per share could owe to nothing more than the vicissitudes of the stock market," the court concluded that the decrease in Cano's stock price did not even "*suggest*" that Cano's alleged misstatements about its estimated proved reserves were material.

The court also rejected the plaintiff's request for leave to amend because—although the plaintiff's opposition to Cano's motion to dismiss included a tentative request to amend the complaint in a footnote—the plaintiff did not file a motion for leave to amend, identify any allegations that it would make to cure its pleading deficiencies, or submit a proposed amended complaint with its opposition to Cano's motion to dismiss. As such, the district court concluded that "defendants should not be subjected to any further costs of litigation."

## Sanctions

### Chancery Court Levies Significant Sanctions Against Party That "Wiped" Computer System

***TR Investors LLC v. Genger*, No. 3994-VCS (Del. Ch. Dec. 9, 2009)**

The Delaware Court of Chancery levied significant sanctions against a party that was found to have intentionally erased potentially relevant, electronically stored information from a company's computer system through the use of sophisticated "wiping" software that targeted information from deleted files remaining in "unallocated" space on company servers. In *TR Investors LLC v. Genger*, the court, relying on *Beard Research* and *Triton*, among other cases, found that the defendant's conduct in wiping clean certain portions of a company server and the defendant's hard drive was in violation of a status quo order issued by the court, warranting sanctions for both contempt and spoliation. Though the court stopped short of issuing a default judgment against the defendant, the "stringent" sanctions imposed against the defendant included (1) requiring him to produce certain documents to which he may otherwise have been able to claim privilege; (2) elevating the burden of persuasion for any defenses or counterclaims that he intended to raise in the action (*e.g.*, if the defendant were required to prevail by preponderance of the evidence on an affirmative defense, he would now be required to prevail by clear and convincing evidence); (3) preventing him from prevailing on any factual issue if the only evidence introduced on the issue is his own testimony; and (4) the payment of at least $750,000 in attorneys' fees and expenses to the plaintiffs' counsel.

In reaching its decision, the court concluded that the defendant acted intentionally, and at a minimum, recklessly. The court held that "[e]ven if [the defendant] did not act with malevolent intent to limit the universe of evidence available to [the opposing party], he was certainly reckless in charging [his technical advisor] to erase all the information of the unallocated space of [the company's] computer system in the face of pending litigation and a judicial order not to destroy or tamper with [the company's] information." The court further stated that if the defendant "believes that running wiping software without advice of counsel or court permission in this context does not constitute recklessness, he has an unusual dictionary. The law uses a more traditional lexicon."

## Scienter

### Sixth Circuit Affirms Dismissal of Diebold Securities Class Action for Failure to Plead Scienter

***Konkol v. Diebold, Inc.*, No. 08-4572 (6th Cir. Dec. 22, 2009)**

The U.S. Court of Appeals for the Sixth Circuit strictly applied the PSLRA's requirement that plaintiffs plead a strong inference of scienter in affirming the district court's dismissal of a securities class action relating to an alleged accounting fraud committed by Diebold, Inc., a publicly traded company that manufactures, distributes and services electronic voting machines and automated teller machines. The complaint alleged that Diebold and various other defendants violated Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder by issuing false and misleading financials that prematurely recognized revenue in violation of GAAP.

In affirming the district court's dismissal, the Sixth Circuit addressed and rejected each of the plaintiffs' nine arguments that the plaintiffs adequately pled scienter. First, the defendants' "access to information" could not support an inference of scienter because the complaint failed to include detailed allegations regarding the substance of the information to which the defendants purportedly had access. Second, the defendants' sale of nearly 40,000 shares after Diebold issued its allegedly false earnings report could not support an inference of scienter because the plaintiffs failed to present a "'meaningful trading history'" to show that the defendants' sales were out of the ordinary. Third, the "[n]ature and [p]ervasiveness of [the] [d]efendants' [a]ccounting [v]iolations"—which the plaintiffs alleged were egregious and basic—could not support an inference of scienter. As the court recognized, the complaint failed to specify the amount of overstated revenue, and GAAP violations alone cannot support an inference of scienter. Fourth, the confidential witnesses' accounts of the alleged fraud could not provide an inference of scienter because the accounts were too generalized and did not connect the defendants to the alleged scheme. Fifth, the short proximity of time between the purported false statements and the disclosure of the fraud could not provide an inference of scienter either. While noting that "[t]he difference of only three days [between the purported false statements and the corrective disclosure] suggests that the [d]efendants knew or had reason to know" of the falsehoods, the proximity of time "alone…does not support a strong inference of scienter." Sixth, the government's investigation into Diebold's operations did not create a strong inference of scienter because, among other things, "[g]overnment investigations can result from any number of causes." Seventh, although the defendants' alleged statements during the class period showed generalized knowledge of Diebold's overall profits and growth, they did not demonstrate that the defendants knew about Diebold's revenue-recognition practices. Eighth, statements contained in memos prepared by Diebold's counsel could not support an inference of scienter because there was no allegation that the defendants "read, received or were informed of the existence of these memos." Finally, the defendants' purported inability to come up with a plausible non-fraud explanation for the alleged accounting errors was no substitute for the plaintiffs' failure to plead scienter. Having found that plaintiffs failed to plead scienter (or propose an amended complaint that did not suffer from the same infirmities), the Sixth Circuit affirmed the dismissal without leave to amend.

## Securities Act

### S.D.N.Y. Dismisses IPO Registration Statement Claims

***In re Agria Corp. Sec. Litig.*, No. 08 Civ. 3536 (WHP) (S.D.N.Y. Nov. 30, 2009)**

Judge William H. Pauley III of the U.S. District Court for the Southern District of New York dismissed claims that Agria Corp., nine of its officers and directors, its largest shareholder and four IPO underwriters violated Sections 11 and 12(a)(2) of the Securities Act by making allegedly misleading statements or omissions in Agria's IPO registration statement. Agria operates in China through contractual arrangements with another company, Primalights III Agriculture Development Co. (P3A), owned by four individuals, including Agria COO Zhixin Xue and the wife of Agria Chairman and Co-CEO Guanglin Lai. Agria disclosed in the registration statement that it relied on its contracts with P3A and on its management to operate, and that any associated legal proceedings (if necessary) would be uncertain, because they would occur in China. Five months after its IPO, Agria disclosed that Xue resigned as COO but would remain P3A's chairman and legal representative. Agria also disclosed that its board learned two months after the IPO that Lai was discussing with Xue paying him a significant sum of money and transferring 22 percent of Agria from its largest shareholder to Xue and his designees to better align P3A's interests with Agria's. The press release attached Xue's e-mails threatening to resign unless he received those payments. The complaint alleged that it was a material misrepresentation or omission to not disclose the negotiations with Xue and his threat to resign, because negotiations must have been under way when the registration statement was issued given that Lai approached the board two months after the IPO with the proposed transaction with Xue. Judge Pauley, applying *Bell Atlantic Corp. v. Twombly* and *Ashcroft v. Iqbal*, determined that the complaint supported a plausible inference that Lai and Xue had been discussing the issue at the time of the IPO as Lai proposed the transaction—with a multimillion-dollar cash payment and significant transfer of stock—to the board two months later. Similarly, it was plausible that Xue's threat to resign as COO was a significant risk to Agria's operations and financial condition. However, the court concluded that the failure to disclose Lai's and Xue's discussions did not render Agria's registration statement misleading, because it disclosed the importance of the relations among P3A, Agria and its officers, and Xue only controlled 30 percent of P3A's stock at the time of the negotiations. Similarly, there was no duty to disclose informal compensation negotiations—such as Lai's with Xue—until Lai formally proposed the transaction to the board, which happened after the IPO.

### S.D.N.Y. Dismisses Section 12(a)(2) Violation Claims Because of Government-Instrumentality Exemption

***In re Fannie Mae 2008 Sec. Litig.*, No. 08 Civ. 7831 (PAC) (S.D.N.Y. Nov. 24, 2009)**

Judge Paul A. Crotty of the U.S. District Court for the Southern District of New York dismissed claims that Fannie Mae, its officers and its underwriters violated Section 12(a)(2) of the Securities Act by making untrue statements of material facts and by omitting other material facts in offering circulars for five securities offerings in 2007 and 2008. Judge Crotty first concluded that Fannie Mae is a government instrumentality "because of its fundamental government-like attributes." Consequently, because Section 3(a) of the Securities Act exempts securities issued by entities acting as a government instrumentality, Fannie Mae's securities do not need to comply with the Securities Act. Because the securities are exempted from compliance with the Securities Act, none of the defendants was subject to Securities Act liability in connection with those securities. Further, Fannie Mae's statutory charter provides that its stock was issued by the United States, and thus its securities are exempt from compliance with the Securities Act, even though Fannie Mae's offering circular states that its obligations "are not those of the United States or of any agency or instrumentality thereof," because the United States was not insuring holders against any losses attributed to Fannie Mae's common or preferred stock.

## Securities Fraud Pleading Standards

### Massachusetts Federal Court Dismisses Section 10(b) Claims Related to Medical Device Billing

***NECA-IBEW Pension Fund v. Neurometrix Inc.*, No. 08-10434 (D. Mass. Dec. 8, 2009)**

Judge Rya W. Zobel of the U.S. District Court for the District of Massachusetts dismissed claims that Neurometrix, its CEO, CFO and COO violated Section 10(b) of the

Securities Exchange Act because the complaint did not allege any material misrepresentations or omissions about reimbursement for one of its medical devices, NC-Stat. Neurometrix encouraged doctors to bill their use of NC-Stat to neurology reimbursement codes, making the use of NC-Stat highly profitable for doctors. However, two directors of reimbursement at Neurometrix and some insurers—with more joining over time—disagreed with the use of those codes to reimburse for NC-Stat. Neurometrix disclosed that it believed that NC-Stat use should be reimbursed under the profitable neurology codes and that some insurers disagreed with the use of neurology codes for NC-Stat. The risk if insurers declined to reimburse for NC-Stat use under the neurology codes was more clearly disclosed as more insurers declined to reimburse for NC-Stat use under the neurology codes. Further, there were no "pervasive" billing problems when Neurometrix made three statements about reimbursement rates, because at the time only one insurer had declined to reimburse through the neurology codes, and two clients were dissatisfied. Finally, the COO's statements on three conference calls about the neurology codes were not false, because he did not claim that those codes were "weighted or valued" for NC-Stat, and the complaint did not allege that he did not believe his statements were true. In addition, the complaint did not allege his statements were wrong, as they only alleged that two directors of reimbursement at Neurometrix and some insurance companies disagreed with the COO's belief that the neurology codes applied to NC-Stat. This ruling was appealed on Jan. 7, 2010.

### Georgia Federal Court Dismisses Claims Involving Marketing of Financial Products to Subprime Consumers

***Waterford Twp. Gen. Employees Ret. Sys. v. CompuCredit Corp.*, No. 1:08-CV-2270-TWT (N.D. Ga. Dec. 3, 2009)**

Judge Thomas W. Thrash, Jr., of the U.S. District Court for the Northern District of Georgia, dismissed claims that CompuCredit Corp. and four of its officers violated Section 10(b) of the Securities Exchange Act by making false or misleading statements about its earnings, the strength of its business, and FDIC and FTC investigations of how it marketed financial products (including credit cards) to subprime consumers. Judge Thrash determined that the complaint adequately pled with particularity how CompuCredit misrepresented its marketing practice, and that those were sufficiently related to its statements about the strength of its business, the legality of those practices, and the FDIC and FTC investigations. However, because CompuCredit was not required to predict the outcome of those investigations and it had sufficiently detailed the risk of a material adverse effect from those investigations, the complaint did not state a plausible claim for relief. Similarly, the complaint did not adequately plead scienter, because there were no allegations that the defendants knew CompuCredit's conduct was illegal. The complaint could not plead scienter by pointing to the individual defendants' positions at CompuCredit without pleading that someone at CompuCredit knew CompuCredit's conduct was illegal or by alleging that the individual defendants were motivated to keep the stock price high because their compensation included CompuCredit equity. Additionally, the complaint did not provide the necessary allegations about specific trades to show that the individual defendants acted by reference to their stock trading practices. Finally, the court noted that the complaint failed to allege loss causation, because the plaintiff had sold its stock before CompuCredit disclosed the FDIC and FTC enforcement actions and the complaint did not allege any earlier partial disclosures or describe their effect on CompuCredit's stock price.

## Stock Option Granting Practices

### California District Court Dismisses Criminal Indictment Against Broadcom Executives

***United States v. Ruehle*, No. SACR 08-00139-CJC (C.D. Cal. Dec. 15, 2009)**

After the close of evidence in an eight-week trial, Judge Cormac J. Carney of the U.S. District Court for the Central District of California dismissed the government's indictment against William J. Ruehle, the former chief financial officer of Broadcom Corp., a California-based semiconductor company. The government alleged that Ruehle and others backdated employee stock options and understated Broadcom's stock-based compensation expenses by more than $2.2 billion. During the trial, Ruehle argued, among other things, that the accounting guidelines at issue were unclear and were misapplied by hundreds of other companies, and that even the government's witnesses did not believe that a crime was committed at the time. In dismissing the indictment against Ruehle and granting judgment of acquittal, Judge Carney held that the government failed to prove that Ruehle had the intent "necessary to violate any of the laws alleged in the indictment," and that the government's legal team had engaged in prosecutorial misconduct by, among other things, "intimidat[ing] and improperly influenc[ing] the three witnesses critical to…Ruehle's defense." Judge Carney also dismissed the indictment against Broadcom co-founder Henry T. Nicholas III (whose trial was scheduled to commence in February 2010); vacated the guilty plea of Broadcom's co-founder Henry Samueli (who had previously pled guilty to making false statements to the SEC); and dismissed without prejudice the SEC's companion case (which the court discouraged the SEC from refiling) against Ruehle, Nicholas, Samueli and former Broadcom general counsel David Dull.

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# Caveat Corporate Litigator: The First Circuit Sets Back the Attorney Work Product Doctrine

By C. Evan Stewart

I have been writing articles about the attorney work product doctrine since 1987.[1] After Judge Pierre Leval delivered his thoughtful and eminently correct decision on that doctrine in *U.S. v. Adlman*[2] on behalf of the Second Circuit, however, I thought that much of the disinformation, misunderstanding, and mischief regarding work product would cease.[3] I was wrong.

### *Adlman*

Judge Leval's opinion on *Adlman* is a necessary predicate to understand where we now find ourselves. In *Adlman*, an in-house lawyer for the Sequa Corporation (Monroe Adlman) asked the company's outside accounting firm to evaluate the tax consequences of a proposed corporate reorganization. The accounting firm did so in a detailed memorandum, setting forth, among other things, an analysis of the likely bases of an IRS challenge to a large tax refund claim the company was likely to interpose as a result of the reorganization.

After Sequa went through with the transaction and claimed the hefty refund, the IRS did indeed bring on an audit, which led to a subpoena for documents that included the accounting firm's memorandum. When Sequa and Mr. Adlman declined to produce the document, the IRS sought to enforce the subpoena before Judge Knapp in the Southern District of New York.

Sequa and Mr. Adlman claimed the protections of the attorney-client privilege and the work product doctrine. Judge Knapp rejected both, however. With respect to the attorney-client privilege, he found that Mr. Adlman had not consulted the accounting firm to receive legal advice. And as to work product, Judge Knapp ruled that that doctrine was not applicable because the memorandum was prepared for litigation that was based on events purely prospective in nature.

In 1995, the Second Circuit partially affirmed the rulings of Judge Knapp (*Adlman I*).[4] In rejecting the claim of attorney-client privilege, the court found that "the evidence supports the conclusion that Sequa consulted an accounting firm for tax advice, rather than that Mr. Adlman, as Sequa's counsel, consulted [the accounting firm] to help him reach the understanding he needed to furnish legal advice." At the same time, however, the court remanded the case on the work product issue. The court ruled that whether or not the events had not yet occurred was immaterial to an analysis under Fed. R. Civ. P. 26(b)(3); the proper standard to be applied was whether the memorandum was prepared in anticipation of litigation that could result from engaging in the proposed conduct.

Judge Knapp, with the foregoing guidance, still was not moved. On remand, he again rejected the claim of work product, and the issue once more went back to the Second Circuit.

In *Adlman II*,[5] a Second Circuit panel headed by Judge Leval ruled in 1998 that the requisite showing under Rule 26(b)(3) to protect attorney work product materials prepared "in anticipation of litigation" was just that—whether the materials had been, in fact, prepared "in anticipation of litigation." Judge Leval's decision rejected a growing number of decisions which imposed a gloss on the language of Rule 26(b)(3), requiring a showing that the sought after materials had been generated "primarily," "principally," or "exclusively" in anticipation of litigation.[6] After a review of the policies underscored by the Supreme Court in *Upjohn* and *Hickman v. Taylor*,[7] Judge Leval termed the IRS's position that it should be entitled to the documents as "untenable":

> If the company declines to make [a candid analysis of litigation risks] or scrimps on candor and completeness to avoid prejudicing its litigation prospects, it subjects itself and its co-venturers to ill-informed decision making. On the other hand, a study reflecting the company's litigation strategy and its assessment of its strengths and weaknesses cannot be turned over to litigation adversaries without serious prejudice to the company's prospects in the litigation.[8]

Consequently, Judge Leval determined that, for purposes of determining whether a document was prepared "in anticipation of litigation," the relevant standard would be to ascertain whether the document was created "because of" the prospect of litigation. On the heels of *Adlman II*, most other courts followed Judge Leval's "because of" standard; it thus seemed that practicing lawyers could predict with some certainty where the work product goal posts were.[9] That all changed, however, when the First Circuit decided to change the rules.

### *Textron*

In connection with an audit of Textron's tax returns, the IRS discovered that a Textron subsidiary had utilized a number of tax shelters about which the IRS had questions. That led to the IRS issuing an administrative summons, seeking all of Textron's tax-related work papers for one of the years under audit. Textron partially resisted the summons, withholding certain documents, including spreadsheets prepared by Textron's lawyers; those spreadsheets (i) listed reserve items for which the ultimate tax treatment was uncertain, and (ii) estimated the likelihood of success with respect to each item in the event of a dispute with the IRS. Textron cited the attorney-client privilege and the work product doctrine as reasons for its non-compliance with the summons.

The district court ultimately denied the IRS's request for enforcement of its summons.[10] While the court acknowledged that the IRS had a legitimate reason for seeking the materials,[11] and while it rejected the claim of attorney-client privilege because Textron had shown the materials to its outside auditors,[12] the court nonetheless ruled that the materials were protected under the work product doctrine and thus not discoverable.[13]

Unlike the attorney-client privilege, disclosure of attorney work product to a non-adverse party (e.g., a company's auditor) does not automatically waive attorney work product protections.[14] Having disposed of the waiver issue, the court then looked to Judge Leval's analysis in *Adlman* (which had subsequently been adopted by the First Circuit)[15] in resolving the matter:

> [I]t is clear that the opinions of Textron's counsel and accountants regarding items that might be challenged by the IRS, their estimated hazards of litigation percentages and their calculation of tax revenue amounts would not have been prepared at all "but for" the fact that Textron anticipated the probability of litigation with the IRS.[16]

On appeal to the First Circuit, a divided three-judge panel affirmed the district court. The First Circuit *en banc*, however, agreed with the IRS's petition for a rehearing *en banc* and vacated the earlier appellate affirmance.

After oral argument before the entire First Circuit, the court, by a three-to-two vote, reversed the district court and ruled that the work product doctrine did not shield the spreadsheets from disclosure to the IRS.[17] The three-judge majority endorsed a new test for evaluating work product: were the documents created "for use" in litigation—i.e., would the materials "in fact serve any useful purpose for Textron in conducting litigation if it arose."[18] Because tax accrual work papers are prepared in the normal course for a public company seeking a "clean" opinion from its auditors, the majority opined that "[a]ny experienced litigator" would not describe such documents "as case preparation materials."[19] The majority was not impressed with Textron's argument that it would be "unfair" for the IRS to have access to the spreadsheets because it would give the IRS a huge advantage in its litigation with Textron, observing that "the essential public interest in revenue collection" trumped any notions that litigation should be a relatively fair fight.[20]

## The Dissent

The two-judge dissent right off noted that the majority decision flew in the face of the First Circuit's own precedent.[21] It next observed (correctly) that the majority's "prepared for" test "is an even narrower variant of the widely rejected 'primary motivating purpose' test used in the Fifth Circuit."[22] The majority's test, moreover, "ignores a tome of precedents from the circuit courts and contravenes much [sic] of the principles underlying the work-product doctrine"; indeed, it even "brushes aside the actual text of Rule 26(b)(3)."[23]

The dissent then went through a careful recitation of the analysis articulated by Judge Leval in *Adlman*, and how that analysis (and the "because of" test) were consistent with the text of Rule 26(b)(3) and the underlying goals and policies of the work product doctrine (as originally articulated by the Supreme Court in *Hickman v. Taylor*).[24] In fact, as the dissent observed, under the "because of" standard, the spreadsheets "contain exactly the sort of mental impressions" that the work product doctrine was designed to protect.[25] And as the dissent conversely observed, under the majority's "prepared for" test, there would be no protection for attorney documents analyzing anticipated litigation; the judges thus warned lawyers going forward "that their work product is not protected in this circuit."[26]

The dissent concluded by acknowledging that the IRS would surely be happy about this sharp change in the law, thus allowing the agency to have a new and "important tool in combating [tax] fraud."[27] But given the fact that the majority's decision "has thrown the law of work-product into disarray,"[28] the dissent called upon the Supreme Court "to intervene and set the circuits straight on this issue which is essential to the daily practice of litigators across the country."[29]

## The Supreme Court

Textron has asked for certiorari review by the Supreme Court.[30] The Court declined to exercise its jurisdiction, however. With the Court's decision not to weigh in, it is clear that the majority's ruling in *Textron* unleashes (like Pandora's Box) widespread mischief into the lives of corporate litigators. First, if only documents "prepared for" litigation are covered, then the universe of protected materials has shrunk enormously; conversely, the amount of motion practice to get access to this increased universe of materials will surely rise commensurately. Careful lawyers will undoubtedly react by reducing their litigation analyses to writing (or eliminating them altogether); as Judge Leval (and others—e.g., the Supreme Court) have observed, such a result would be hard to reconcile with good corporate decision making.[31] Other foreseen (and unforeseen) consequences also lurk. As the dissent in *Textron* noted, for example, under the majority's approach litigation reserve decisions and specific amounts thereof are likely fair game under the "prepared for" test.[32]

## Conclusion

At bottom, the majority's decision in *Textron* is wrongly decided and will have many bad results flowing from it—unless the Supreme Court steps in and overrules it. As the Eighth Circuit made clear over three decades ago in one of the truly seminal decisions on work product, the doctrine protects litigation analysis, wholly without regard to "use" in the litigation at issue; indeed, the analysis can be for litigation that is terminated or unrelated to the litigation at issue.[33] Furthermore, the type of litigation analysis done by the Textron lawyers is/was clearly *opinion* work product, attorney materials which "enjoy[ ] a nearly absolute immunity and can be discovered only in very rare and extraordinary circumstances."[34] Such "very rare and extraordinary circumstances" were clearly not shown by the IRS in *Textron*—the agency only wanted the litigation materials to ensure that it would not have to be engaged in a fair fight. That should never be the governing principle. But until the Supreme Court sets the law back to its *Adlman* days, the cautions of the *Textron* dissent must be carefully heeded.

## Endnotes

1. *See, e.g.*, C. E. Stewart, *The Attorney Work Product Doctrine*, 92 Case & Comment, 1987; C. E. Stewart, *Corporate Counsel and Attorney Work* Product, N.Y.L.J., Nov. 8, 1993; C. E. Stewart, *Corporate Counsel and Privileges: Going, Going,…*, N.Y.L.J., July 11, 1996.
2. 134 F.3d 1194 (2d Cir. 1998).
3. *See*, *e.g.*, C.E. Stewart, *The Attorney-Client Privilege: The Best of Times, the Worst of Times*, The Professional Lawyer, 1999; C. E. Stewart, *Hickman v. Taylor Reinvigorated by the Second Circuit, with Important Benefits for Litigants*, ABA Pretrial Practice & Discovery, July, 1998.
4. 68 F.3d 1495 (3d Cir. 1995).
5. 134 F.2d 1194 (2d Cir. 1998).
6. *E.g.*, *In re Woolworth Corporation Securities Class Action Litigation*, 1996 WL 306576 (S.D.N.Y. June 7, 1996); *In re Leslie Fay Companies Inc. Securities Litigation*, 161 F.R.D. 274 (S.D.N.Y. 1995); *In re Kidder Peabody Securities Litigation*, 1996 WL 263030 (S.D.N.Y. May 17, 1996); *Garrett v. Metropolitan Life Ins. Co.*, 1996 WL 325725 (S.D.N.Y. June 12, 1996); *In re Wilkie Farr & Gallagher*, 1997 U.S. Dist. LEXIS 2927, 1997 WL 118369 (S.D.N.Y. March 14, 1997).
7. *U.S. v. Upjohn*, 449 U.S. 383 (1981); *Hickman v. Taylor*, 329 U.S. 497 (1947).
8. 134 F.3d at 1200.
9. *See*, *e.g.*, *In re Sealed Case*, 146 F.3d 881 (D.C. Cir. 1998); *In re Grand Jury Subpoena*, 357 F.3d 900 (9th Cir. 2004); *U.S. v. Roxworthy*, 457 F.3d 590 (6th Cir. 2006). Prior to the First Circuit's recent decision, the Fifth Circuit had been the principal outlier. *See In re Kaiser Aluminum & Chem. Co.*, 219 F.3d 586 (2000), *cert. denied*, 532 U.S. 919 (2001) (applying a "primary purpose" test).
10. *U.S. v. Textron, Inc.*, 507 F. Supp. 2d 138 (D.R.I. 2007).
11. *Id*. at 145.
12. *Id*. at 152. It is black letter law that disclosure of privileged materials to a third party waives the privilege. *See*, *e.g.*, *In re Subpoena Duces Tecum*, 738 F.2d 1367 (D.C. Cir. 1984).
13. *Id*. at 150.
14. *Id*. at 152-53.
15. *Maine v. U.S. Dep't of the Interior*, 298 F.3d 60 (1st Cir. 2002).
16. 507 F. Supp. 2d at 150. That the documents were useful in getting a "clear" opinion from Textron's auditors was beside the point insofar as "there would have been no need to create a reserve in the first place, if Textron had not anticipated a dispute with the IRS that was likely to result in litigation or some other adversarial proceeding." *Id*.
17. 577 F.3d 21 (1st Cir. 2009) (*en banc*).
18. *Id*. at 27, 30.
19. *Id*. at 28. *See also id*. at 31. *See generally U.S. v. Arthur Young & Co.*, 465 U.S. 805 (1984) (rejecting accountant work product privilege).
20. *Id*. at 31.
21. *See supra* note 15. Bizarrely, the majority argued that the "prepared for" test is not inconsistent with the "because of" test; that is obvious sophistry and clearly wrong. 577 F.3d at 32-34.
22. 577 F.3d at 32. *See supra* note 9.
23. 577 F.3d at 32.
24. *See supra* note 7.
25. 577 F.3d at 36.
26. *Id*. at 38.
27. *Id*. at 43.
28. *Id*.
29. *Id*.
30. *See* J. Finet & A. Bennett, *Textron Seeks Supreme Court Review of Ruling on Tax Accrual Work Papers*, ABA/BNA Lawyer's Manual on Professional Conduct 20, Jan. 6, 2010.
31. *See supra* notes 7, 8.
32. 577 F.3d at 37. The dissent noted its concern with this "sharp practice" becoming the norm. *Id*. Even before the *Textron* decision, the issue of disclosure of litigation reserves was on the radar screen of corporate litigators as being fraught with dangers to the attorney-client privilege and the work product doctrine. *See* August 8, 2008 letter from the Litigation Advisory Committee of the Securities Industry and Financial Markets Association to R. Hartz, Chairman, Financial Accounting Standards Board, regarding an amendment of FASB Statements Nos. 5 and 141(R). [This letter (and others commenting on the FASB proposals) can be found at http://www.fasb.org/home.].
33. *See In re Murphy*, 560 F.2d 326 (8th Cir. 1977). *See also* C. E. Stewart, *Jumping on a Hand Grenade for a Client*, Federal Bar Council Quarterly, Nov. 2009.
34. 560 F.2d at 336.

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# The Pendulum Begins to Swing Back: *Kohen v. PIMCO*

By David Pepper

The methods and techniques of manipulation are limited only by the ingenuity of man.[1]

## I. Introduction

"Commodity manipulation litigation is on the rise."[2] The pressure to curb the perceived influence of speculators on commodity prices has mounted, effectively forcing the Commodity Futures Trading Commission (CFTC) to spring into action. In turn, the CFTC has dramatically stepped up its enforcement efforts to combat the manipulative practices of certain players in the futures markets.[3] These enforcement actions have given rise to related private class action lawsuits alleging similar commodity manipulation claims on behalf of buyers, and sellers, who traded commodity futures contracts at artificial prices.[4] However, the road to recovery in a class action lawsuit alleging commodity manipulation is fraught with high hurdles and intimidating challenges. Before a class action can proceed to trial, or, in most instances, to settlement, the definition of the class must be certified by a court.[5] To get a class certified, the class action lawyer will need to deal with "surprisingly unsettled" questions of what standards govern a district judge in deciding a motion for class certification under Rule 23 of the Federal Rules of Civil Procedure.[6] Based on recent divergent opinions delivered by four appellate circuits, perhaps the most tricky required showing for class certification under Rule 23 is that of "predominance"—a plaintiff must show that issues common to the class predominate over issues affecting individual class members.[7] Then, if the class certification hurdle is successfully negotiated, the class action lawyer will face the daunting task of actually proving manipulation under the Commodity Exchange Act (CEA).[8] These challenges can best be explained by analyzing *Kohen v. Pacific Investment Management Co.*, the landmark commodity manipulation class action that is currently pending in the Seventh Circuit.[9]

## II. The PIMCO Controversy

### 1. Background

*Kohen v. PIMCO* was spawned by the controversy that roiled the market for Treasury futures in June of 2005. By the summer of 2005, the market for futures on 10-year U.S. Treasury notes was facing an increasing imbalance. Hedge funds and other investors had piled into the futures market, causing it to triple in size from 2000 to 2005, while the supply of bonds cheaply available to fulfill these contracts had dwindled.[10] The dollar volume of contracts traded had boomed, exceeding $200 billion as of August 2, 2005, compared with about $62 billion five years earlier.[11] Meanwhile, the amount of bonds available to deliver against those contracts had decreased, in part because the Treasury had been issuing shorter-dated bonds to finance U.S. budget deficits and also because more foreign investors, who tend to hold the bonds for longer periods, were buying them as well.[12]

Treasury futures contracts specify a number of different bond issues that are acceptable for delivery, but problems can arise when one of the deliverable bonds is a lot cheaper than the others and the traders who must deliver face a battle to get those scarce "cheapest-to-deliver" bonds. Certainly, some traders are winners in this scenario—those holding the cheapest-to-deliver bonds as demand pushes up the price.[13] In general, futures investors usually demand delivery on less than 10% of all contracts—they don't want to actually take possession of the underlying bond. More often, they trade their old contracts, which come due at the end of each quarter, for new ones.[14]

### 2. The Alleged Manipulation

From 2000 to 2004 the volume and open interest of the Chicago Board of Trade 10-Year Treasury note futures contract steadily increased while the available supply of Treasury notes deliverable in satisfaction of the futures contracts remained constant or declined; this made the futures contract susceptible to manipulation by a person in control of a large long position.[15] This growing imbalance in the Treasury futures market came to a head in June 2005, when market participants noticed a serious mismatch: only about $10 to $13 billion of cheapest-to-deliver, 10-year Treasury notes were available for the September futures contract, on which the total value of bets was as much as $170 billion.[16] That caused the price of the September contract to rise sharply, as market players bet those on the wrong side of the futures trade would have to deliver more expensive bonds.[17] The relevant contracts traded on the Chicago Board of Trade.

As it happened, one of the biggest bond fund managers in the world, Pacific Investment Management Co. (PIMCO), had amassed a colossal position in June 10-year futures—speculated to be as large as $14 billion.[18] PIMCO manages the retirement assets of many of the world's largest companies and employee organizations (including firefighters and teachers), as well as the bond portfolios of various governments, endowments, charitable organizations, corporations, and mutual funds.[19] PIMCO oversees about $756 billion of assets, including the $159 billion PIMCO Total Return fund run by the legendary bond guru Bill Gross.[20]

Typically, fund managers would simply "roll" their June contracts for September contracts, but because the price of the September contracts had risen so much, the trade became prohibitively expensive.[21] But when PIMCO decided to keep its June contracts, the market took that as a signal the firm would demand delivery. That caused a rush on the cheapest-to-deliver bonds—and there weren't enough of those cheapest-to-deliver bonds available to fulfill that demand.[22] It isn't known how many bonds PIMCO actually received, but the perceived demand for the cheapest-to-deliver bond for the June contract—a 10-year Treasury note maturing in February 2012—turned into real demand as investors scrambled and clamored to get that bond.[23] Adding to the urgency: the next cheapest-to-deliver bond was about a full percentage point more expensive than the February 2012 one, and the CBOT levies a fine of 1% of a contract's value on anyone who fails to deliver a bond.[24]

This shortage in the deliverable supply of the 10-year notes proved costly for many investors who had to pay a premium to get them, and caused deliveries in other parts of the bond market to fail.[25] This general inaccessibility of the cheapest-to-deliver bond caused the price of the June futures contract to rise sharply, because the market expected more expensive bonds to be delivered—a seemingly "uneconomic" outcome (as discussed further below). This created an unusual opportunity for anyone who was holding the cheapest-to-deliver bond to make an unusually large profit by selling that bond at the higher futures price.[26]

## III. Did PIMCO Illegally Manipulate The Market for the June Contract Under the CEA?

The extreme and historic imbalance between supply and demand in Treasury futures and the deliverable supply caught the attention of regulators and investors alike. Specifically, investors who were short the June Contract complained that PIMCO's actions artificially drove the price on the contract higher, forcing them to pay a "monopoly price" to cover their short positions.[27] In turn, several class action lawsuits were filed shortly thereafter on behalf of private investors, later consolidated as *Kohen et al. v. PIMCO* in the Northern District of Illinois.[28]

In *Kohen v. PIMCO*, plaintiffs Breakwater Trading LLC and Richard Hershey alleged that defendant PIMCO manipulated the prices of both the June futures contract as well as the cheapest-to-deliver Treasury note underlying that contract, in violation of §§ 9(a), 22(a) and 22(a)(1) of the Commodities Exchange Act (CEA).[29] By March 31, 2005, PIMCO held more than $16.3 billion in the June Contract, which plaintiffs claimed was of "unprecedented size." Plaintiffs also claimed that this long position exceeded the available supply of the cheapest-to-deliver Treasury note.[30] Additionally, from March 20, 2005 until the end of June 2005, PIMCO hoarded $13.3 billion worth of the February 2012 Treasury note, which was the cheapest-to-deliver Treasury note for the June Contract and was in excess of 75% of the deliverable supply of such notes.[31]

As the June Contract neared expiration, PIMCO held its long position in the June Contract, which plaintiffs claimed was "highly unusual." According to plaintiffs, physical deliveries in the market for Treasury futures occur less than 1% of the time because traders usually offset their future contract positions before their contracts mature.[32] After trading in the June Contract closed, PIMCO represented that it took deliveries on that contract and acquired a large position in the cheapest-to-deliver Treasury note "for investment purposes"; however, by September 30, 2005, defendants had sold all of their cheapest-to-deliver Treasury note holdings.[33] Plaintiffs alleged that the motive and intent underlying PIMCO's conduct was to profit from artificially high prices. Throughout the class period, May 9 to June 30, 2005, the pricing relationships and trading behavior of the June Contract and the cheapest-to-deliver note exhibited anomalies, which plaintiffs alleged evidenced an artificial market.[34] Plaintiffs claimed common injury resulting from the purchase of June Contracts during the class period at artificially high prices to cover their short positions, thereby incurring losses of $600 million.[35]

### 1. The Standard for Manipulation Under the CEA

Manipulation is the "intentional exaction of a price determined by forces other than supply and demand," its means "limited only by the ingenuity of humankind."[36] The futures market lends itself to manipulation more readily than a cash market.[37] Accordingly, Congress' raison d'etre for the CEA has been to prevent, and provide ample avenues of redress for, the manipulation of commodity futures contract prices by "big traders."[38] Under the CEA, it is a felony (1) to manipulate, (2) to corner, or (3) to make false reports concerning a commodity.[39] The CEA establishes a violation for market manipulation when (1) the defendant possessed an ability to influence market prices; (2) an artificial price existed; (3) the defendant caused the artificial prices; and (4) the defendant specifically intended to cause the artificial price.[40] The evidence of manipulation may be as varied as the means of a manipulation.[41]

### 2. Market Power Manipulations in the Futures Markets

Two of the most discussed forms of market manipulation are the "squeeze" and the "corner."[42] A "corner" amounts to a near monopoly of a cash commodity, coupled with the ownership of long futures contracts in excess of the amount of that commodity, so that shorts—traders who because of the monopoly cannot obtain the cash commodity to deliver on their contracts—are forced to offset their contract with the long at a price which the holder of the long position dictates, which of course is as high as the long holder can prudently make it.[43] Historically, a corner can only be performed through the purchase of long contracts in excess of the known deliverable supply, through purchase of the entire cash supply, or through a combination of both.[44] In a "squeeze," the manipulator acquires a dominant futures position and/or a dominant amount of the cash supply to allow the manipulator to demand artificial prices from traders who must make delivery in the face of a shortage of supply[45]—there might not be an actual monopoly of the cash commodity itself.[46] When analyzing the ability to influence prices under the corner or squeeze theories of manipulation, courts look to the defendant's ability to control parts of the market.[47] However, courts and administrative decisions point out that proof of manipulation does not always require market control.[48] "Buying or selling in a manner calculated to produce the maximum effect upon prices, frequently in a concentrated fashion and in relatively large lots," is one form of manipulation, among others.[49] Further, control of the relevant cash market is not a necessary element of manipulation.[50] Critics claim that market power manipulations, such as squeezes, cause costly distortions in consumption, production, storage, and commodity flows. By distorting relative prices, manipulation reduces the value of a futures contract as a hedging instrument. Given these various deleterious effects, a market power manipulation reduces the efficiency of a futures market as a risk transfer and price discovery mechanism.[51]

It should be noted that many squeezes do not involve intentional manipulation of futures prices, but are caused by various natural market forces, such as, for example, unusual weather conditions which have caused abnormally low crop production.[52] However, given a shortage of deliverable supplies for whatever reason, the futures price can be manipulated by an intentional squeeze where the holder of a long position acquires contracts substantially in excess of the deliverable supply and so dominates the futures market that he can force the shorts to pay his dictated and artificially high prices in order to settle their contracts.[53]

### 3. The *Kohen* Plaintiffs Alleged That PIMCO Engaged in an Illegal Manipulation Under the CEA, Thereby Causing Class-wide Injury

The *Kohen* Plaintiffs contended that PIMCO intended to cause artificial prices—specifically, they allege that PIMCO: (1) "knowingly" changed its behavior as the futures contracts became susceptible to manipulation by persons controlling a large long position by their acts of acquiring an "extraordinary large long position" and refusing to liquidate; (2) was well aware of this form of manipulation; (3) possessed both the motive and intent for the manipulative acts described in the complaint, namely to increase its financial return; and (4) intended to and did manipulate prices of the June Contract during the class period.[54]

One recurrent form of manipulation has been the "long-long" manipulation. In the "long-long" form of manipulation, a company that is long in the futures contract also buys (or goes "long") the deliverable instrument on that contract. The *Kohen* Plaintiffs allege that PIMCO engaged in a "long-long" manipulation by making unprecedented purchases of the deliverable supply (of cheapest-to-deliver bonds) during trading and by taking the largest deliveries in the history of the CBOT, thereby causing an all-time record divergence between the cash price and futures price.[55] Plaintiffs made several arguments regarding both the sheer size and the relative size of PIMCO's conduct—evidence was submitted that showed PIMCO's share of the open interest in June 2005 Contract long positions increased from 20% at the start of the alleged manipulation period on May 9, 2005, to 87% on the final day of all trading in that contract, on June 21, 2005.[56] Just as the time for deliveries on the June 2005 Contract began to draw near, PIMCO began to engage in the highly unusual conduct of purchasing large amounts of the cheapest-to-deliver note on that contract.[57] PIMCO had increased its share of the deliverable supply of the cheapest-to-deliver note from less than 12% on May 9, 2005 (the first day of the Class Period) to almost 42% by May 24, 2005[58]—by that date, PIMCO owned three times as many futures positions in the cheapest-to-deliver notes than were owned by other parties.[59] PIMCO, alone, took deliveries on more than 132,500 June 2005 Contracts—this amount was greater than the amount of deliveries taken by all traders combined on any previous U.S. Treasury 10-Year futures contract in the entire history of the CBOT.[60] PIMCO's all-time record insistence on deliveries, coupled with its purchases of $6 billion in the deliverable instrument during trading in the June 2005 Contract, provided PIMCO with $20 billion of the cheapest-to-deliver notes (Feb. 2012), more than 100% of the entire normally available supply of the deliverable instrument.[61] In sum, Plaintiffs argued that PIMCO's hoarding of the cash instrument amounted to an illegal corner—a key component of its illegal long-long manipulation.[62]

While the evidence of manipulation may be as varied as the means of a manipulation, one important type of evidence of manipulation is uneconomic conduct such as that outlined above.[63] If the firm's conduct would negatively impact a competitive price-taking firm but would cause changes in market prices that profit the larger firm, then inferences of manipulative impact and intent are suggested.[64] Plaintiffs argued that PIMCO engaged in uneconomic conduct predicated on causing and exploiting higher prices and special pricing relationships, by embarking on a course to take its all-time record deliveries.[65] Plaintiffs further alleged that PIMCO engaged in this uneconomic conduct with the specific intent to cause uneconomic deliveries of what PIMCO claimed was a poisonous, artificially inflated August 2012 note even for the September 2005 futures contract for which it was the cheapest-to-deliver note—and such note was much more artificially inflated as a basis to price the liquidation purchases paid by the shorts in the June 2005 Contract.[66]

### 4. PIMCO's Counterargument in Support of Its Motion to Dismiss the Complaint

PIMCO moved to dismiss the complaint pursuant to Rule 12(b)(6) for failure to state a claim upon which relief can be granted.[67] PIMCO based this motion on a losing argument: that the securities laws and the CEA should be construed analogously. Like the securities acts, PIMCO reasoned, the CEA seeks to protect those investors who are actually harmed by market manipulation, but it does not aim to provide generalized insurance to traders who speculate in the highly risky and volatile commodities markets.[68] PIMCO warned that permitting a CEA claim, like this one, to proceed without regard to whether the plaintiff suffered any actual damages proximately caused by the manipulation distorts the CEA into something "worse than a generalized insurance policy"—it makes the CEA a mechanism for awarding windfall profits to speculators who in fact benefited from any manipulation that occurred, "and of course, the class action device greatly magnifies that mischief."[69]

In furtherance of this policy argument, PIMCO attempted to apply the Supreme Court's decision in *Dura v. Broudo*, a landmark securities case, to the facts of *Kohen*, arguing that plaintiffs failed to state an actionable claim because the class definition included uninjured members.[70] In *Dura,* the Supreme Court reversed the Ninth Circuit's standard for pleading the element of loss causation for a securities fraud claim.[71] The Supreme Court ruled that merely alleging an inflated purchase price is inconsistent with the Securities Exchange Act of 1934's requirement that a plaintiff prove that a defendant's fraudulent conduct caused the plaintiff's economic loss.[72] In response, the Northern District of Illinois aptly noted, *Kohen v. PIMCO* is not a securities fraud case and, thus, the elements of proof are different.[73] Therefore, the District Court did not find *Dura* controlling on the issue of whether the class definition includes uninjured members. Judge Posner of the Seventh Circuit stated further that because the plaintiffs sold short, then, prima facie at least—being forced as they were to cover by June 30—they were injured if the price of cover was artificially inflated during the period between their sale and the delivery date.[74] Judge Posner quipped that PIMCO's "repeated, indeed obsessive" citations to *Dura* "suggest[ed] desperation."[75]

PIMCO made several other strained arguments. PIMCO represented that it took deliveries on the June Contract and acquired a large position in the cheapest-to-deliver Treasury note for "investment purposes." The District Court dismissed this argument, reasoning that by September 30, 2005, defendants had already sold all of their cheapest-to-deliver Treasury note holdings.[76]

PIMCO also argued that a mere refusal to liquidate its position in the June Contract is not the type of affirmative manipulative exacerbation that other courts have relied upon.[77] PIMCO argued that the type of manipulative intent that would suffice is evidenced by conduct summarized in *In re Indiana Farm Bureau Cooperative Association, Inc.:* "Manipulative intent may be inferred…where, once the congested situation becomes known to him, the long exacerbates the situation by, for example, intentionally decreasing the cash supply or increasing his long position in the futures market."[78] The District Court rejected this argument, ruling that although *In re Indiana Farm Bureau Cooperative Association, Inc.* set forth two situations in which manipulative intent may be inferred, that list is by no means exclusive.[79]

PIMCO further asserted that it did not have the ability to manipulate prices because the June Contract allows for delivery of a number of other Treasury notes besides the cheapest-to-deliver Treasury note.[80] PIMCO claimed that it only held 3.16% of the notes deliverable under the terms of the June Contract. In support of this argument, PIMCO cited the CFTC's decision in *In re Cox*: "the terms of the underlying futures contract should not be lightly ignored when calculating deliverable supply. If the terms of the contract permit delivery of premium grades of the commodity, then premium grades must be counted as part of the relevant supply, if otherwise available."[81] Therefore, PIMCO contended, June Contract prices could not have been artificial because the price was based on a mix of notes that were expressly deliverable under the terms of the June Contract, aside from just the cheapest-to-deliver note.

PIMCO's made one further last-gasp argument—it tried to defeat class certification by arguing that the class definition was impermissibly overbroad because it included individuals who had suffered no cognizable injury.[82] This was PIMCO's most interesting argument, and one that merits further discussion below.

### 5. The District Court Ruled That Plaintiffs Adequately Pleaded Their Manipulation Claim Under the CEA

The District Court noted that intent in a manipulation claim is a subjective inquiry and may be inferred from the facts alleged and the totality of the circumstances.[83] Accepting plaintiffs' factual allegations as true, and drawing all reasonable inferences in their favor, the District Court was persuaded that plaintiffs had adequately pleaded that defendants intended, at the time of acquisition, to cause an artificial price and subsequently exercised the ability to influence prices.[84] The District Court ruled that, considering the totality of the circumstances, it might reasonably be inferred that PIMCO intended to acquire a very large long position in the June Contract and a large position in the cheapest-to-deliver Treasury note and that PIMCO would be benefited by refraining from liquidating these positions and instead taking delivery of more valuable notes other than the cheapest-to-deliver Treasury note.[85] Moreover, in a market that was susceptible to manipulation by a dominant long position, it was reasonable to infer that PIMCO was well aware of its potential ability to influence prices and that it intended to manipulate the futures market at the time of acquisition of the large contract positions.[86] Accordingly, the District Court ruled that plaintiffs had sufficiently pleaded their claims that defendants violated the CEA.[87]

## IV. The Evolving Predominance Standard for Class Certification as it Relates to *Kohen v. PIMCO*

The *Kohen* Plaintiffs had negotiated a major hurdle in having their complaint sustained by the District Court; however, they were not yet out of the woods. For Plaintiffs' class action to proceed, a crucial, and controversial, question had to be answered: could they satisfy the requirements of Federal Rule of Civil Procedure 23 and get their class certified? The recent trend has been for appellate courts to instruct District Courts to scrutinize class certification motions more closely than before.[88] This trend has resulted in shifting, divergent standards for class certification across Federal circuits. Over the past three years, the challenge of convincing a court to certify a class can be likened to that of kicking a football, through strong shifting winds, between moving goal posts.

### 1. The Predominance Requirement For Class Certification Under FRCP 23(b)(3)

The *Kohen* Plaintiffs moved for class certification pursuant to Federal Rule of Civil Procedure 23. The plaintiffs' class definition included "[a]ll persons who purchased, between May 9, 2005 and June 30, 2005, inclusive, a June 10-year Treasury note futures contract in order to liquidate a short position."[89] In opposition, PIMCO argued, under Rule 23(b)(3), that this class definition was fatally flawed because the class included some investors who were not injured by the alleged manipulation of the June Contract, and because there were potential conflicts of interest among class members who might have suffered differing losses over different periods.

Under Rule 23(b)(3) a plaintiff seeking class certification must show that the "questions of law or fact common to class members predominate over any questions affecting only individual members."[90] In essence, predominance is concerned with whether the named plaintiffs can, through their individualized cases, offer proof on a class-wide basis.[91] Numerous courts have recognized that individual issues will predominate over common questions if the fact of injury cannot be proven on a class-wide basis.[92] According to PIMCO, because, among other things, the class improperly included those who did not lose money in their speculation on the June Contract, plaintiffs failed to show the predominance necessary for class certification.

Because of the potentially devastating liability that a certified class action represents, defendants are often willing to settle on unfavorable terms rather than run the risk of a verdict rendered on behalf of a class. The predominance requirement for class certification has become an especially tricky hurdle to negotiate.

A District Court has broad discretion to determine whether certification of a class is appropriate.[93] However, recent U.S. Supreme Court decisions have encouraged District Courts to examine claims more stringently early on in litigation.[94] The trend has been for appellate courts to instruct District Courts, beginning in the mid-1990s, to scrutinize class certification motions more closely.[95] The recent class certification opinions in *In re Hydrogen Peroxide Antitrust Litigation*, *In re Initial Public Offerings Securities Litigation*, and *In re New Motor Vehicles Canadian Export Antitrust Litigation* have surely caused class action lawyers to reassess their approach to class certification.[96] In each of these opinions, appellate courts reversed the trial court's grant of class certification. Each of these courts was concerned that the plaintiffs were not able to establish widespread injury to the class through common evidence. In situations like these, courts have generally found the so-called "predominance" requirement of Rule 23(b) to be lacking—or, in other words, that common issues do not predominate over individual ones—and have therefore refused to grant class certification. These opinions regarding class certification, each delivered by a different appellate circuit, have recognized that District Courts should not allow flimsy class allegations to exert undue settlement pressure on defendants. This represents a dramatic change from older class certification decisions, like *Blackie v. Barrack*,[97] in which the Ninth Circuit held that lower courts considering class certification motions are "bound to take the substantive allegations of the complaint as true."[98] However, in *Kohen v. PIMCO*, Judge Posner, speaking for the Seventh Circuit, made it clear that cases like *Hydrogen Peroxide*, *IPO*, and *Canadian Autos* do not abrogate the well-established rule that for purposes of class certification, plaintiffs need not show that every individual in the class was harmed by the defendants' alleged conduct—only that it is plausible that most were.

### 2. *In re IPO Securities Litigation*—The Second Circuit Rejected Plaintiffs' Motion for Class Certification, Thereby Imposing Strict New Standards on Plaintiffs' Lawyers

In 2006, the Second Circuit Court of Appeals' decision in *In re IPO Securities Litigation* made it more difficult for plaintiffs to win class certification by requiring District Courts to make "determinations" as to whether all of the Rule 23 requirements, including predominance, are met and have been established by the facts. In *IPO*, the Second Circuit vacated a District Court opinion granting class certification in a consolidated class action alleging violations of the securities laws in connection with initial public offerings. The District Court judge, Shira Scheindlin, had issued an order granting, in part, plaintiffs' motions for class certification.[99] Judge Scheindlin considered the standard of proof that must be met to obtain class certification: citing the U.S. Supreme Court's decisions in

*General Telephone Co. of the Southwest v. Falcon* and *Eisen v. Carlisle & Jacquelin*, she noted that a court must conduct a "rigorous analysis" in which it "may be necessary for the court to probe behind the pleadings," but emphasized that the court cannot "conduct a preliminary inquiry into the merits of a suit."[100] Judge Scheindlin found that plaintiffs need only make "some showing" that they had satisfied the requirements of Rule 23, including the predominance requirement under Rule 23(b)(3), and concluded that plaintiffs had satisfied their burden by offering a theory of loss causation that was not "fatally flawed."[101] Applying the "some showing" standard, Judge Scheindlin found that plaintiffs had sufficiently met the Rule 23 requirements, including the predominance element.[102]

The defendant underwriters appealed Judge Scheindlin's decision to the Second Circuit, which concluded that her use of a "some showing" standard was erroneous.[103] After examining the Second Circuit cases upon which Judge Scheindlin had relied, as well as decisions from other circuits, the appeals court concluded that clarification of the standard applicable to class certification was required.[104] The Second Circuit followed up this inquiry by announcing a more rigorous standard for class certification, concluding that a District Court may certify a class only after making "determinations" that all of the Rule 23 requirements are met.[105] In making such determinations, the District Court judge must resolve factual disputes relevant to each Rule 23 requirement and determine that each requirement has been established by the facts.[106] The court expressly disavowed that a "some showing" standard would suffice and that an expert's testimony may establish a component of a Rule 23 requirement simply by being not "fatally flawed."[107]

After articulating the appropriate standard for evaluating class certification, the Second Circuit ruled that the *IPO* Plaintiffs could not be certified as a class, because the plaintiffs' own evidence demonstrated that the prerequisite of predominance of common questions over individual ones could not be met with respect to either reliance or knowledge.[108] Without the benefit of the presumption of reliance in this case, individual questions of reliance would predominate.[109] As to knowledge, the court concluded that plaintiffs' claim that common issues of a lack of knowledge of the scheme would predominate was undermined by their own allegations as to the widespread nature of the scheme. Accordingly, the court vacated Judge Scheindlin's order granting class certification and remanded for further proceedings.[110]

### 3. *In re Hydrogen Peroxide*—The Third Circuit Followed the Second Circuit's Reasoning in *IPO* and Announced a Rigorous Predominance Standard for Class Certification

In *In re Hydrogen Peroxide Antitrust Litigation*, the Third Circuit Court of Appeals vacated a lower court's decision to certify a class action over an alleged price-fixing conspiracy in the market for hydrogen peroxide.[111] Both sides had presented the opinions of expert economists who disagreed on the key disputed predominance issue—whether antitrust impact was capable of proof at trial through evidence common to the class, as opposed to individualized evidence.[112] Only the "predominance" requirement of Rule 23(b)(3) was disputed.[113] Writing for the Third Circuit, Judge Anthony Scirica ruled that the District Court judge erred by failing to conduct a sufficiently "rigorous analysis" before concluding that the proposed class would be able to prove "antitrust impact" through common rather than individual evidence.[114] On the issue of predominance, the District Court judge had said that the plaintiffs "need only make a threshold showing that the element of impact will predominantly involve generalized issues of proof, rather than questions which are particular to each member of the plaintiff class."[115]

In the appeal, the Third Circuit focused on the predominance element and required a showing that the class is "sufficiently cohesive."[116] Judge Scirica explained that the lower standard of a "threshold showing could signify, incorrectly, that the burden on the party seeking certification is a lenient one or that the party seeking certification receives deference or a presumption in its favor."[117] As a result, Judge Scirica concluded that the term "threshold showing" is "an inadequate and improper standard."[118]

In the wake of *Hydrogen Peroxide*, plaintiffs seeking class certification will therefore face a new urgency—plaintiffs' counsel must lay as much groundwork as possible before filing suit in order to make the stringent showing that it will face relatively early in the litigation. Further, the Third Circuit's approach in *Hydrogen Peroxide* seems ripe for export to other circuits because Judge Scirica closely followed the reasoning of the Second Circuit's defendant-friendly class certification opinion in *In re IPO Securities Litigation*.

### 4. *Kohen v. PIMCO*—The Pendulum Swings Back as the Seventh Circuit Imposes Important Boundaries on the Class Certification Question

Plaintiffs' class definition in *Kohen v. PIMCO* included "[a]ll persons who purchased, between May 9, 2005 and June 30, 2005, inclusive, a June 10-year Treasury note futures contract in order to liquidate a short position.[119] Regarding the predominance element of class certification under Rule 23, PIMCO argued that individual issues regarding whether individual class members suffered economic losses might predominate over issues common to the class because the class included a potentially significant number of investors who suffered no injury under the CEA in their speculation on the June Contract.[120] Additionally, PIMCO argued that there were predominant individual issues related to plaintiffs' expert's statistical model and predominant issues raised by class members who satisfied their futures contract obligation with securities rather than cash.[121] Therefore, according to PIMCO, plaintiffs' "impermissibly overbroad" class definition suffered from a fatal flaw in that plaintiffs failed to show the so-called predominance element necessary for class certification.[122]

Plaintiffs argued, and the District Court agreed, that the predominant issue in this case was whether defendants unlawfully manipulated prices of the June Contract in violation of the CEA.[123] Accordingly, if plaintiffs could prove price manipulation, then the "fact of injury will have been established for all members of the class that purchased the June Contract at higher prices than otherwise would have existed absent manipulation."[124] In sum, the common legal grievance, violation of the CEA, "depends upon proof and findings pertaining to defendants' course of conduct and favorable findings would prove the claims of all class members who purchased the June Contract."[125]

All told, the District Court found that plaintiffs' class definition did not suffer from a fatal flaw.[126] The District Court judge, Ronald Guzman, ruled that at the class certification stage of litigation, it would be premature to deny plaintiffs the opportunity to "unify in their task to prove that defendants engaged in a common course of conduct that negatively affected all members of the proposed class."[127] Judge Guzman reasoned further that plaintiffs alleged that defendants' conduct manipulated the price of the June Contract upward to an artificial level, and thus, each purchaser of a June Contract within the class period would have paid a higher price than would otherwise be the case absent the alleged manipulation.[128] Therefore, Judge Guzman granted plaintiffs' motion for class certification, concluding that all members of the class had suffered injury and that defendants' concerns over the final determination of net damages for some individual members of the class could be resolved in the damages stage of the litigation.[129]

The District Court in *Kohen* relied on the decisions of other courts considering class certification for price manipulation claims under the CEA that have also found common questions to predominate. In *In re Sumitomo Copper Litigation*, "[t]he common factual questions of the who, what, when, where, and how of the conspiracy, and the common legal questions of the application of the law, particularly the Commodity Exchange Act, to the facts proven predominate over the individual questions of whether the conspiracy caused each class member some injury."[130] In *In re Natural Gas Commodities Litigation*, the presence of class members with arguably conflicting interests did not undermine the predominance requirement because all class members had the same shared interest in proving price artificiality.[131]

Judge Guzman reasoned that courts generally focus on the showing of predominance of common questions at the liability stage of litigation rather than at the damages stage.[132] Therefore, the District Court rejected PIMCO's argument that individual questions would predominate because, at some point, damage calculations may be required on an individual basis.[133] For the same reasons, the District Court rejected PIMCO's arguments related to the class members that satisfied their futures obligations with securities rather than cash, as these issues go to the individual determinations of damages after liability has been established.[134] The District Court was satisfied that all members of the class had suffered injury when they purchased the June 2005 Contract at a higher price than they would have absent the alleged manipulation, regardless of whether that same class member later benefited from the alleged manipulation when selling that same contract or others.[135] Since all class members suffered a common injury, the District Court determined that plaintiffs sufficiently demonstrated that common questions would predominate.[136] For the foregoing reasons, the District Court granted plaintiffs' motion for class certification.[137]

PIMCO appealed from the District Court's class certification order. Writing for the Seventh Circuit Court of Appeals, Judge Richard Posner adamantly rejected PIMCO's argument that the class should not be certified, condemning that argument as "ill-timed, ill-conceived, and [one that] must fail."[138] Judge Posner reasoned that "a class will often include persons who have not been injured by the defendant's conduct; indeed this is almost inevitable because at the outset of the case many members of the class may be unknown, or if they are known still the facts bearing on their claims may be unknown. Such an inevitability does not preclude class certification."[139]

Judge Posner acknowledged that a class should not be certified if it is apparent that it "contains a great many persons who have suffered no injury at the hands of the defendant."[140] Although some of the class members in *Kohen* were probably net gainers from the alleged manipulation, Judge Posner observed that "there is no reason at this stage to believe that many were."[141] He acknowledged the possibility that some of the members of the class were actually speculating on a rise in the price of the June Contract, and made some short sales merely as a hedge, and because of PIMCO's alleged conduct obtained a net profit.[142] Judge Posner ruled that while the plaintiffs had not yet proven that PIMCO tried to corner the market, or succeeded—"at this stage in the proceeding we must assume that they can prove it."[143] The plaintiffs sold short, "so, prima facie at least—being forced as they were to cover by June 30—they were injured if the price of cover was artificially inflated during the period between their sale and the delivery date."[144] By virtue of this ruling, the Seventh Circuit effectively shifted the burden to the defendants to establish that the class definition was overbroad.

PIMCO also argued that class certification should have been denied because of potential conflicts of interest among class members that would make it impossible for class counsel to represent all of them impartially under Federal Rule of Civil Procedure 23(a)(4).[145] Judge Posner dismissed that argument, ruling that at this stage in the litigation, the existence of such conflicts was hypothetical—if and when the conflicts became real, the District Court would certify subclasses with separate representation of each.[146] Judge Posner ruled that to deny class certification now, because of a potential conflict of interest that might not become actual, would be premature.[147]

For the foregoing reasons, the Seventh Circuit Court of Appeals affirmed the District Court's order certifying the plaintiffs' class as defined. Subsequent to this decision, the Seventh Circuit denied PIMCO's petition for a rehearing, en banc, and the U.S. Supreme Court denied PIMCO's petition for a writ of certiorari in a brief order.[148]

### 5. Reconciling the Lower Predominance Standard Announced in *Kohen v. PIMCO* with the Stringent Class Certification Standards Laid Out in *Hydrogen Peroxide* and *IPO*

Recent decisions in several federal courts of appeals, including *Hydrogen Peroxide* and *IPO*, have changed the landscape for class actions by calling for a more stringent standard of review for class certification. In each of these decisions, the appellate courts reversed the District Court's order granting class certification due, in part, to the concern that plaintiffs were not able to adequately show predominance of the class as required by Rule 23(b)(3). However, Judge Posner's opinion in *Kohen v. PIMCO* serves as an important reminder that the evolution of stringent class certification standards that is reflected in decisions like *Hydrogen Peroxide* and *IPO* is not boundless. In *Kohen v. PIMCO*, Judge Posner, speaking for the Seventh Circuit Court of Appeals, ruled that for purposes of class certification, or, more specifically, to show predominance under Rule 23(b)(3), plaintiffs need not show that every individual in the class was harmed by the defendants' alleged conduct—only that it is plausible that most were.[149] Therefore, where injury to a substantial majority, but not necessarily all, of the class is facially plausible, the burden appropriately shifts to the defendants to establish that certification would be inappropriate. This key aspect of *Kohen v. PIMCO* appears to be consistent with the longstanding principle that "injury may be presumed when it is clear the violation results in harm to the entire class."[150] Christopher Lovell, lead attorney for the *Kohen* plaintiffs, provided his take on the significance of Judge Posner's decision upholding class certification:

> The pendulum has begun to swing back. The excessive reliance of the law on corporatism and distrust of District Court judges and juries is over. This is the beginning. Pragmatists like Judge Posner recognize, from experience, the experience of the last few years the need to incentivize good behavior and disincentivize bad behavior by financial institutions, and have that need inform the arguments on class certification.[151]

Despite Judge Posner's progressive, plaintiff-friendly ruling in *Kohen v. PIMCO*, the class action lawyer shouldn't let his or her guard down when it comes to making the proper showings required by Rule 23. In the wake of *Hydrogen Peroxide* and *IPO*, the plaintiff seeking certification for a class damaged by a commodity manipulation should lay as much groundwork as possible before filing suit in order to make the stringent showing that it could face relatively early on in the litigation, including as it relates to the predominance element.

## V. Conclusion

It is certainly true that the pricing of Treasury futures contracts depends on a wide array of factors, including the stated and unstated policies of the Federal Reserve, inflation, the United States Treasury's budget and debt policies, tax policy, economic growth, and the growth rate of incomes and capital gains.[152] However, many market professionals agree that the PIMCO controversy in Treasuries demonstrates a larger trend: hedge funds and other investors have piled into the futures market, causing it to explode in size over the past nine years, while the supply of cash products cheaply available to fulfill these contracts has dwindled.[153] As more investors get burned by the rampant volatility in the commodities and derivatives markets, more class actions are sure to follow. The Seventh Circuit's recent plaintiff-friendly decision in *Kohen v. PIMCO* upholding class certification should help pave the road a bit for future private class actions alleging commodity manipulation.

## Endnotes

1. *Cargill, Inc. v. Hardin*, 452 F.2d 1154, 1163 (8th Cir. 1971). Because the means of manipulation are limited only by human ingenuity, wise policy has avoided defining manipulation in the CEA or the CFTC regulations.
2. *See* Bernard Pesky & Gregory Asciolla, *Analyzing Proper Pleading Standard For Commodity Manipulation Claims*, N.Y.L.J., Feb. 10, 2009.
3. *See* http://www.cftc.gov/lawandregulation/enforcementactions/index.htm. For example, from December 2002 to date, the CFTC has filed a total of 43 enforcement actions in the energy markets alone, charging a total of 73 respondents/defendants (42 companies and 31 individuals). The CFTC has obtained $445,940,000 in civil monetary penalties in settlement of these energy market enforcement actions. *See Memorandum from CFTC on Energy Markets Enforcement Results* (Nov. 17, 2008).
4. In *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, the Supreme Court held that the CEA contained an implied private right of action but left open the contours of that right. 456 U.S. 353, 394–95 (1982). On the heels of *Merrill Lynch*, and driven in large part by concern over the Court's direction that the courts should fill in the "interstices" of the newly created cause of action in the absence of congressional action, Congress amended the CEA to include an express private right of action for "actual damages." Futures Trading Act of 1982, Pub. L. No. 97-444, § 235, 96 Stat. 2294, 2322-23 (1983) (codified as amended at 7 U.S.C. § 25). Brief of

Defendant-Appellant at 28, *Kohen v. Pac. Inv. Mgmt. Co*., No. 08-1075 (7th Cir. Sep. 16, 2008).

5. *See* Fed. R. Civ. P. 23.

6. *See In re Initial Pub. Offering Sec. Litig*., 471 F.3d 24, 26 (2d Cir. 2006).

7. *See* Fed. R. Civ. P. 23.

8. 7 U.S.C. § 13(a)(2).

9. *Kohen v. Pac. Inv. Mgmt. Co.*, 571 F.3d 672 (7th Cir 2009).

10. Mark Whitehouse, *Short-Bond Shortage Isn't Over—Imbalance in 10-Year Treasuries That Cost Some Investors Millions Looms Anew in September Futures*, Wall St. J., Aug. 11, 2005, at C1.

11. *Id.*

12. *Id.*

13. *Id.*

14. *Id.*

15. *Kohen v. Pac. Inv. Mgmt. Co.*, 244 F.R.D. 469, 473 (N.D. Ill. 2007).

16. Whitehouse, *supra* note 10.

17. *Id.*

18. *Id.* PIMCO did not disclose the size of its Treasury futures position, and PIMCO's CEO Bill Gross brushed off the speculation in an interview with Bloomberg Television. *Id.* Gross was also interviewed on CNBC on Aug. 9, 2005, and gave an "unequivocal" denial that the firm had tried to orchestrate a squeeze. *Bond Futures Industry Debates Steps to Protect It From 'Fails,'* Los Angeles Times, Aug. 12, 2005, at C4.

19. Brief of Defendant-Appellant at 3, *Kohen v. Pac. Inv. Mgmt. Co.*, No. 08-1075 (7th Cir. Sept. 16 2008).

20. *See* http://www.reuters.com/article/rbssFinancialServices%20-%20Diversified/idUSN0733371120090707.

21. Whitehouse, *supra* note 10.

22. *Id.*

23. *Id.*

24. *Id.*

25. *Id.*

26. *Id.* The Chicago Board of Trade, in response to the June 2005 controversy, established limits on trading positions "for the purpose of reducing the potential threat of market manipulation, congestion or price distortions." Starting in December 2005, traders were limited to holding $2.5 billion of 30-year bond contracts, $5 billion of 10-year note contracts, $3.5 billion of five-year note contracts and $5 billion of two-year note contracts in the last 10 days of a contract's life. *Bond Futures Industry Debates Steps to Protect It From 'Fails,' supra* note 18.

27. *Kohen v. Pac. Inv. Mgmt. Co.*, 571 F.3d 672, 675–76 (7th Cir. 2009).

28. *See Kohen v. Pac. Inv. Mgmt. Co.*, 244 F.R.D. 469, 472 (N.D. Ill. 2007).

29. *Id.* at 472.

30. *Id.*

31. *Id.* at 473.

32. *Id.*

33. *Id.*

34. *Id.*

35. *Kohen v. Pac. Inv. Mgmt. Co.*, 571 F.3d 672, 676 (7th Cir. 2009).

36. *In re Energy Transfer Partners Natural Gas Litig.*, No. 4:07-cv-3349, 2009 U.S. Dist. LEXIS 75859, at *10 (S.D. Tex. Aug. 26, 2009) (citing *Cargill, Inc. v. Hardin*, 452 F.2d 1154, 1163 (8th Cir. 1971); *United States v. Reliant Energy Servs.*, 420 F. Supp. 2d 1043, 1056 (N.D. Cal. 2006); *United States Commodity Futures Trading Comm'n v. Enron Corp.*, No. H-03-909, 2004 WL 594752, at *4 (S.D. Tex. Mar. 10, 2004); and *Sumitomo Copper Litig.*, 182 F.R.D. 85, 90 (S.D.N.Y. 1998)).

37. *See Board of Trade v. Olsen*, 262 U.S. 1, 39 (1923).

38. Brief for Plaintiff-Appellee at 9, *Kohen v. Pac. Inv. Mgmt. Co.*, No. 08-1075 (7th Cir. Oct. 16, 2008) (citing Commodity Exchange Act § 3, 7 U.S.C. § 5 (the core purpose of the CEA is "to deter and prevent price manipulation or any other disruptions to market integrity"); *Leist v. Simplot*, 638 F.2d 283, 304-306, n. 42 (2d Cir. 1980), *aff'd*, *Merrill Lynch. v. Curran*, 456 U.S. 353 (1982)).

39. 7 U.S.C. § 13(a)(2).

40. 7 U.S.C. § 13(a); *In re Energy Transfer Partners Natural Gas Litig.*, 2009 U.S. Dist. LEXIS 75859, at *9–10 (citing *In re Amaranth Natural Gas Commodities Litig.*, 587 F. Supp. 2d 513, 530 (S.D.N.Y. 2008); *Crude Oil Commodity Litig.*, No. 06 Civ. 6677(NRB), 2007 WL 19465553, at *3 (S.D.N.Y. June 28, 2007); *In re Natural Gas Commodity Litig. (Natural Gas I)*, 337 F. Supp. 2d 498, 507 (S.D.N.Y. 2004); *United States Commodity Futures Trading Comm'n v. Enron Corp.*, No. H-03-909, 2004 WL 594752, at *4 (S.D. Tex. Mar. 10, 2004).

41. *See Cargill, Inc. v. Hardin*, 452 F.2d 1154, 1163 (8th Cir. 1971).

42. *Id.* at 1162. Most commentators refer to a dominant position in the cash or spot market as a corner, while such position in the futures market is denoted as a squeeze. *See The Delivery Requirement: An Illusory Bar to Regulation of Manipulation in Commodity Exchanges*, 73 Yale L.J. 171 (1963). Aside from squeezes and corners, manipulation can take many other forms, such as "marking the close" and the false reporting of trade data.

43. *Cargill*, 452 F.2d at 1162. One of the most spectacular reported cases illustrating such a corner is *Peto v. Howell*, 101 F.2d 353, 355 (7th Cir. 1938). It was there alleged, and the court found that the evidence substantiated the allegations, that the defendant acquired long futures in corn in the amount of 8,500,000 bushels to be delivered in Chicago; that approximately 7,000,000 bushels were delivered to the defendant in satisfaction of these contracts, which constituted 97 percent of the deliverable supply in Chicago and 90 percent of the deliverable supply in the whole country; that there remained 1,500,000 bushels of futures which could therefore not be satisfied by delivery; and that the defendant was therefore able to dictate an arbitrarily high price in settlement of these contracts. Not all corners, of course, are so massive or so successful.

44. *United States Commodity Futures Trading Comm'n*, 2004 WL 594752, at *12.

45. *See id.* at 12–14.

46. *Id.* at 12.

47. *Id.* at 12–13 (*see also Cargill*, 452 F.2d at 1164–65 (court looks at whether Cargill held a dominant long position in the future and whether there was an insufficient supply of wheat available from sources other than Cargill)).

48. *Id.* at 13 (*see also In re Soybean Futures Litig.*, 892 F. Supp. 1025, 1047 (N.D. Ill. 1995) (a dominant or controlling position in the market is not a requisite element to either manipulation or attempted manipulation and is not essential to altering successfully the forces of supply and demand); *In re Henner*, 30 A.D. 1151, 1232-1239 (Agric. Dec. 1971) (control of the relevant cash market is not a necessary element of manipulation, and defendant had attempted to manipulate prices even though he was not in a position to squeeze or corner the market)).

49. *Id.* at 13–14 (citing *In re Henner*, 30 A.D. at 1227).

50. *Id.* at 13 (citing *In re Henner*, 30 A.D. at 1227).

51. Craig Pirrong, *Squeezes, Corpses, and the Anti-Manipulation Provisions of the Commodity Exchange Act*, 17 Regulation (1994), *available at* http://www.cato.org/pubs/regulation/regv17n4/reg17n4c.html.

52. *See Cargill*, 452 F.2d at 1162.

53. *Id.* at 1162.

54. *Kohen v. Pac. Inv. Mgmt. Co.*, 244 F.R.D. 469, 484 (N.D. Ill. 2007).

55. Brief for Plaintiff-Appellee at 14, *Kohen v. Pac. Inv. Mgmt. Co.*, No. 08-1075 (7th Cir. Sept. 16, 2008).

56. *Id.* at 11.

57. *Id.*

58. *Id.* Plaintiff-Appellee's brief compared PIMCO's hoarding of the deliverable supply of the cheapest-to-deliver ("CTD") note to other cases in which deliverable supplies were manipulated. *See Cargill*, 452 F.2d at 1160 (long futures holder manipulated with 24% of deliverable supply); *G. H. Miller & Co. v. United States*, 260 F.2d 286, 289 (7th Cir. 1958) (72.1% of deliverable supply); *Great Western Food Distribs. v. Brannan*, 201 F.2d 476, 481 (7th Cir. 1953) (29.3% of deliverable supply); *Landon v. Butler*, 14 A.D. 429 (CEA No. 65, June 20, 1955) (21% of deliverable supply).

59. Brief for Plaintiff-Appellee at 11, *Kohen v. Pac. Inv. Mgmt. Co.*, No. 08-1075 (7th Cir. Sept. 16, 2008).

60. *Id.*

61. *Id.* at 12. The Federal Reserve had to take the highly unusual step of releasing its 2/12 Notes in order to prevent the unprecedented occurrence of what the market calls "uneconomic" deliveries, that is, deliveries of non-CTD notes. See Federal Reserve historical lending, *available at* http://www.newyorkfed.org/markets/seclend/historical/search.cfm.

62. *See id.* at 11.

63. *See Cargill*, 452 F.2d at 1163. For example, the one instance in which a long's insistence on large deliveries makes legitimate economic sense is if prices on the futures contract are artificially low or cheap compared to the price of the deliverable instrument. In that one instance, it is economically rational for the long to refrain from selling out its long position at a low price and instead take delivery. Also, the long's rational conduct could tend to cause convergence, which would help the market as a whole. However, precisely the opposite situation existed in this case on May 9, 2005, the first day of the Class Period. The June 2005 Contract was then very "rich," yet PIMCO did not sell into this richness. Brief for Plaintiff-Appellee at 12, *Kohen v. Pac. Inv. Mgmt. Co*., No. 08-1075 (7th Cir. Sept. 16, 2008).

64. *Cargill*, 452 F.2d at 1163. *See also Strobl v. N.Y. Mercantile Exch.*, 582 F. Supp. 770 (S.D.N.Y. 1984) (defendant's conduct was against economic self-interest and supported inference of conspiracy to manipulate); *In re Ind. Farm Bureau Coop. Ass'n*, No. 75-14, 1982 WL 30249, at *23 (CFTC Dec. 17, 1982) (forcing uneconomic delivery is price distorting); *Cargill*, 452 F.2d at 1163 (though not required for manipulation, uneconomic acts are indicative or manipulation); *In re David G. Henner*, 30 A.D. 1151, 1174, 1192 (CEA No. 161, Sept. 15, 1971) ("inescapable inference" of manipulative intent to raise price by uneconomically paying "more than he would have had to pay" for futures at close of trading).

65. Brief for Plaintiff-Appellee at 12, *Kohen v. Pac. Inv. Mgmt. Co.*, No. 08-1075 (7th Cir. Sept. 16, 2008). (*citing* e-mail from Chris Dialynas, Senior Treasury Trader, PIMCO to PIMCO's Investment Committee regarding the June 2005 Contract "prefer to stand for delivery and exploit potential for front month to go on special" (May 9, 2005)).

66. *Id.* at 14.

67. *Kohen v. Pac. Inv. Mgmt. Co.*, 244 F.R.D. 469, 474 (N.D. Ill. 2007).

68. Brief of Defendant-Appellant at 35, *Kohen v. Pac. Inv. Mgmt. Co.*, No. 08-1075 (7th Cir. Sept. 16, 2008)

69. *Id.*

70. *See Dura v. Broudo*, 544 U.S. 336 (2005).

71. *Id.* at 346.

72. *See id.*

73. *Kohen v, Pac. Inv. Mgmt. Co.*, 244 F.R.D. 469, 475 (N.D.Ill. 2007). Compare *Dura*, 544 U.S. at 341-42 (listing the essential elements of a securities fraud claim: a material misrepresentation, scienter, a connection with the purchase or sale of a security, reliance, economic loss, and loss causation), with *In re Soybean Futures Litig.*, 892 F. Supp. 1025, 1045 (N.D. Ill. 1995) (listing the elements of a price manipulation claim: "(1) the defendant possessed the ability to influence prices; (2) an artificial price existed; (3) the defendant caused the artificial price; and (4) the defendant specifically intended to cause the artificial price.").

74. *Kohen v. Pac. Inv. Mgmt. Co.*, 571 F.3d 672, 679 (7th Cir. 2009).

75. *Id.*

76. *Kohen*, 244 F.R.D. at 473.

77. *Id.* at 484–85.

78. *Id.* (*citing In re Ind. Farm Bureau Coop. Ass 'n*, No. 75-14, 1982 WL 30249, at *8 (CFTC Dec. 17, 1982)).

79. *Id.* at 485 (citing *Cargill, Inc. v. Hardin*, 452 F.2d 1154, 1163 (8th Cir. 1971) ("The methods and techniques of manipulation are limited only by the ingenuity of man.").

80. *Kohen*, 244 F.R.D. at 482.

81. *Id.* at 482–83 (*citing In re Cox*, No. 75-16, 1987 CFTC LEXIS 325, at *20 (CFTC July 15, 1987)).

82. Brief of Defendant-Appellant at 41–42, *Kohen v. Pac. Inv. Mgmt. Co.*, No. 08-1075 (7th Cir. Sept. 16, 2008).

83. *Kohen*, 244 F.R.D. at 484 (citing *In re Ind. Farm Bureau Coop. Assn.*, 1982 WL 30249, at *5).

84. *Id.*

85. *Id.*

86. *Id.*

87. *See id* at 485.

88. Daniel Abuhoff, *A Tougher Standard For Class Certification in Antitrust Actions*, Sec. Law 360, Jan. 9, 2009, *available at* http://www.law360.com.

89. *Kohen*, 244 F.R.D. at 475. As to commonality and predominance, Plaintiffs claimed to have demonstrated, among other things, the following: each Class member purchased the exact same standardized, fungible and interchangeable June 2005 Contract during the period in which prices were alleged to be unlawfully high; each Class member did so in the exact same centralized CBOT marketplace subject to the exact same standardized customs, practices, and binding CBOT rules; the price that each Class member paid allegedly was unlawfully inflated by Defendants' exact same highly unusual departure from its prior history of conduct. Brief for Plaintiff-Appellee at 16, *Kohen v. Pac. Inv. Mgmt. Co.*, No. 08-1075 (7th Cir. Sept. 16, 2008).

90. *In re Hydrogen Peroxide Antitrust Litig.*, 552 F.3d 305, 310 (3d Cir. 2008).

91. *Kohen*, 244 F.R.D. at 472 (*citing Hyderi v. Wash. Mut. Bank, FA*, 235 F.R.D. 390, 398 (N.D. Ill. 2006).

92. Brief of Defendant-Appellant at 21–22, *Kohen v. Pac. Inv. Mgmt. Co.*, No. 08-1075 (7th Cir. 2008).

93. *Retired Chi. Police Ass'n v. City of Chi.*, 7 F.3d 584, 596 (7th Cir. 1993).

94. *See Ashcroft v. Iqbal*, 129 S. Ct. 1937 (2009); *Bell Atlantic v. Twombly*, 550 U.S. 544 (2007).

95. Daniel Abuhoff, *A Tougher Standard For Class Certification in Antitrust Actions*, Sec. Law 360, Jan. 9, 2009, *available at* http://www.law360.com.

96. *See In re Hydrogen Peroxide Antitrust Litig.*, 552 F.3d 305 (3d Cir. 2008); *In re New Motor Vehicles Canadian Exp. Antitrust Litig.*, 522 F.3d 6 (1st Cir. 2008); and *In re Initial Pub. Offering Sec. Litig.*, 471 F.3d 24 (2d Cir. 2006).

97. *See Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975).

98. *Id.* at 901.

99. *See In re IPO Secs. Litig.*, 227 F.R.D. 65, 122 (S.D.N.Y. 2004).

100. *Id.* at 90–91 (*citing Gen. Tel. Co. of the Southwest v. Falcon*, 457 U.S. 147, 160-61 (1982), and *Eisen v. Carlisle*, 417 U.S. 156, 177 (1974)).

101. *See In re IPO Secs. Litig.*, 227 F.R.D. at 114–15.

102. *See id.*

103. *See In re Initial Pub. Offering Sec. Litig.*, 483 F.3d 70 (2d Cir. 2007).

104. *See id.*

105. *Id.* at 41.

106. *Id*.

107. *Id.* at 42.

108. *Id.* at 72–73. The court rejected plaintiffs' invocation of the fraud-on-the-market presumption of reliance, concluding that the presumption was inapplicable because the market for IPO shares was not efficient and because the plaintiffs' own allegations as to how slowly the market corrected the alleged price inflation indicated "the antithesis of an efficient market." *Id.* at 55–56.

109. *Id.* at 57. As an example of why the presumption of reliance cannot apply in the IPO context, the court pointed to the fact that during the 25-day "quiet period," analysts cannot report concerning IPO securities, thereby precluding the numerous, contemporaneous analyst reports that are a characteristic of an efficient market.

110. *Id.* at 63–64.

111. *In re Hydrogen Peroxide Antitrust Litig.*, 552 F.3d 305, 327 (3d Cir. 2008).

112. *See id.*

113. *Id.* at 311.

114. *See In re Hydrogen Peroxide Antitrust Litig.*, 552 F.3d 305.

115. *Id.* at 321.

116. *Id.* at 310–11.

117. *Id.* at 321.

118. *Id.*

119. *Kohen v. Pac. Inv. Mgmt. Co.*, 244 F.R.D. 462, 472 (N.D. Ill. 2007).

120. *See id.* at 474. According to PIMCO's appellate brief, Hershey, for example, held long positions on days when Plaintiff Breakwater alleges price artificiality peaked and it suffered damages. Similarly, Hershey's long position put him on the opposite side of trading from Plaintiff Josef Kohen, who initiated and closed a short position during the same period. The trading records show that sophisticated class members bought and sold hundreds of contracts on almost a daily basis, frequently taking positions opposite each other at the same price on the same day. For example, on May 17, 2005, class member Millennium Partners L.P. bought 87 contracts at a price of 112.14, and Barclays Bank PLC House sold 100 contracts at the same price. Similarly, on May 23, 2005, Millennium sold 45 contracts at 112.18 and Barclays bought 100 contracts at the same price. Brief of Defendant-Appellant at 14, *Kohen v. Pac. Inv. Mgmt. Co.*, No. 08-1075 (7th Cir. Sept. 16, 2008).

121. *Kohen*, 244 F.R.D. at 479–80.

122. Brief of Defendant-Appellant at 41–42, *Kohen v. Pac. Inv. Mgmt. Co*., No. 08-1075 (7th Cir. Sept. 16, 2008). PIMCO argued that proof of the fact of injury as to individual class members would be overwhelmingly complex in this case, causing individual issues to predominate. Some traders engaged in thousands of trades during the Class Period, frequently establishing both long and short positions, and proving injury necessarily would require examination of voluminous individual trading records regarding the June 2005 Contract. Determination of whether purported class members were "injured" also would require an analysis of their positions in the underlying Treasury notes, with claimed damages resulting from their June futures position offset "by the measure of the increase in value which accrued to" their holdings in the Treasury notes that could be delivered in satisfaction of the June 2005 Contract. Individual class members might also be hedged in other ways. Brief of Defendant-Appellant at 50–51, *Kohen v. Pac. Inv. Mgmt. Co. LLC*, No. 08-1075 (7th Cir. Sept. 16, 2008).

123. *Kohen*, 244 F.R.D. at 480.

124. *Id.*

125. *Id.*

126. *See id.* at 475.

127. *Id.*

128. *Id.*

129. *Id.* at 475–76.

130. *See In re Sumitomo Copper Litig.*, 182 F.R.D. 85, 90-91 (S.D.N.Y. 1998).

131. *In re Natural Gas Commodities Litig.*, 231 F.R.D. 171, 183 (S.D.N.Y. 2005).

132. *Kohen*, 244 F.R.D. at 480 (citing *In re Natural Gas Commodities Litig.*, 231 F.R.D. at 180-81).

133. *Id.*

134. *See id.*

135. *Id.* at 475.

136. *See id.*

137. *Id.* at 485.

138. *See Kohen v. Pac. Inv. Mgmt. Co. LLC*, 571 F.3d 672, 680 (7th Cir. 2009).

139. *Id.* at 677.

140. *See id.* at 677–78 (*see also Romberio v. Unumprovident Corp.*, No. 07-6404, 2009 WL 87510, at *8 (6th Cir. Jan. 12, 2009); *Oshana v. Coca-Cola Co.*, 472 F.3d 506, 514-15 (7th Cir. 2006)).

141. *Kohen*, 571 F.3d at 678. Judge Posner discussed the many variations of investment strategies that might have been used by class members in *Kohen*: A short seller hopes the price of the security that he's selling will fall. He knows it may rise and that his speculative gamble will therefore fail, but if the rise is caused or increased by a violation of law the incremental loss caused by the violation entitles him to an award of damages. And while it is true that short sellers may want to hedge part of the risk of a rise in the price of the security that they are selling short, they will not hedge the entire risk, as that would eliminate the prospect of speculative gains that motivates short selling. Suppose a short seller sells a security at $80, hoping the price will fall below that by the delivery date; nonetheless fearing that the price might rise far enough to bankrupt him, he hedges by contracting to buy the security at $100 should it rise that high. That will cap his potential loss at $20, but he will sustain a loss if the defendant drives the price of the security to any level above $80. *Id.*

142. *Id.* Judge Posner explained that it is not clear how many of these "long" speculators the class may contain, but it probably does not contain many. Otherwise PIMCO would not have made huge purchases of the June Contract in order to drive up the price at which short sellers would have to close out their sales. Put differently, were there not a great many net short sellers of the June Contract, PIMCO could not have driven its price to an artificially high level because only short sellers would buy at such a price, for they alone would have to close out their short positions by buying the June Contract. *Id.* at 678-79.

143. *Id.* at 678–79.

144. *Id.* at 679.

145. *Id.* (citing Fed. R. Civ. P. 23). Regarding these conflicts of interest, PIMCO argued that the class as defined included class members who *purchased* on the same days that other class members *sold* and

vice versa, frequently on opposite sides of the same transaction. Because each class member's damages would depend on showing that the price artificiality was higher when they bought than when they sold (or higher when they liquidated (offset) than when they initially established a short position), class members would have diametrically opposite interests in proving the degree of price artificiality at particular times. The class as defined was therefore beset with irreconcilable conflicts of interest that prevented any putative class representative from being an adequate representative of all absent class members. Brief of Defendant-Appellant at 22, *Kohen v. Pac. Inv. Mgmt. Co. LLC*, No. 08-1075 (7th Cir. Sept. 16, 2008).

146. *Kohen*, 571 F.3d at 679. Judge Posner elaborated on this ruling as follows: [c]lass members covered by buying the June Contract, thus capping their losses, at different times during the seven-week period embraced by the complaint. One who covered very early would want to show that the effect of PIMCO's alleged misconduct peaked then. Moreover, the curve of rising prices for the June Contract dipped at one point during the complaint period and class members who covered during the dip might want to show that PIMCO's effect on the price level was completed by then and the post-dip rise in prices was due to market forces for which PIMCO was not responsible. Suppose the price had risen from $100 at the beginning of the complaint period to $130 at the bottom of the dip, and from $130 to $150 between then and the delivery date. Short sellers who covered during the dip would want to show that it was PIMCO who pushed the price up from $100 to $130, and that insofar as market forces were shown to be responsible for part of the price rise, these forces operated after the dip rather than before. Short sellers who covered at the end of the period would want to show that the entire price increase, from $100 to $150, was due to PIMCO's illegal activity. *Id.* at 679–80.

147. *Id.* at 680.

148. *Kohen v. Pac. Inv. Mgmt. Co. LLC*, 2009 U.S. App. LEXIS 18807 (7th Cir. Ill. July 31, 2009); *Pac. Inv. Mgmt. Co. LLC v. Hershey*, 130 S. Ct. 1504 (U.S. 2010).

149. *See Kohen*, 571 F.3d 672.

150. *In re Hydrogen Peroxide Antitrust Litig.*, 552 F.3d 305, 326 (3d Cir. 2008).

151. Jacqueline Bell, *PIMCO Loses Bid To Decertify Class*, SEC. LAW 360, Jul. 9, 2009 (quoting Christopher Lovell of Lovell Stewart and Halebian LLP), *available at* http://www.law360.com.

152. Brief of Defendant-Appellant at 11, *Kohen v. Pac. Inv. Mgmt. Co. LLC*, No. 08-1075 (7th Cir. Sept. 16, 2008). PIMCO argued that the substantial impact any one of these factors can have on the pricing of Treasury futures contracts was demonstrated in this case. At 2:00 p.m. on May 24, 2005, the FOMC announced that it had "voted to raise its target for the federal funds rate by 25 basis points to 3 percent at its May 3 meeting." Market participants understood the FOMC's action to mean that it was unlikely to raise rates further to the level the market had previously anticipated. "This change in expectations justified paying higher prices for Treasury notes and Treasury futures, so prices on both went up." Not surprisingly, May 24 and 25 are the dates on which Plaintiff Breakwater alleged it suffered losses resulting from high levels of price artificiality. *Id.*

153. Whitehouse, *supra* note 10.


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# Towards a More Consolidated Universe: Why and How Regulation Must Promote *Essentially* Inevitable Cross-Border Stock Exchange Mergers

By Arielle L. Katzman

## Introduction

Just a short while ago, news of potential mergers between various stock exchanges dominated headlines. With players hailing from opposite sides of the oceans, each participant brought different core competencies to the deal. In addition to the traditional floor-based stock trading exchanges, participants have included the more advanced Alternative Trading Systems (ATSs) including Electronic Communication Networks (ECNs); entities specializing in alternative products like derivatives; and collateral industries such as clearing and settlement.

However, in the wake of the current financial crisis, the market machinery has seemingly ground to a halt. Any modest merger and acquisitive activity that manages to capture headlines at least features a connection to the financial meltdown.[1] Credit has dried up, the Dow has dipped into unfathomably low territory, and businesses continue to announce closures and liquidations. With the media's continuous projection of this dismal scene, the crisis has commanded the attention of policymakers, businesses, and investors. Although it is entirely appropriate to focus on what is shaping up to be one of the most severe recessions in history,[2] other market issues, which may seem irrelevant or merely ancillary to this main plot, still have an important role in the marketplace drama.[3]

In this twenty-first century, capital markets have become incredibly globalized,[4] and securities regulations must keep pace with this reality. The financial crisis itself demonstrates the internationalization of markets.[5] The cascade of collapsing economies from Iceland to New York has laid bare the ramifications of a globally interconnected marketplace. Undeniably, the market implosion is of particular relevance to the New York economic climate and has impacted virtually every business, and critically altered the entire financial sector. Thus, the New York business attorney cannot simply hew to a parochial view, but must confront these global phenomena of crisis and consolidation, which uniquely impact New York. But notwithstanding the significance of the New York locus, the issue must be examined in the larger global context. As policymakers reevaluate current regulatory schemes in light of the crisis, they cannot ignore globalization. Importantly, most of the literature on the internationalization of finance preceded the financial fallout, and the crisis will undoubtedly factor into any emerging plans. In light of the increased insularity that has developed since the crisis, attention to regulating the globalized marketplace may not solidify again until the recession definitively terminates. Countries such as the United States have focused on constructing plans with a myopic view towards domestic affairs instead of supranational initiatives. But perhaps right now is an opportune time to reevaluate market policies; perhaps globalization was not just part of the problem, but can serve as an integral part of the solution by rejuvenating the economy. The downturn's revelation of regulatory shortfalls does not indicate that international finance is inherently problematic; rather, poor coordination within and between countries has precipitated the ensuing financial mayhem.[6]

Moreover, there is a natural affinity between international finance and stock exchanges that deserves further development. Both international finance and stock exchanges share the purpose of promoting the most efficient use of capital by expanding the scope of the marketplace and breaking down barriers between businesses and investors. In an era of multinational corporations, multinational stock exchanges comprise the next logical step.

This article advocates stock exchange consolidation as the superior method of globalizing the marketplace and explores the attendant regulatory issues. Part I.A establishes the background context, discussing the evolution of stock markets, with a particular emphasis on the impact of globalization. Part I.B focuses on consolidation and considers whether consolidation is an inevitable result of globalization; weighs the advantages and disadvantages of consolidation; and highlights concerns that have arisen in recent mergers. Part II.A discusses the current U.S. regulatory scheme and its misalignment with the current market atmosphere. Regulatory barriers both discourage cross-border transactions and produce suboptimal benefits in executed deals. Part II.B highlights notable, progressive steps toward harmonization taken by the United States, but argues that these steps have not gone far enough. Part III surveys and analyzes current proposals for facilitating a globalized marketplace. Part IV compares the main regulatory proposals to extract the merits from each plan; this analysis forms the basis for recommendations on regulating cross-border exchanges. The article concludes that regulatory reforms must be enacted to promote stock market consolidation, which is the optimal and essentially inevitable[7] route to the globalization of finance. Once the United States and other countries make necessary modifications to their regulatory regimes to accommodate a true scheme of international finance, the current rate of consolidation will vastly expand, and consolidation will emerge as the primary and most effective mechanism for international coordination. Specifically, reform must encompass convergence and harmonization of policies followed by mutual recognition of home country regimes. Mutual recognition must serve as the centerpiece of reform because it promotes competition while creating an equitable environment of minimum standards and comparability that safeguards market integrity; achieves efficiency through home country regulation; and is feasible to execute. Although countries should bilaterally negotiate mutual recognition agreements to maintain flexibility and attentiveness to their unique specifications, they should do so within the framework of a strengthened international organization focused on securities regulation. This global forum will play a supportive role to bilateral agreements and mutual recognition by fostering harmonization, implementation, and enforcement. An international organization will also broaden the scale on which these agreements occur. Additionally, the proffered proposal can still accommodate some self-regulation. By incorporating elements from various reform options, this article's solution will establish strong international linkages while minimizing concerns.

This article employs a U.S.-focused approach given the powerful (albeit declining)[8] market position of the United States and its unique approach to regulation. An important background issue is whether the U.S. system of regulation should change to specifically accommodate foreign participation or whether changes must be more sweeping and apply to remaining domestic operations. Emphasis is placed on relations with the European Union, the United States' most important partner in international transactions. Nevertheless, the concepts developed have global applicability.

## I. Background Context

### A. Modern Stock Markets and International Finance

Stock markets have vastly changed from their historical origins. Computerized, for-profit regimes have quickly supplanted predecessors based on open outcry systems and exclusive membership. However, regulatory changes have not sufficiently paralleled this fundamental conversion.[9] The gravity of this mismatch between rules and the system these rules were designed for is further compounded by the internationalization that accompanied these changes.

Various factors account for the globalization of stock markets. Greater investor wealth and education, which increase market demand,[10] serve as principal driving forces for the internationalization of the marketplace. Technological advancements have also made a contribution by enabling markets to respond to this increased demand for global products.[11] The transition from floor-based trading to electronic trading has facilitated the widespread distribution of information, increased the speed and accuracy of trades, reduced the costs of trades, and increased industry competitiveness.[12] In the aggregate, these factors "undermine not only floor trading as a means of executing trades but also the incumbency effect that has shielded exchanges, especially in America, from foreign competition."[13] Additionally, demutualization of stock exchanges has prodded the development of international markets as profit-seeking exchanges have sought to skip over borders to increase liquidity by expanding listings and access to new investor capital.[14]

The primary characteristics of the international financial system include (non-home country) listings on foreign exchanges, investment in foreign companies either directly on foreign exchanges or through one's home country, using global depository receipts or global depository shares (GDRs or GDSs), and stock market consolidation. A liberalization of regulatory rules can generally advance all of these components of the international financial system. Although consolidation is just one aspect of globalization, as explained *infra*, it represents the maximally efficient alternative, and it will emerge as the dominant route of international expansion once appropriate reforms are implemented. Additionally, consolidation can occur at various levels. While this article focuses on consolidation of traditional exchanges, traditional exchanges are absorbing ECNs, and vertically integrating by assuming clearance and settlement functions. Consolidation also occurs on a smaller scale through fractional purchases of other exchanges.

### B. Stock Market Consolidation

#### 1. Is It Inevitable?

The literature too often assumes the inevitability of consolidation and globalization without any explanation. Scholarship has noted the trend towards consolidation, and addressed the attendant need for regulatory reform generically,[15] but these two points must be reconciled. The sequencing of consolidation and regulation is important as it relates to the issue of the appropriate role of regulation. Arguing that consolidation is inevitable implies that no regulatory reform is needed because efficient markets will reach that result by the invisible hand.[16] However, it is not entirely accurate to characterize consolidation as inevitable. A more appropriate description follows: trends indicate globalization and consolidation, but the full extent and advantages of consolidation cannot be realized given current regulatory impediments to international linkages. Regulatory barriers[17] must be removed to foster the continued thrust of globalization and consolidation, and to enable previously consolidated exchanges to operate on a truly transnational basis.[18] Regulations should not merely react to problems that organically arise—for example, by waiting for the markets to reach some critical mass of consolidation, which is unlikely to occur, or unlikely to occur with sufficient speed, absent regulatory modifications. Rather, regulations should survey market developments, anticipate the direction of trends, and adjust accordingly to promote and maximize the efficacy of these changes (i.e., to create a more hospitable environment that cultivates consolidation).[19] Additionally, the current trends may also engender these reforms by pressuring regulators to respond. Thus, consolidation and regulations operate synergistically, each encouraging the other.[20]

Notwithstanding the importance of regulatory guidance, consolidation still demonstrates aspects of inevitability; thus, it is "essentially" inevitable. Consolidation is already occurring in the current environment as a product of the same factors that generally promote global market operations discussed *supra* (e.g., demutualization, technology, etc). But consolidation is proceeding at a suboptimal speed and producing suboptimal outcomes. The current regulatory framework is hostile to single platform operations,[21] the holy grail of consolidation;[22] this may deter consolidation entirely,[23] or where consolidation still occurs, regulations discourage full consolidation onto a single platform.[24] Thus, the current regulations decrease both the quantity and quality of consolidation.

Subsequent to regulatory reform, consolidation will prevail even though regulations need not be specific to consolidation, just the reality of an international marketplace. Once these accommodating regulations are in place, consolidation versus merely listing on a foreign exchange or placement of foreign trading screens[25] is likely to emerge as the dominant and most efficient method of global participation.[26] Reforms will increase the desirability of consolidation by enabling complete consolidation onto a single platform, which confers additional efficiencies. Once single platform trading becomes feasible, a consolidated exchange would not need separate trading screens. Appropriate regulatory reform will also drive competition, which will result in increased and more effective consolidation.[27] Moreover, consolidation also operates in a self-perpetuating manner, exerting a contagious effect by pressuring lonely operating exchanges to search for new partners.[28]

Stock market consolidation offers numerous virtues that surpass the benefits conferred by simply increasing market access. On balance, these justifications for stock market consolidation outweigh a few potential concerns.

### 2. Advantages of Exchange Consolidation

Enhanced efficiency and profitability militate in favor of stock market consolidation. By combining resources and different specialties and product offerings, two (or more) previously separate exchanges can achieve great economies of scale and cost savings. For example, combined operations can realize savings by sharing trading systems, and reducing fixed costs and overhead. [29] In addition to achieving economies of scale, consolidated exchanges can increase efficiency and profitability by expanding their scope of operations, which increases liquidity and enables the collection of more listing, trading and data fees. Once a transatlantic exchange has significantly increased market volume and liquidity, it can even command higher commissions for offering a superior product.[30] Additionally, consolidation promotes innovation as companies collaborate and combine resources to enable new possibilities, and innovation contributes to greater efficiency and profitability.

More efficient operations and enhanced profitability benefit different constituencies. As public companies, exchanges that are profitable confer a boon on their stockholders. Exchanges can pass the benefits of their increased efficiency, liquidity, and profitability on to consumers of the exchange (investors and listers) in the form of reduced fees, best prices, and quicker execution. Global consolidation can also confer these benefits by creating a competitive environment which incentivizes regulators to maximize the welfare of *all* securities market participants.[31]

Market psychology can also enhance the success of consolidation. The market would no longer deem the single exchange to be "foreign"—with potential negative ramifications—when it involves domestic leadership. Even if a modified system of regulation is adopted, the beneficial bonding effect should remain or increase,[32] since presence in the United States *in conjunction* with domestic partnership signals corporate integrity. Moreover, mergers generally increase the prestige of both the acquirer exchange and the acquired, and this effect can especially benefit "the weaker partner," rendering "the overseas affiliate a more credible venue for trades than it would have been as an independent entity."[33]

Operating as one consolidated company (assuming regulatory hurdles are overcome) on a single platform brings additional advantages as opposed to simply accessing the market through placement of a foreign trading screen or assigning separate responsibility over particular markets to each side of the consolidated exchange. A common trading platform concentrates the resources of both exchanges to develop one trading network, which could foster the development of more powerful technology to handle greater liquidity.[34] Additionally, because the costs of developing trading technology are fixed, a merged exchange can achieve large economies of scale as it increases the number of financial products on its platform.[35] One unified exchange can also decrease market fragmentation by featuring all investment products on a single platform available to several markets, as opposed to listing on multiple platforms in multiple markets. The increased market size and scale of consolidated operations benefit investors by presenting a larger array of investment options, while offering listing companies access to a larger pool of capital. Although the merger of exchanges creates an opportunity for single-platform trading, under the current regulatory environment, these benefits can only be realized if products are offered as "global" shares that satisfy each jurisdiction's regulatory requirements.[36] Thus, the full benefits of consolidated stock exchanges cannot be realized until the regulatory barriers are addressed.

The combined effect of all of these advantages of consolidation is to direct capital to the most productive and efficient use, benefiting all market participants. "In theory, a unified world stock market would enable pools of capital, wherever they are to be found, to be directed into the most productive uses available anywhere in the world, a result that should enhance efficiency and productivity." [37] These consequences are aligned with the United States Securities and Exchange Commission's (SEC's) mandate of ensuring the efficiency and transparency of U.S. markets and facilitating capital formation in the United States, a pillar frequently treated as secondary to the prong most often stressed—investor protection.[38] But, in reference to the potential of cross-border exchange mergers, even the SEC has acknowledged that "[c]apital markets are globalizing, to the potential benefit of investors everywhere."[39]

### 3. Adverse Consequences of Exchange Consolidation

Consolidation also introduces some concerns, but none of these shortcomings substantially detracts from its many benefits. First, the principal criticism relates to antitrust arguments.[40] If consolidation proceeds at full speed, the eventual result may be an oligopolistic system of inflated fees and conditions that operate to the detriment of consumers. Massive industry shrinkage is not a desirable goal. However, oligopolies are not necessarily problematic since a system dominated by a few players can lead to hyper-competition, which can enhance efficiency and ultimately benefit consumers. Consolidation in the airline industry illustrated this effect, delighting consumers with significantly reduced ticket prices subsequent to a shrinkage in industry players.[41]

Second, opponents allege that consolidation would decrease listings. This criticism makes various false assumptions: that companies currently cross-list, which lacks statistical support;[42] that investors have access to multiple exchanges, which certainly is not true in the United States given the absence of foreign trading screens, and the additional costs of accessing foreign securities; and that market fragmentation is beneficial, which is generally untrue. Whether reforms facilitate placement of trading screens or consolidation onto a single-platform, cross-listing would be rendered unnecessary. Decreased fragmentation of the market will enhance liquidity, and competition will remain strong or increase as exchanges struggle to attract sole listings.

Third, consolidation will introduce additional non-regulatory challenges. Irrespective of regulatory barriers, differences in business structure can also complicate the operation of consolidated exchanges, assuming that the differences themselves are not so serious as to completely halt consolidation. Corporate cultural/governance policies, currency variance, and language barriers present non-regulatory difficulties for consolidated exchanges. Nevertheless, these same considerations are not insurmountable as they have not prevented the operation of multinational corporations and cross-border mergers in various industries.

In sum, these critical arguments do not undermine the conclusion that ultimately consolidation should lead to a more competitive environment with benefits redounding to all participants.

### 4. Varying Success of Recent Examples

Although stock exchange consolidation debuted several years ago, recent examples underscore regulatory concerns with respect to these linkages. Consolidation has been most successful where regulatory coordination is maximized, which has occurred when exchanges occupy the same jurisdiction or share membership in a supranational regime.

#### a. Intrajurisdictional Triumphs

The majority of merger activity has been intrajurisdictional. This trend supports the conclusion that disparate systems of regulation discourage consolidation and reconcilable regulatory systems facilitate consolidation. As in other exchange developments, the United States gingerly delayed jumping onto the cross-border consolidation bandwagon.

The formation of Euronext provides a paradigm of success (to be contrasted with Euronext's subsequent merger, described *infra*), free of many regulatory obstacles that currently hinder U.S. consolidation. Claiming to be the first integrated European stock and derivatives market, Euronext is the product of a September 2000 merger among the Paris, Amsterdam, and Brussels exchanges. The touchstone of Euronext operations is centralization, both of its order-driven trading system and clearing organization. Euronext also features harmonization of regulations and listing requirements, and allows brokers of the constituent markets to trade in any of the markets.[43] Although these countries had separate regulatory systems prior to the merger (and brokers will still be subject to home regulators), European Union membership indicates they were already operating under common rules and had a precedent for cooperation. Notably, despite separately operating subsidiaries that maintain their own listings, trading system, and regulator, Euronext claims to have a "single trading platform," and members can trade on all exchanges.[44]

The U.S. exchanges have also consolidated domestically. In the early twentieth century, over 100 U.S. securities exchanges either consolidated or shut down as a result of national exchanges absorbing local exchanges with the removal of geographic and communication barriers that sheltered exchanges from competition.[45] More recently, the New York Stock Exchange (NYSE) acquired former rivals Archipelago, an advanced electronic trading platform,[46] and Amex.[47] These actions occurred largely in tandem with Nasdaq's market moves, which include the acquisition of Instinet, an electronic trading network,[48] as well as the Philadelphia Stock Exchange and the Boston Stock Exchange.[49] Domestic mergers faced the same regulatory scheme both before and after the transactions, eliminating a major obstacle with which cross-border deals must contend.

### b. Cross-Border Complications

In 2007, the NYSE merged with Euronext to form "the world's first truly global stock exchange group."[50] However, in many ways this merger is incomplete and cannot realize the full benefits of consolidation because the combined company will not trade on a single platform unlike Euronext itself, whose constituent markets trade with a single central order book.[51] Maintaining separate order books ensures two separate systems of regulation. Indeed, the exchanges intentionally designed the system this way, as it provided the NYSE with a non-U.S. trading venue to attract foreign firms frustrated by the U.S. regulatory system.[52] Euronext also resisted U.S. regulation.

Admittedly, the combined company will realize some cost benefits in the form of reduced overhead and shared trading systems,[53] but these pale in comparison to the full benefits of complete consolidation. The merger was intended to unite synergies as the new company was envisioned to combine "NYSE's global brand and leading cash marketplace with Euronext's international, cross-border, and diversified product range, technology and integration skills."[54] It is unclear whether the benefits derived from a combination of synergies will be sufficient to compel future merger activity absent regulatory changes. Additionally, although cost savings benefit the bottom lines of both companies and accordingly their respective shareholders, investors and issuers are being deprived of the benefits of single-platform consolidated trading. Even if the increased profitability and efficiency may trickle down in the form of lower fees and quicker execution time, investors and issuers will not realize the enhanced liquidity and breadth of market access that should be attendant on exchange consolidation.

Nasdaq's participation in the cross-border arena also demonstrates the evolution of mega-globalized exchanges. Like the NYSE, Nasdaq commenced its consolidation course with domestic activity. Nasdaq subsequently coordinated its actions with the international fever in 2007, merging with Borse Dubai and OMX (which is itself a product of the consolidation of several Nordic exchanges).[55] Similar to the NYSE-Euronext deal, NASDAQ-OMX also employs separate regulation by jurisdiction.

If the United States is not able to come to common agreement with the European Union to facilitate complete consolidation, regulatory coordination and consolidation with Asian exchanges, whose regulatory systems diverge even more from the American way, are even less likely.

## II. Regulatory Framework

The benefits of international finance are myriad,[56] but bringing these benefits to fruition requires a suitable regulatory environment that enables and promotes cross-border interaction. A principal, contemporary problem with securities regulation is that while "[t]he interests of investors and issuers are increasingly global in nature… the interests of securities regulators still tend to be local.… Thus, regulators often do not regulate for competitive position in the global market, but rather for the protection of local interests."[57] In particular, the policies of the United States must be altered to accommodate international entry because the European Union is already more amenable to U.S. entry.[58] But reforms cannot occur in isolation; as joint efforts, cross-border deals require regulatory cooperation and coordination.

### A. Current U.S. Regulatory Scheme and Its Barriers

The U.S. regulatory system has been criticized as unduly hampering capital market integration.[59] Currently, the United States operates its markets under the principle of neutrality, subjecting foreign entities to the same regulations as their domestic counterparts. Initially, this system seems to demonstrate parity; however, it has discouraged foreign entry. Despite a few windows to accessing the markets, foreign companies are severely limited in entering the United States without submitting to SEC regulation. SEC oversight extends to virtually any foreign penetration of the U.S. securities market; thus, foreign exchanges, issuers, and broker-dealers are subject to most of the same regulations applicable to their domestic counterparts.[60] Specifically, foreign exchanges cannot place trading screens with brokerage firms without registering as an exchange with the SEC;[61] securities listed on foreign exchanges cannot be directly offered to U.S. investors unless they are registered with the SEC;[62] and foreign broker-dealers cannot solicit U.S. investors without registering with the SEC.[63] These rules deter single-platform trading of consolidated exchanges. The combined effect also forces U.S. investors to incur extra costs in accessing securities on foreign exchanges.[64] Thus, the SEC's focus on investor protection has not always produced optimal investment opportunities. Conversely, the European Union's emphasis on breaking down market barriers[65] is more conducive to cross-border linkages and mergers.

Moreover, the SEC does not consider the degree of home country regulation governing market entities. This failure to distinguish lacks sense "[o]n its face.… Some non-domestic issuers may therefore be overregulated, subject to overlapping and redundant regulation under SEC and home country rules, while others, likely from developing countries, may actually be underregulated."[66] This inconsistency also applies to the regulation of broker-dealers and exchanges. Additionally, for all entities this duality is problematic for another reason: adherence to the SEC's extensive rules on disclosure and liability is even more onerous when these rules constitute the second regime with which foreign entities must comply.

Self-regulation, another defining aspect of the U.S. securities markets,[67] constitutes a more liberal aspect of U.S. regulation, but poses a major problem in determining cross-border regulation: what impact does self-regulation have on foreign participants, and can foreigners participate in self-regulation? Even within the United States, critics have denounced self-regulation as an ineffective method.[68] It is doubtful that the United States would accept freestanding foreign self-regulation over concerns of competency and ensuring comparability. Self-regulation is also significant because the United States' commitment to the self-regulation model may be impeding the progress of regulatory reforms.[69]

### B. Progress and Pitfalls in Internationalization

Notably, the United States has made some advances in the internationalization of securities regulation, adopting three characteristics of the European Union's single market project: convergence, harmonization and mutual recognition.[70] Scholars have expressed hope that the "adoption of these concepts and strategies raises the prospect of actual progress toward the development of a trans-Atlantic marketplace.…[71] Prior accommodations such as relaxed reporting and disclosure for non-U.S. issuers,[72] 144A offerings,[73] and various exceptions from provisions of Sarbanes-Oxley have not created a sufficiently hospitable environment to attract foreign issuers, exchanges and securities firms to the United States. However, recently the United States has shown a willingness to accept international standards, which suggests an increasing receptiveness to a foreign approach and international pressure. For example, the United States has agreed to rely on foreign audits to the extent deemed appropriate, and has entered into an agreement with the European Union for mutual recognition of audit systems.[74] It has also accepted the International Organization of Securities Commission's (IOSCO's) disclosure standards—which largely mimic the existing U.S. requirements.[75] Additionally, the United States no longer requires foreign companies to reconcile their financial statements with U.S. Generally Accepted Accounting Principles (GAAP).[76] Moreover, the United States has accepted the international capital adequacy requirements of Basel II through a phased-in approach.[77] Significantly, in adopting some reforms, the United States has considered or agreed to extend its new approach to domestic companies as well. This raises the important possibility that any changes to the regulation of securities markets may also affect domestic companies.[78]

Notwithstanding these signs of improvement, the failure to resolve the most pressing regulatory issues and the absence of increased cross-border activity suggest that the United States is not going far enough. One scholar has succinctly summarized the current state with three observations about the regulation of U.S. securities markets: (1) U.S. securities regulation is not producing optimal regulation for many issuers; (2) foreign issuers and U.S. investors are shifting capital raising and investment activities away from the U.S. markets; and (3) financial service providers have played an integral role in aiding the movement of capital raising and investment activity away from the United States, serving as the primary drivers of the "new internationalization" of U.S. securities regulation.[79] Another author has observed the mismatch between the current environment and the general SEC approach, while remaining hopeful about the SEC's capacity to bring about beneficial changes:

> A new global capital market landscape is inexorably being created, a reality that the SEC will inevitably have to acknowledge as the flaws in its current regulation and regulatory approach are increasingly teased forth. It is a transformation that has a real chance to engender substantive change in the scope, structure and content of the federal securities laws. The SEC will inevitably be forced to act. If the SEC promulgates regulation that not only pays heed to the new capital markets paradigm, but does so in a manner comporting with sound regulatory process, it will do so in a more economical and responsive manner.[80]

Therefore, to remain competitive in a rapidly globalizing world, the United States must implement appropriate regulatory reforms to fully embrace the factors promoting globalization of modern stock markets (discussed *supra* Part I.A) and to fully thrive on the modern theme of interconnectedness. The need for reform is especially pressing for the United States because it espouses a nationality-neutral approach to regulation, but its methods of regulation are "unique" and "cannot easily be extended to non-U.S. exchanges."[81] Furthermore, the European Union has also demonstrated resistance to SEC regulation of the European half of a transatlantic exchange.[82]

Despite agreement on the need for regulatory reform in the United States, the scope is not self-defining. For example, should changes apply to domestic operations as well, or should reform be limited to treatment of foreign entities? Creating parity with domestic exchanges and broker-dealers is an important consideration to guard against the threat of home country disadvantage and regulatory arbitrage. Additional issues to consider include the appropriate level of convergence and coordination with other countries, and whether a bilateral or multilateral approach is most appropriate. These difficult questions help to explain the SEC's cautious, and at times sluggish, approach in adopting changes. The SEC has indicated it recognizes the current state of affairs and the task at hand, officially stating that "[t]he SEC has been anticipating exchange globalization for some time and will continue to collaborate with its regulatory counterparts abroad to resolve potential regulatory issues in a manner consistent with U.S. law and in a way that protects investors, promotes capital formation, and ensures fair and efficient markets."[83] Notwithstanding this prescient forecasting and noble intention, efforts have seemingly ground to a halt. Admittedly, the SEC faces a tremendous task that entails significant consequences and lacks a clear solution. The ramifications of the SEC's actions will be magnified by the fact that

> [t]he U.S. securities regulatory scheme is arguably the benchmark against which the world's other securities regimes are measured. This does not mean that these other regulatory systems aspire to mimic the U.S. regime; rather, they look to the United States to measure the appropriateness of their regulation, borrowing from the United States as they deem appropriate and differentiating themselves where economic or other interests militate.[84]

Conservatism by the SEC often appears as the best defense to upholding its admirable principles and preserving the benefits of a strict regulatory policy.[85] While such concerned consideration is commendable, prompt exploration and resolution of the questions, not inaction, are more appropriate responses.

## III. Options for Cross-Border Regulation

Scholars have espoused various proposals for dealing with overlapping legal regimes in global offerings and transactions. These proposals generically apply to international market linkages and are not specially tailored to consolidation in particular. However, "[t]he problem of regulating cross-border exchanges should be viewed in the context of the SEC's need to open up the U.S. securities markets to more international competition."[86] Opening these markets will clear the path for consolidation. The proposed rules target various levels, including issuers, exchanges, and broker-dealers. Even where a proposal does not specify regulation of an exchange, which comprises the most direct issue in the consolidation context, these proposals involve the same underlying concerns. Exchange regulation vis-à-vis issuer regulation represents an alternative way of imposing oversight with a more top-down approach. The operations of exchanges govern the regulation of constituent issuers, and rules for issuers determine the quality of securities offered on an exchange. This is because in the United States, absent an exemption, exchanges are subject to registration and regulation by the SEC,[87] and registered exchanges can only trade registered securities[88] and must ensure that issuers comply with the federal securities laws.[89]

Although all of the proposals presented here suffer from some shortfalls, they would each make a significant improvement to the current status quo and respond to the numerous difficulties inherent in cross-border and extraterritorial securities regulation.[90] Most proposals have focused on designing a specific set of rules for dealing with cross-border transactions, but home country rules will factor into determining the content of these rules.

### A. Issuer Choice

Portable reciprocity, a form of issuer choice, is one of the most liberal proposals that has been offered. Under this system, issuers would select a regulatory regime from among participating countries, and the rules of this regime would govern all aspects of the issuance and trading of the company's securities irrespective of where transactions actually occur.[91] Advocates of issuer choice contend that such a system would promote competition among regulatory authorities, improving the overall quality and efficiency of securities regulation.[92] This would be achieved for various reasons, which include eliminating barriers posed by the current U.S. system of securities regulation, challenging the alleged SEC monopoly over U.S. securities regulation, enabling regulators to achieve economies of scale in regulation, and encouraging regulators to craft efficient regimes to attract selection by issuers (which will presumably result in issuance in that jurisdiction).[93] "As countries seek to establish a niche for themselves in the international competition for securities issues," portable reciprocity would produce a "spectrum of regulations."[94] Proponents argue that investors, in addition to issuers, will react to this spectrum as the market will respond appropriately to the level of risk attendant on the selection of a particular law; thus, investors would apply appropriate discounts based upon the level of disclosure required by the governing law.[95] Accordingly, issuer choice also involves investor choice.

Nevertheless, portable reciprocity suffers from many flaws.[96] The biggest concern it poses is the threat of a race to the bottom, where issuers may flock to the least restrictive regimes.[97] This is especially likely to occur in the absence of any nationality requirement. Additionally, without a mechanism of comparability, participants in the securities markets will not operate on an even playing field. The claim that investors can apply a discount to account for this disparity assumes that investors will understand the implications of the differences between regulatory regimes. But the tenuousness of this assumption implicates many concerns about investor protection. Portable reciprocity also poses serious problems for implementation and enforcement.

Scholars have extended the portable reciprocity concept to allow choice of regulation by exchanges.[98] However, this variation has been largely dismissed as an unviable option as it may actually decrease regulatory competition, while issuer choice would create a "purer regulatory market for securities laws."[99]

Although the issuer choice option is perhaps the least feasible out of the panoply of proposals, a more narrowly tailored application of its underlying principle of mutual recognition deserves further attention.[100]

### B. Mutual Recognition

Mutual recognition presents the most feasible and effective alternative to regulating internationalized capital markets. Different proposals embracing the mutual recognition perspective vary in nuance, but share the same essential view of separate jurisdictional regulation subsequent to a comparability analysis.

#### 1. An Interlude on Convergence

Convergence and harmonization of basic regulatory criteria serve as preconditions of mutual recognition because they enable countries to satisfy a comparability assessment, which is a prerequisite to mutual recognition. Cross-border mergers exert pressure on regulators to increase convergence.[101] But achieving convergence and harmonization presents many difficulties. Some scholars concede that harmonization would theoretically resolve the regulatory dilemma, but doubt its feasibility as the markets are "plagued by conflicting legal systems"[102] that are arguably irreconcilable. Although convergence implies an averaging of the principles of two systems, in practice, discrete policies of participants will dominate. Both the United States and the European Union, the systems on which this article is focused, have demonstrated some intransigence to adoption of the other's system.

Preservation of principles of U.S. regulation should and will characterize any convergence initiatives. In addition to recognizing necessary changes that must first occur in the United States, one scholar envisions a conversion process with the SEC exerting pressure on foreign markets "to bring the other markets up to U.S. standards."[103] Given the United States' resistance to compromising its fundamental market values, this may be the only way for the United States to participate in a system of mutual recognition. The U.S. system, while imperfect, may be preferable to foreign regimes as stricter rules can better protect market integrity, but foreign recalcitrance poses a major obstacle. In fact, disagreement with costly disclosure and litigation aspects of the U.S. system partially explains foreign abandonment of U.S. markets (in addition to the costs of dual compliance).

Convergence will also require certain fundamental changes in the United States, given its sui generis approach to regulation. It is more realistic for convergence to proceed in the direction of majority rule vis-à-vis the minority. Many scholars have offered the general suggestion of decreasing the burden of litigation and regulation to halt the "erosion" of the United States' competitive position in the capital markets.[104] More specifically, three principal changes in the United States will pave the road for mutual recognition with European markets:[105] there must be a separation of self-regulatory responsibilities and exchange operations, a redefinition of best execution in the trade-through rule[106] to permit exchanges to compete on services in addition to price, and the opening of the U.S. market to foreign financial service providers (foreign exchanges with their trading screens). These modifications challenge the SEC's accustomed manner of operation, and it is not entirely clear to what extent, and when (if ever), they will occur.

Differences in regulatory philosophy and governance will also frustrate convergence between the United States and the European Union.[107] U.S. securities law is more enforcement-oriented as compared to the prudential European approach of working out problems with violators.[108] Additionally, EU securities law is less centralized than U.S. securities law. EU directives establish goals and guidelines to be implemented and enforced by Member States;[109] this principle-based approach contrasts with the SEC's rules-based system of governance.[110] Accordingly, the U.S. Committee on Capital Markets Regulation encourages the United States to adopt more principle- and prudential-based approaches, and notes that such changes will render the United States more amenable to harmonization and participation in mutual recognition.[111] But the transnational structure of the European Union in conjunction with its principle-based philosophy would still present a potential catch-22. Negotiation with the European Union could have broad applicability; however, full and robust execution by Member States is not guaranteed. Conversely, the existence of the EU as a body may constrain direct negotiation with Member States, which must first comply with EU directives. Thus, convergence initiatives pursuant to a system of mutual recognition would need to consider both the European Union and Member State levels.

Nevertheless, convergence may not be as infeasible as critics allege. Firstly, opponents exaggerate the regulatory differences among jurisdictions. Currently, U.K. disclosure standards, which are followed by most European countries, are quite close to U.S. standards;[112] thus, achieving convergence with European countries may be an achievable goal. Secondly, notwithstanding concerns about ultimate execution and enforcement, direct negotiations with the European Union would efficiently achieve convergence and mutual recognition with many countries in one fell swoop. Although reaching such an agreement will entail negotiating with the several members states, these Member States have themselves sufficiently converged already. Accordingly, a singular bilateral agreement with the European Union could produce multiple European linkages. Thirdly, convergence can actually foster additional convergence: legal regimes converge to foster mutual recognition, and mutual recognition may increase pressure on the SEC and lawmakers to modify the regime applicable to domestic participants to eliminate or further reduce any differential.[113] Consequently, the U.S. regulatory system would move closer to the foreign regime, as that foreign regime moves closer to the U.S. system by adopting essential U.S. elements that cannot be compromised. In fact, global convergence to a common denominator appears to have already begun: post-Sarbanes-Oxley, governments in Asia and Europe have selectively integrated elements of U.S. law that they believe will enhance the reputations of their capital markets, while "the United States, too, is vigorously engaged in securities law reform, though it is actively seeking to make its laws less burdensome for issuers."[114] Lastly, convergence does not mean imitation; in fact, maintaining regulatory diversity is an important goal.[115] Moderate changes are acceptable and appropriate; countries will need to focus on nuance in achieving a convergence which is sufficient to ensure substantively comparable systems, but not so onerous as to require a radically altered framework that one side deems objectionable.

### 2. Tafara and Peterson's Substituted Compliance Proposal

Seizing on the virtues of mutual recognition, Tafara and Peterson, two officers of the SEC (who quickly disclaimed any responsibility of the SEC), offered a comprehensive "Blueprint for Cross-Border Access to U.S. Investors: A New International Framework."[116] The framework is touted as offering "a compromise—increased access by foreign market participants to the U.S. capital market, with a dramatic reduction in duplicative and unnecessary regulatory oversight, in exchange for a system that creates a true partnership between the SEC and the home regulator."[117] The proposal focuses on two sources of foreign linkages: foreign stock exchanges (and their trading screens)[118] and foreign broker-dealers. Under the proposal, both entities would no longer need to register with the SEC to access U.S. markets as long as the SEC deems that they are subject to adequate home regulation, which is "substantively similar" to U.S. securities law and regulation; this process comprises the proposal's two prongs of "regulatory preconditions" and "exemption requirements." Regulatory preconditions could be satisfied through a prior bilateral agreement between the two countries, subject to reevaluation on a periodic basis. This would necessitate strong cooperation between the SEC and foreign regimes. Additionally, satisfaction of the exemption requirements would provide an exemption from U.S. regulation except for the anti-fraud rules. As an extra layer of protection, investors would also receive a mandatory disclosure that foreign trading entails different legal and regulatory protections. Thus, substituted compliance is a variant on issuer choice as it permits the foreign entity to select home state regulation or regulation by the foreign market.

The proposal's bilateral focus embraces the most efficacious approach to harmonization. In contradistinction to multilateral discussions, the proposal's bilateral negotiations (which reconcile different regulatory regimes through "bilateral substituted compliance") will proceed more quickly and effectively.[119] A series of bilateral negotiations may even hasten global synchronization. While an overarching global framework for facilitating cross-border market interaction is useful for coordinating and encouraging such endeavors, wide-scale regulatory coordination as a direct goal is simply unrealistic and administratively difficult. The bilateral nature of the plan also minimizes the existence of regulatory double standards, which currently characterizes the American-European relationship. Although U.S. disclosure standards pass muster for issuing securities in the European Union, EU disclosure standards are not deemed adequate in the United States.[120] Mutual recognition would eliminate this one-sidedness, without requiring the SEC to compromise its admittedly noble commitment to market transparency and efficiency.

Substantive similarity is another virtue of the proposal. Substantive similarity enables realization of the benefits of home state regulation, which mitigates cost concerns attendant on complying with multiple regimes, and is itself a more effective method of regulation. Mutual recognition's division of regulatory responsibility is logical from an administrative standpoint as countries can best monitor and enforce rules against those agents within their jurisdiction given geographic proximity and better familiarity. Although mutual recognition requires participating countries to relinquish regulatory authority, substantive similarity provides assurance (supported by an underlying bilateral agreement, disclosure obligations, etc.) that the home country will faithfully execute oversight duties. The substantively similar evaluation also ensures that the system does not discriminate against domestic issuers by subjecting them to a radically more onerous regulatory regime. Furthermore, the proposal still accommodates regulatory experimentation without encouraging regulatory arbitrage.[121] Thus, substantive similarity (especially with the extra disclosure requirement) should not interfere with the SEC's goal of investor protection.

Despite these potential advances, the proposal still has some pitfalls, and the authors forthrightly concede some of these weaknesses. The proposal makes certain key assumptions. These include: both retail and institutional investors actively seek to invest in foreign securities and would benefit from the lower costs and additional information; investors would benefit from increased competition in the market; and assuming regulatory oversight and enforcement agreements are in place, regulatory differences in like-minded jurisdictions are not so great that U.S. investors would be unable to assess additional risks.[122] Moreover, the Tafara and Peterson proposal does not adequately address the importance of regulatory convergence, relegating it to a mere background principle.[123] Additionally, the task of determining comparability may be difficult, and the proposal, like all others, raises concerns about implementation and enforcement.

### 3. MiFID as a Model

Another scholar has expanded upon the Tafara and Peterson proposal, and suggests using the European MiFID approach (Markets in Financial Instruments Directive) as a paradigm example.[124] MiFID provides a regulatory structure for European markets to operate in and among EU Member States; essentially, it accords investment firms and exchanges a passport to conduct business in other Member States once they are authorized to conduct business by the home country. Mutual recognition, minimum standards, and home country supervision comprise the basis of the passport concept.[125]

Although adopting a MiFID approach would provide a solution to regulating cross-border exchanges, extending MiFID to the United States and beyond will be difficult in the absence of preparatory steps which have occurred in Europe. Eric Pan, the proposal's author, does identify fundamental changes that must occur in the United States,[126] but the background context of MiFID should still be acknowledged. The European Union has an extensive history of cooperation, and prior to MiFID, had already achieved substantial progress in integrating member markets. Moreover, European countries have an established tradition of joint governance and already collaborate through various transnational bodies. MiFID emerged from a concerted effort to create a single integrated market as outlined by the Financial Services Action Plan[127] and the Lamfalussy Report.[128] MiFID was not implemented in isolation, but was complemented by other integration initiatives such as the Prospectus Directive[129] (allowing the use of a single prospectus for offerings in all Member States) and the Transparency Directive[130] (imposing ongoing disclosure requirements for all exchange-listed companies). Thus, Europeans elevated mutual recognition as a priority while attempting to preserve market integrity.[131] Therefore, despite its attractiveness, the importation of this passport concept into the cross-border arena may not prove successful in the absence of a history of cooperation and commitment to integration. Nevertheless, the concept has potential viability between the United States and the European Union, which do have a history of cooperation, so long as existing efforts are strengthened[132] and necessary changes are adopted.

Moreover, the success of MiFID is also questionable;[133] the dearth of pan-European offerings[134] seems to indicate weaknesses in this approach. Exposure to liability in all Member States, each with unique schemes, under both the Prospectus Directive and Transparency Directives may contribute to deterrence of wide-scale offerings.[135] Additionally, Member State retention of control in the implementation and enforcement realms (subsidiarity) presents disparity concerns. For example, each Member State employs a different model of supervision and varies in enforcement intensity (of the rules derived from the same basic principles).[136] While subsidiarity is a product of the EU integration model, separate implementation and enforcement procedures will characterize any MiFID/mutual recognition system; thus, the same concerns remain. These variations would be less severe when applying a MiFID approach to a bilateral arrangement between two countries, but multiparty involvement is at the heart of the MiFID concept. Furthermore, the European Union has addressed the implementation/enforcement problem by creating the Committee of European Securities Regulators, a separate regulatory body with the purpose of harmonizing implementation and enforcement, discussed *infra*. Indeed, Pan explains that "the MiFID passport reflects many decades of experience by the European Union, where aspirations for mutual recognition have been foiled by inconsistent implementation of directives and imposition of special requirements by certain member states."[137] Thus, an additional institutional link is necessary to successfully effectuate the MiFID approach.

Like the Tafara and Peterson proposal, the MiFID approach entails complications and possible negative ramifications, in addition to the great potential benefits of mutual recognition. Accordingly, despite a brief endeavor and initial optimism, the SEC has not yet committed to definitive implementation of a mutual recognition program.[138] But these shortcomings do not warrant wholesale dismissal of mutual recognition as a means of cross-border regulation; rather, they should serve as guidance for reformulating an analogous approach.

### 4. A First Foray: The MJDS Home Country Rules Approach

Mutual recognition debuted in the United States in 1991 with Canada under the multi-jurisdictional disclosure system (MJDS), which allows issuers to enter a foreign market while complying with home country rules. Although MJDS does not accord absolute immunity from U.S. laws,[139] it substantially improves the regulatory atmosphere for foreign issuers. For example, companies can use home country disclosure documents and prospectuses (affixed with a warning to U.S. investors of tax consequences and of pursuing remedies in a foreign jurisdiction).

Despite initial discussion of a broader application of MJDS, the United States has not expanded its scope beyond Canada.[140] Canada's similarities to the United States rendered it an obvious choice as there were probably few convergence precondition issues that stymie harmonization among other countries. Notwithstanding this halting progress, the equivalence concept proves to be the most workable of all of the alternatives presented in this article.

## C. Self-Regulation

Given the United States' historical preference for self-regulation,[141] some scholars have suggested extending the self-regulatory regime to govern transnational markets. Although European countries other than the United Kingdom do not share this tradition of self-regulation, some argue that "it is likely that self-regulation will be an important element of any regulatory scheme covering cross-border markets."[142] Increased reliance on self-regulation suggests that Europeans may be more receptive to this approach.[143] Notably, Euronext already employs a system of self-regulation,[144] like most exchanges, by setting and enforcing its own market rules. Additionally, self-regulation is likely to play a prominent role in the transnational regulatory structure because investors will only be attracted to markets that are perceived as open and fair, and conformance to rules governing conduct of members through self-regulation is one way to achieve a trustworthy reputation.[145] Moreover, self-regulation has the advantage of quick adaptation to rapidly evolving markets. Even where international coordination is required, exchanges can respond to current market conditions more swiftly and more effectively than an outside regulator given their personnel's greater familiarity with operations.[146] Another factor militating in the direction of self-regulation relies on a negative argument—this approach may simply be more viable than some alternatives, as it is unlikely that a supranational securities commission with the power to promulgate and enforce international standards will emerge in "the foreseeable future."[147] Thus, other avenues, such as self-regulation, deserve exploration.

Nevertheless, self-regulation poses many problems.[148] Firstly, self-regulated, demutualized stock exchanges face numerous conflicts of interest; one such conflict is between the exchange's owner-stockholders and its customers. Consequently, self-regulation creates incentives for both underregulation and overregulation as a result of profit-maximizing objectives.[149] Underregulation avoids the costs of enforcement and may entice more companies to list on the exchange. Conversely, overregulation can maximize profits since regulation can serve as a source of funds for the exchange (from fines and other payments). However, underregulation remains the main concern because there is no guarantee that listed companies will not violate exchange rules.[150] Notably, these arguments against self-regulation apply to self-regulation in general, even on purely domestic exchanges. But if the system suffers from these shortcomings at this singular level, unrestrained self-regulation seems especially doomed at the next multijurisdictional level, with issuers and traders based all around the world. Secondly, the computerization of trading renders self-regulation less compelling since oversight can be exercised absent physical presence.[151] Thirdly, self-regulation will not suffice as an independent mode for cross-border regulation. Unless complemented by mutual recognition, an exchange operating in several jurisdictions would still need to contend with different regulatory frameworks because self-regulation supplements government regulation. At least in the United States, self-regulators enforce federal securities laws in addition to their own rules using sanctions available to them, such as denial of membership and privileges.[152] Coordination through a multijurisdictional organization may also help effectuate self-regulation.

### D. Transnational Regulatory Organization

An international organization must play some role in resolving the cross-border regulatory dilemma. Oversight and coordination through an international body can operate in conjunction with and enhance the proposals discussed *supra*. For example, transnational regulation can be centralized within a transnational organization which utilizes principles of convergence and mutual recognition to create transnational securities laws. The organization can enunciate either binding rules or more flexible standards to guide member countries. Worldwide harmonization of rules would certainly facilitate international finance: issuers would only need to comply with one set of distribution procedures and disclosure requirements, and one set of liability standards and enforcement remedies.[153] Thus, global adherence to uniform policies would create an equitable environment, decrease compliance costs, and resolve enforcement concerns. Notwithstanding these potentialities, experience in many contexts, even outside of securities law, has proven that international bodies are frequently toothless and ineffective.

To be effective, an international body would need to transcend the role of the extant international organizations, but a strengthened international body may flounder despite purportedly expansive powers. In order to achieve widescale coordination to facilitate international linkages, an international body would need to first mediate among numerous constituencies—an exceedingly difficult task. Convergence between a multitude of diverse interests will only multiply the problems experienced in brokering sufficient convergence between two countries. Additionally, even if it were possible to create an "international SEC," empowering such an agency with ample power over the market structure may not be the best source of regulation, as "government agencies are not well suited to make the kind of business decisions that would be involved in establishing an international securities market."[154] The time-consuming and uncertain process characteristic of transnational organizations cannot quickly adapt to the rapidly changing and technologically advancing securities markets.[155] Perhaps it is more appropriate to restrict governmental involvement to protecting investors and the market against fraud and anti-competitive practices.[156]

The experience of EU single market integration, previewed *supra*, serves as a case study in cross-border coordination through centralization.[157] On the one hand, the framework's involvement of twenty-seven Member States demonstrates the potential of multilateral global cooperation. But previous coordination efforts and numerous similarities in governance and culture facilitated progress in the EU situation. Thus, it would be difficult to implement a more global application of mutual recognition through a transnational body (or bodies) among multiple countries that lack the foundational, transnational European structure. Additionally, the EU regime has actually experienced the predictable difficulties of implementation and enforcement expected to result from the involvement of twenty-seven Member States, each with unique perspectives and concerns. Even with the Lamfalussy decision-making procedure for the adoption of EU legislation affecting securities markets, which has enabled much of the European Union's success with the single market initiative, the process still entails a complex and hierarchical procedure. The efficacy of the entire approach has been called into question.[158] Notably, during the strains of the financial crisis, fractures within the European single market have become apparent.[159] Accordingly, some academics have advocated the creation of a European-type SEC, in recognition of the virtues of the SEC's governance system.[160] However, such a strengthened body would still have to contend with the many difficulties endemic to all large cross-border structures, and may be inappropriate on a transnational scale.

Additionally, why create a new international regulator when there are already international bodies whose scope should theoretically cover such regulation? For example, IOSCO seems aptly suited for the position, and might be "the most important of all organizations for influencing international securities regulations."[161] IOSCO's preamble declares precisely what international global markets require: to have "[s]ecurities authorities resolve to cooperate together to ensure better regulation of the markets, on the domestic as well as on the international level, in order to maintain just, efficient and sound markets."[162] Nevertheless, IOSCO's lack of binding power over its members hamstrings its ability to fulfill these idealistic and necessary visions. Perhaps there is reluctance to simply empower currently existent bodies, which might be tainted by prior inefficiencies, but the prospect of a new and effective international regulator is unlikely. In fact, "[n]oticeably absent from the few statements made by the SEC regarding mutual recognition is any proposal about forming an intergovernmental body…or granting new powers to the International Organization of Securities Commissions to facilitate on-going cooperation between the SEC and other regulators.…"[163]

Recognizing the potential of IOSCO, scholars have suggested modified forms. One proposal envisions a single organization with binding, self-regulatory powers over transnational exchanges.[164] Such an organization would be exceedingly difficult to bring to life, and would have many handicaps based on its emphasis on multilateral treaties and self-regulation.[165] Eric Pan offers a more feasible alternative, suggesting the Committee of European Securities Regulators (CESR) as a paragon.[166] CESR represents just one among many transnational bodies involved in the Lamfalussy process and the integration of the European securities markets. CESR's particular tasks are instructive on the responsibilities an effective international securities organization could and should have. While CESR has a mandatory role in the regulatory process, IOSCO provides nothing more than a forum, as it exercises no power. Through cross-border information-sharing, CESR assists with implementation and enforcement conducted at the national level. Although the EU integration process has still experienced problems, the moderate approach of the CESR model—a strengthened but not overly powerful international body—offers a realistic option that could facilitate transnational regulation. Such a forum for coordination, at least on minimum standards and basic principles, with an emphasis on implementation and enforcement, serves as a necessary complement to any mutual recognition regime.[167]

Notwithstanding debate regarding the appropriate role of an international regulator in the securities markets, there is a strong consensus on the need for an institutional linkage. The disagreement stems from whether this regulator should play a primary or ancillary role, and whether policies should take the form of binding rules or flexible standards. Thus, the appropriate level of power to confer upon such an organization is unclear. An international organization must have sufficient power to command uniform implementation and enforcement. However, countries are unlikely to (and should not) submit to an omnipotent monolith that lacks attentiveness to current situations, which may rapidly develop and are unique to each country. Despite recent optimistic endeavors showcasing international cooperation, no momentous developments have occurred.

## IV. Tying It All Together: A Comparative Analysis Yields Recommendations

Many scholars have grown frustrated with the mainstream reform options of issuer choice, mutual recognition, self-regulation, and negotiation through a centralized international body. In a search for alternatives, some have suggested fanciful plans such as creating an offshore free zone for primary distributions of foreign issuers, liberated from restrictions other than minimum disclosure requirements.[168] This article does not endorse such a novel proposal; rather, it strives to critically evaluate and compare the prevailing alternatives and to offer recommendations on which aspects of these options are most feasible and desirable. Although there is no single, perfect solution, the SEC must revive its interest in the subject, and further extend its previous endeavors.

In light of the advantages and shortcomings of the various proposals, on balance, a system of mutual recognition that emphasizes joint and interdependent regulation primarily via bilateral negotiations, coordinated with a strengthened international securities organization, and some self-regulation, holds the greatest potential for governing cross-border markets. This article advocates the general concept of mutual recognition, but not necessarily its precise embodiment in the Tafara and Peterson or MiFID models. Mutual recognition should serve as the fulcrum of reform, with the various other components providing a supporting function. This suggested mechanism of reform incorporates principles from the different proposals presented *supra*, not in a jumble, but in an orderly attempt to maximize the benefits that each approach offers, while minimizing costs and concerns. The system envisioned will follow the guiding principles of simplification, efficiency, competition, and fairness without abdicating[169] investor protection, a top priority for the SEC.

Mutual recognition improves upon issuer choice, as it can achieve the same fundamental benefits—such as regulatory diversity, competition, and economies of scale—without the problems of pure issuer choice. Mutual recognition is really a variant of portable reciprocity, as it accords foreign entities passport access to a host country based upon respecting the regulatory prowess of another country. But the unbounded nature of issuer choice renders it an unlikely candidate for adoption anytime soon, and the more restricted nature of mutual recognition is preferable. Mutual recognition resolves the biggest handicap of portable reciprocity, a race to the bottom, by imposing optimal regulatory relationships, minimum standards and comparability assessments. By empowering issuers with greater control over regulation of the securities market, portable reciprocity creates a misalignment of interests, and leads to a race to the bottom because, presumably, issuers are focused on profitability and prefer minimum regulation. Conversely, mutual recognition correctly places the locus of control and decision-making among government representatives and experienced regulators, guided by the mission of facilitating robust and fair capital markets. Although issuer choice can achieve efficiency through consolidation of regulation over all operations of an entity, the absence of any (or of a substantial) nexus between the regulator and a participant's operations will detract from optimal efficiency and the integrity of regulation. Conversely, mutual recognition's basis in home country regulation achieves a more effective consolidation by enabling a single regulator to develop a fuller expertise in the complete operations of an exchange or broker-dealer, and to exercise strong oversight and enforcement power given proximity and jurisdiction. Regulatory consolidation as a result of mutual recognition enables smoother regulation from the regulator's perspective, and more facile compliance for the entity; this should translate into more secure and transparent markets for investors. Thus, as compared to issuer choice, mutual recognition can achieve an even stronger and more meaningful economy of scale that benefits all market participants.

The preconditions of convergence and the comparability analysis attendant on the mutual recognition system espoused by this article will also enhance confidence in home country regulation and preserve market integrity and investor protection; this should render the option more palatable to the SEC, which must reluctantly relinquish some regulatory control. Portable reciprocity lacks both prerequisites, while Tafara's and Peterson's substituted compliance fails to emphasize convergence.[170] Official confirmation of the strength of another regulatory regime is preferable to portable reciprocity's complete reliance on the ability of investors to discern differences in regulatory regimes. Mutual recognition can also maintain higher standards for better quality markets than portable reciprocity by establishing minimum standards. These standards will be meaningful because major markets such as the United States and the European Union will not compromise their fundamental principles of regulation (and they should not) in the harmonization process; therefore, other countries will have to rise to this more stringent regulatory level if they wish to connect with the major markets.[171] Convergence and mutual recognition are well-suited to incremental application to test these approaches. For example, convergence can occur just to the extent of satisfactory comparability to ensure diversity in regulation. Maintaining diversity of regulation is an important goal and factor militating against complete convergence; diversity ensures that regulation is suited to the particular needs of a country and promotes regulatory experimentation and competition, which can result in more efficient methods. Mutual recognition allows for the preservation of diversity. Additionally, on the issuer level, mutual recognition can first apply solely to large companies that already provide extensive disclosures to the market.[172] Such gradual implementation will pave the way for more extensive harmonization and full-scale recognition; flexible bilateral agreements will facilitate such adjustments.

The mutual recognition regime should occur in the context of a strengthened IOSCO or the creation of a new international securities organization. Such organization shall serve as a forum for global coordination, convergence, and equivalence. Although participating countries would privately and bilaterally negotiate the specifics of binding rules and retain enforcement responsibilities, the transnational body must play a mandatory role in the process. Centralization through a transnational body will help establish both minimum principles and binding standards, increasing global harmonization and convergence. Such convergence will facilitate execution of new bilateral agreements, and these arrangements will also incrementally increase convergence. Bilateral coordination is necessary to specifically tailor the mutual recognition program to participating countries and to fine-tune broadly agreed upon principles and minimum standards. Bilateral agreements are most efficient because they can also proceed and operate more rapidly than multilateral engagements, which are often plagued by too many competing interests. The bilateral agreements should remain adaptable and easily amendable so that countries can experiment with the appropriate scope of the arrangement and accommodate market developments. In addition to establishing a framework of rules, the central organization should also coordinate implementation and enforcement of these rules. Thus, a transnational body must be more powerful than those currently in existence, but should not serve as the primary source of regulation. With reference to the proposals presented, Pan's CESR vision, with its emphasis on implementation and enforcement, highlights certain responsibilities that should characterize an institutional linkage.[173]

Self-regulation can also still play a role in the regulatory process. Although global self-regulation would not be feasible, self-regulation should continue to exist where appropriate. By bringing regulators closer to the object of regulation, self-regulation can achieve a more searching scrutiny of operations as well as an enhanced understanding of the needs of the local environment. Self-regulation will work best on a microcosmic level, and might continue in some reincarnation, particularly in the United States where it constitutes a major part of the regulatory landscape. For example, employing an industry SRO (with jurisdiction restricted to a particular country) as opposed to internalized exchange self-regulation can achieve the benefits of self-regulation[174] while avoiding the major conflict-of-interest problems. There also may be a global role for these industry SROs to the extent that various countries create such positions, as national SROs can coordinate through the aforementioned international body.

Although this proffered solution still presents some concerns regarding implementation and enforcement, these considerations factor into all proposed reforms, and are outweighed by the significant potential of fostering a vigorous and effective global capital market. Moreover, the composite reform suggested in this article attempts to minimize the severity of these challenges while extracting the unique merits offered in each approach. The bilateral nature of the process should exert direct pressure upon market partners to sincerely implement and enforce proposals; as a ramification of not faithfully complying, a derelict country could lose passport access. A country's ability to forcefully threaten suspension or rescission of privilege in the bilateral context will be reinforced by membership in the suggested international organization. The transnational organization should assist in implementation and enforcement, and a noncompliant party would develop a tarnished reputation among the other members. Moreover, convergence and comparability can take account of, or at least reduce, differences in implementation and enforcement so long as the underlying framework is sufficiently explicit. Thus, this article's proposal for adopting "mutual recognition plus" embodies a conservative and flexible approach that the markets are currently well poised to adopt.

## Conclusion

Notwithstanding an organic tendency for consolidation to arise, regulations should facilitate and appropriately respond to this global trend. New York business attorneys will keenly experience the consequences of market movement and regulatory reform. Reforms that expand market access will increase competition of exchanges; once regulatory barriers are removed, competition in conjunction with technological innovations, the international atmosphere, and the need for economies of scale, will drive consolidation with redoubled force. Consolidation is the most efficient mode of maximizing liquidity and capital efficiency with benefits to investors, issuers and the broader capital markets. Regulatory reform can further extend the consolidation continuum by increasing the quantity and depth of events. Greater consolidation will occur when exchanges are confident that a hospitable infrastructure is in place, and international agreements that form or have already been formed will receive more favorable regulatory treatment. The end result should permit the existence of a fully integrated consolidated exchange operating on a single platform and unburdened by extraneous regulatory hassles.

While considerable debate exists over the optimal method of regulating transnational markets,[175] immediate action is required. Of the various proposals, bilateral mutual recognition agreements complemented by a strengthened or newly baptized international body, and characterized by some degree of self-regulation, holds the most potential for dealing with the complexities of international financial markets. Cooperation and coordination among countries must supplant insular tendencies and a patchwork of regimes which restrain growth and produce suboptimal results. An effective framework will have broad applicability to internationalizing the markets. Although European countries have remained the primary focus in discussions with the United States and will likely be the main beneficiaries of a system such as mutual recognition,[176] other emerging markets can also reap the benefits of a well-vetted system. Membership in an international securities organization should not be limited to Americans and Europeans.

Although the financial crisis has seemingly brought markets to a standstill, small transnational transactions are still occurring, and regulators must respond accordingly. Rather than viewing international markets as part of the problem, the United States and other countries must embrace the global universe as part of the solution. Reform can also hasten a new endogenous consolidation movement that has developed as decreased trading activity compels exchanges to find ways to survive.[177] As other markets, particularly European markets, challenge the United States' historically dominant position, participation of the United States will become less essential. Accordingly, the United States must move with the times and include global market reform in its recovery plans to remain a strong competitor. By spearheading an initiative, the United States can exercise greater influence over shaping the global landscape while stabilizing its internal markets, and preserving its superpower status.

## Endnotes

1. For example, in response to the NYSE Euronext's launch of its own European Multilateral Trading Facility (NYSE Arca Europe), NASDAQ recently announced its intention to acquire a European alternative trading platform. This move serves as an indication that a fragmented market of numerous small trading facilities will not endure in the current tough financial climate. Jeremy Grant, *NASDAQ Plans to Buy European Platform*, FIN. TIMES, Mar. 12, 2009 ("Analysts have said deterioration in equity markets—and sharp declines in the value of trades done—means some of the MTFs [multilateral trading facilities] are unlikely to survive."). *See also* Jeremy Grant, *LSE Part of Group Eyeing LCH.Clearnet Bid*, FIN. TIMES, Feb. 19, 2009 ("Clearing has moved centre stage in the wake of the Lehman Brothers default as policymakers press for it to be applied to areas of the markets where no clearing has hitherto existed—such as sections of the over-the-counter or bilaterally negotiated markets."). Expansion into post-trade business has become increasingly important as profits plummet with declining trades. The LSE's leap may also be in part a response to the possibility of a U.S. acquisition of LCH.Clearnet. *See id.*
2. *Recession Worst for "100 years,"* BBC NEWS, Feb. 10, 2009, http://news.bbc.co.uk/1/hi/uk_politics/7880189.stm ("The reality is that this is becoming the most serious global recession for, I'm sure, over 100 years as it will turn out.") (quoting U.K. Cabinet Minister Ed Balls, former economic advisor to Gordon Brown).
3. A recent visit to the Securities and Exchange Commission's (SEC) website demonstrates the lack of attention accorded to stock exchange consolidation. While the SEC maintains a separate page committed to multilateral policy initiatives, it has not entered any updates since about 2006. *See* SEC, Multilateral Policy Initiatives, http://www.sec.gov/about/offices/oia/oia_multilateral.htm (last visited Nov. 2, 2009).
4. *See* Steven M. Davidoff, *Regulating Listings in a Global Market*, 86 N.C. L. REV. 89 (2007); *see also* COMM. ON CAPITAL MKTS REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 2-3, 29-34 (2006).
5. *See, e.g.,* Charles Duhigg & Carter Dougherty, *From Midwest to M.T.A., Pain From Global Gamble*, N.Y. TIMES, Nov. 2, 2008, at A1 (describing how the collapse of a Dublin-based Irish bank and Canadian CDOs dragged down investors including a Wisconsin school board that purchased CDOs from Canada using loans from a Dublin-based German bank).
6. *C.f.* Ethiopis Tafara & Robert J. Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 HARV. INT'L L.J. 1, 32 (2007) ("Our markets are now interconnected and viewing them in isolation—as we have for so long—is no longer the best approach.…").
7. See discussion *infra* Part I.B.1 for a further explanation of this qualified declaration of inevitability.
8. COMM. ON CAPITAL MKTS REGULATION, *supra* note 4, at ix, 2-5 ("[T]he United States is losing its leading competitive position as compared to stock markets and financial centers abroad."); John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 234 (2006) (reviewing data indicating that transactions, listings, and trading volumes are migrating to less extensively regulated countries).
9. Tafara & Peterson, *supra* note 6, at 32. "As a consequence, the traditional methods that the SEC and its foreign counterparts use to oversee cross-border market activity have lost some of their historical efficacy."
10. *Id.* at 31.
11. *Id.*; *see also* Andreas Fleckner, *Stock Exchanges at the Crossroads*, 74 FORDHAM L. REV. 2541, 2579 (2006) ("Consolidation among stock exchanges is a good example of how technology can prompt a certain market structure."). As an aside, technological advancements have also become a necessity to compete with rapidly expanding ATSs.
12. Chris Brummer, *Stock Exchanges and the New Markets for Securities Laws*, 75 U. CHI. L. REV. 1435, 1460-66 (2008).
13. *Id.* at 1461.
14. Eric J. Pan, *A European Solution to the Regulation of Cross-Border Markets*, 2 BROOK. J. CORP., FIN. & COM. L. 133, 136 (2007) (citing demutualization and increased competition as factors that led to consolidation of European exchanges); Sara M. Saylor, Note, *Are Securities Regulators Prepared for a Truly Transnational Exchange?*, 33 BROOK. J. INT'L L. 685, 693-95 (2008).
15. Saylor, *supra* note 14, at 716. "Consolidation is driven by the exchanges themselves as they begin to seek more effective and efficient ways to maximize profit." *Id.* at 687. ("Because the future of stock exchanges and the markets that they operate is 'inseparably linked' and inevitably cross-border, securities regulations should try to meet this new market structure and become, in a way, cross-border itself."). Saylor's justifications for the inevitability of stock market consolidation include the factors discussed *supra* in the context of globalization of markets, such as profit-maximization goals of demutualized exchanges and a breakdown of other cost barriers including increased technology. *Id.* at 693-95. But the existence of promotional factors does not guarantee continued consolidation if regulatory barriers are not addressed, a point even inevitability scholars acknowledge. *See* Norman S. Poser, *The Stock Exchanges of the United States and Europe: Automation, Globalization, and Consolidation*, 22 U. PA. J. INT'L ECON. L. 497 (2001). On the one hand, Poser acknowledges that institutional, structural and regulatory obstacles inhibit movement toward a world market, conceding that "[d]espite the evident trend of the world's stock exchanges to consolidate, the appearance of a world stock exchange in the foreseeable future is by no means inevitable." *Id.* at 500, 539. However, he also concludes that the difficulties in regulation will not prevent further consolidation. *Id.* at 540. Recent developments since the publication of Poser's article in 2001 may solidify his inevitability theory since he states that a "unitary market" would require participation of both the NYSE and Nasdaq. Both of these prominent exchanges have since executed cross-border mergers, but these mergers underscore the problems of cross-border consolidation.
16. *But see* Saylor, *supra* note 14, at 716. Without the clarification provided *supra,* there is a logical disconnect in arguing that consolidation is inevitable, but then stating the appropriate regulatory scheme is not in place. Shouldn't an *inappropriate* regulatory environment discourage further consolidation and globalization?
17. In accord with the prevailing view, this article assumes that regulatory barriers are a significant force to reckon with. However, it is important to acknowledge the countervailing position that regulatory barriers are not as pronounced as critics assert. For example, foreign companies have effectively accessed U.S. markets through 144A offerings, which are private offerings to Qualified Institutional Buyers (QIBs) exempt from usual registration and disclosure requirements. Howell E. Jackson & Eric J. Pan, *Regulatory Competition in the International Securities Markets: Evidence from Europe—Part II,* 3 VA. L. & BUS. REV. 207 (2008). The 144A offering comprises the U.S. piece of an international style-offering. Surprisingly, European issuers often voluntarily comply with purportedly onerous U.S. disclosure standards despite exemption. *Id.* at 257 ("Therefore the decision not to conduct a U.S. public offering had less to do with the tough U.S. disclosure requirements, and more to do with non-legal concerns such as timing, placement success and recognition by the U.S. investment community."). Nevertheless, the 144A option largely excludes participation by retail investors. Additionally, U.S. investors have pursued other alternatives for accessing foreign markets, such as using a foreign broker-dealer, or using a U.S. broker-dealer who contacts a foreign broker-dealer. Howell E. Jackson, Andreas M. Fleckner & Marc Gurevich, *Foreign Trading Screens in the United States*, 1 CAP. MKTS L. J. 54, 69-72 (2006). However, these circuitous routes to foreign investment are more costly, and limit trading

strategy. *Id.* at 73-74. Investment in foreign markets also poses particular risks for retail investors, the investors of greatest concern to the SEC. *See* Tafara & Peterson, *supra* note 6, at 41-42. Moreover, while these alternatives are adequate to avoid U.S. registration requirements or foreign trading screen placement, they still omit benefits to be reaped from completely integrated global exchanges. In sum, regulatory barriers do not serve as an absolute bar to foreign linkages, but they do produce a suboptimal result.

18. Saylor, *supra* note 14, at 702. "[C]ooperation is a necessary step in facilitating the inevitable consolidation of exchanges across national borders, but, because of fundamental regulatory differences…there remain several barriers to overcome if stock exchanges truly begin to function on a transnational basis."

19. This article argues regulatory reform should not only react to the current situation, but also embrace a proactive approach in promoting future international developments. Conversely, regulations are typically reactive. Coffee, *supra* note 8, at 298 (hypothesizing that "law follows, rather than leads, economic developments.…").

20. *Compare* Jackson & Pan, *supra* note 17, at 161 (discussing how European regulatory cooperation has encouraged consolidation of the European exchanges), *with* Eric Pan, *The New Internationalization of US Securities Regulation: Improving the Prospects for a Trans-Atlantic Marketplace*, 5 Eur. Co. L. 73, 75 (2008) ("The SEC already acknowledges that the merger of cross-border markets will 'compel these markets to argue for further regulatory easing of restrictions,' and the recent regulatory initiatives…are a response to some of these pressures.") (citation omitted). *See also* Jackson, Fleckner & Gurevich, *supra* note 17, at 75 (predicting that "the consolidation of the global financial markets will likely put pressure on the current situation in coming years").

21. U.S. securities law requires any exchange operating in the United States to register with the SEC; thus, the foreign component of the consolidated entity would also be subject to SEC regulation if its products were offered in the U.S. *See infra* Part II.A (discussing the current regulatory environment).

22. Pan, *supra* note 20, at 75. "The economic benefit of cross-border exchange consolidation is to concentrate trading on a single platform."

23. In some instances, regulatory concerns do not deter the discussion of mergers, but ultimately prevent the deals from reaching fruition. *See, e.g.,* Hal S. Scott, International Finance: Transactions, Policy, & Regulation 649 (15th ed. 2008) (discussing the failed LSE-Deutsche Borse merger).

24. *See infra* Parts I.B.2, I.B.4.b, II.A (explaining how the current regulatory environment has resulted in consolidated exchanges that do not operate on single platforms, which prevents full realization of benefits).

25. Currently, placement of foreign trading screens in the United States requires SEC registration and regulation. *See infra* Part II.A (detailing the regulatory framework).

26. Accommodating placement of trading screens will also be beneficial, and consolidation should not be the *only* mode of conducting cross-border business. However, a liberalization of rules will provide a big boost to consolidation initiatives which maximize efficiency. *See infra* Part I.B.2 (discussing advantages of consolidation).

27. *Cf.* Fleckner, *supra* note 11, at 2541. Citing deregulation as one factor, in addition to technological advances and globalization, which fosters competition.

28. *See* Pan, *supra* note 14, at 136.

29. *See* Pan, *supra* note 20, at 75.

30. *See* Brummer, *supra* 12, at 1479.

31. Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. Cal. L. Rev. 903, 951 (1998).

32. The bonding hypothesis explains that compliance with the SEC's higher disclosure standards and the greater prospect of enforcement assists foreign firms in reducing agency costs, and thus accounts for a valuation premium for firms that cross-list in the U.S. Coffee, *supra* note 8, at 235-36, 284-92.

33. Brummer, *supra* note 12, at 1478.

34. *See id.* at 1476.

35. *Id.*

36. *See id.*

37. Poser, *supra* note 15, at 499.

38. Tafara & Peterson, *supra* note 6, at 31-32.

39. Press Release, SEC, SEC Office of International Affairs and Divisions of Market Regulation and Corporation Finance Release Fact Sheet (June 16, 2006), http://www.sec.gov/news/press/2006/2006-96.htm.

40. It is ironic to express antitrust fears in light of the current U.S. market situation, which can essentially be characterized as a duopoly between the NYSE and Nasdaq. The SEC's approach stifles competition by preventing the exertion of genuine international pressure on domestic markets. Once market access is increased, these exchanges will no longer be able to retain their dominant positions by simply maintaining their current practices. They will need to seek ways of increasing efficiency, and consolidation with global competitors will present the best choice. Indeed, in response to global and industry pressures, both Nasdaq and the NYSE have already altered their business models and embraced consolidation.

41. I thank Professor Eric Pan of Cardozo Law School (N.Y., N.Y.) for suggesting this pertinent analogy.

42. Not only are foreign companies not cross-listing, but they increasingly bypass the U.S. market for any listing or IPO. *See, e.g.,* Comm. on Capital Mkts Regulation, *supra* note 4, at 39, 29-39 ("[F]oreign companies are simply not coming.…").

43. Poser, *supra* note 15, at 504-05.

44. Scott, *supra* note 23, at 648.

45. Saylor, *supra* note 14, at 695.

46. *SEC Approves NYSE, Archipelago Merger*, USA Today Money, Feb. 28, 2006, http://www.usatoday.com/money/markets/us/2006-02-28-nyse-archipelago-ap_x.htm.

47. Carl Gutierrez, *NYSE Euronext To Buy Amex*, Forbes.Com, Jan. 17, 2008, http://www.forbes.com/2008/01/17/nyse-euronext-amex-markets-equity-cx_cg_0117markets42.html.

48. *SEC Approves NYSE, Archipelago Merger*, *supra* note 46.

49. *Id.*

50. Press Release, NYSE Euronext, http://www.nyse.com/events/1175251256417.html (last visited Apr. 10, 2009).

51. Euronext does maintain a subsidiary-like structure; however, its central order book and its constituents' common EU membership enable greater integration.

52. Scott, *supra* note 23, at 655.

53. Pan, *supra* note 20.

54. *NYSE Group and Euronext Announce Merger*, NYSE Group Newsl., June 2006, *available at* http://www.nyse.com/about/publication/1145959806931.html (quoting Jean-François Théodore, CEO of Euronext).

55. NASDAQ OMX, Milestones, http://www.NASDAQomx.com/whoweare/milestones/ (last visited Apr. 11, 2009).

56. Scott, *supra* note 23, at 19. Listing the following potential benefits of international finance: enables a country to smooth its financial needs, promotes domestic investment and growth, enhances macroeconomic discipline, constrains excessive regulation, and increases competition.

57. Davidoff, *supra* note 4, at 124-25.

58. *See infra* note 120 and accompanying discussion regarding this double standard.

59. *See, e.g.,* Pan, *supra* note 14, at 137-39; Comm. on Capital Mkts Regulation, *supra* note 4, at x-xiii; *see also* Coffee, *supra* note 8, at 234. *But see id.* at 231(concluding "the impact of high-intensity enforcement [which is characteristic of the U.S. regulatory system] appears to yield both costs and benefits").

60. *See* Tafara & Peterson, *supra* note 6, at 47; *see also* Brummer, *supra* note 12, at 1440-41 (discussing territorial governance of U.S. securities laws).

61. Securities Exchange Act of 1934 § 5, 15 U.S.C. § 78e (2006) (absent an exemption, transactions on unregistered exchanges are unlawful).

62. Securities Act of 1933 § 5, § 77e (2006) (prohibiting transactions in unregistered securities).

63. Securities Exchange Act of 1934 § 15, 15 U.S.C. § 78o (2006).

64. Jackson, Fleckner & Gurevich, *supra* note 17, at 73-74.

65. *Id.* at 55.

66. Davidoff, *supra* note 4, at 132.

67. *See* Onnig H. Dombalagian, *Demythologizing the Stock Exchange: Reconciling Self-Regulation and the National Market System*, 39 U. Rich. L. Rev. 1069, 1190-1122 (2005) (explaining the U.S. system of self-regulation).

68. *See, e.g.,* Saylor, *supra* note 14, at 700-01; *see also infra* Part III.C.

69. Dombalagian, *supra* note 67, at 1126. "While the Commission has enumerated a number of options for regulating access to foreign markets, it has resisted granting such relief generally, mostly because such markets are incapable of providing the SRO [self regulatory organization] function U.S. exchanges provide without significant disruptions to their business model."

70. Pan, *supra* note 20, at 73.

71. *Id*

72. Davidoff, *supra* note 4, at 130-31 (summarizing differences in required forms).

73. For an explanation of 144A offerings, see *supra* note 17.

74. Scott, *supra* note 23, at 56.

75. *Id.* at 120-21.

76. Acceptance From Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards without Reconciliation to U.S. GAAP, Securities Act Release No. 8879, Exchange Act Release No. 57026, Investment Company Act Release No. 1306, 92 S.E.C. Docket 717 (Dec. 21, 2007).

77. Scott, *supra* note 23, at 347-83.

78. Brummer, *supra* note 12, at 1472. Domestic companies may exert pressure on lawmakers to achieve parity with foreign parties. *See infra* Part III.B.

79. Pan, *supra* note 20, at 74-75.

80. Steven M. Davidoff, *Paradigm Shift: Federal Securities Regulation in the New Millennium*, 2 Brook. J. Corp. Fin. & Com. L. 339, 341 (2008).

81. Pan, *supra* note 14, at 137.

82. *Id.* In fact, Europeans have expressed a preference for intra-European exchange mergers over transatlantic combinations because of regulatory concerns implicated by U.S. involvement. Comm. on Capital Mkts Regulation, *supra* note 4, at 69.

83. Press Release, *supra* note 39.

84. Davidoff, *supra* note 57, at 137.

85. Strict enforcement intensity entails benefits that counter costs. *See* Coffee, *supra* note 8, at 300. For example, more lenient enforcement may "retard" the United States' ability to minimize capital costs. *Id.* at 308-09.

86. Pan, *supra* note 14, at 139.

87. Securities Exchange Act of 1934 § 5, 15 U.S.C. § 78e (2006) ("Transactions on unregistered exchanges").

88. Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 40,760, 68 SEC Docket 2,045 (Dec. 8, 1998). Conversely, issuers listed on a foreign trading screen are not subject to SEC regulation. *See* Jackson, Fleckner & Gurevich, *supra* note 17, at 68.

89. In the United States, listing on an exchange subjects issuers to the securities law and SEC oversight, which apply to publicly traded securities. Securities Act of 1933 § 3, 15 U.S.C. § 77c (2006) ("Classes of securities under this subchapter"); Securities Exchange Act of 1934 § 12, 15 U.S.C. § 78l (2006) ("Registration requirements for securities"); *id.* § 13, § 78m (2006) ("Periodical and other reports"); Brummer, *supra* note 12, at 1452-55 (discussing the role of stock exchanges as "facilitators" of securities laws and noting that the Exchange Act mandates registration of exchanges and requires that registered exchanges adopt listing rules that assure compliance with federal laws like mandatory disclosure and that issuers have proper corporate governance); SEC, The Laws that Govern the Securities Industry, http://www.sec.gov/about/laws.shtml (last visited Nov. 2, 2009).

90. For a discussion on some of these difficulties in the context of the United States' expansive regulatory approach, see Choi & Guzman, *supra* note 31, at 914-15.

91. *Id.* at 918.

92. *Id.* ("[M]aintaining strict territorial boundaries for determining which securities regulations should apply is becoming increasingly anachronistic given the fluid international nature of most capital markets.… Portable reciprocity is able to separate investment decisions made on the basis of particular capital markets from the regulatory protections present in such markets, thereby increasing regulatory competition."). *See also* Jackson & Pan, *supra* note 17, at 211.

93. *See* Jackson & Pan, *supra* note 17, at 212; Choi & Guzman, *supra* note 31, at 923-24.

94. Choi & Guzman, *supra* note 31, at 906.

95. *Id.* at 916.

96. *But see id.* at 924-34 (attempting to address and minimize some of these concerns).

97. Choi and Guzman counter that a race to the bottom is not inevitable given the diversity of issuers and investors, which will support a broad spectrum of regulatory regimes and competition. *Id.* at 917.

98. Brummer, *supra* note 12, at 1442-43.

99. *Id.* at 1442-43, 1482-84, 1485-86.

100. Choi and Guzman refer to such a system as "normal reciprocity," but argue that it does not go far enough in increasing regulatory competition. *Id.* at 918-21. Some scholars have even classified issuer choice and substituted compliance under the same rubric of "choice-of-law." *See* Brummer, *supra* note 12, at 1441-42.

101. Brummer, *supra* note 12, at 1479-80.

102. Saylor, *supra* note 14, at 687.

103. Pan, *supra* note 14, at 165-66.

104. *See, e.g.*, Comm. on Capital Mkts Regulation, *supra* note 4, at xii.

105. Pan, *supra* note 14, at 138.

106. Regulation NMS establishes the trade-through rule, which requires "trading centers" to ensure the execution of a trade at the best price available on any automated trading center. 17 C.F.R. § 242.611 (2008); *id.* § 242.600(77) (2008); *see also* Pan, *supra* note 14, at 153-54.

107. This discussion does not imply that EU-specific concerns are more serious than those related to mergers with other countries; in fact, the European Union's policies are more aligned with U.S. policies as compared to Asian countries.

108. *See* Scott, *supra* note 23, at 116.

109. Saylor, *supra* note 14, at 705. Notably, the European Union's principles-based approach to regulation presents somewhat of a contradiction to its prescriptive approach to regulating particular financial products. In terms of product regulation, the European Union employs a stricter top-down approach as compared to the United States. Such diversity in regulation suggests that the European outlook is not as fundamentally different from the U.S. perspective as it may initially seem.

110. *See* Brummer, *supra* note 12, at 1469. Stating that the European "principles-based" approach emphasizes cooperation with securities authorities rather than compliance.

111. Comm. on Capital Mkts Regulation, *supra* note 4, at 8-10.

112. Scott, *supra* note 23, at 139.

113. *See id.* at 197 (noting how harmonization and mutual recognition lead to convergence when a host country adopts the home country's rules.).

114. Brummer, *supra* note 12, at 1471-72; *see also supra* Part II.B.

115. Brummer, *supra* note 12, at 1480. Distinguishing between mutual recognition, which retains issuer choice, and standardization, "where regulators of exchanges adopted identical rules and regulations for transactions on the exchange. . . . [S]tandardization would conversely remove any element of regulatory diversity and, with it, issuer choice."

116. Tafara & Peterson, *supra* note 6, at 53-67.

117. *Id.* at 68.

118. Tafara's and Peterson's bifurcation of their analysis between broker-dealers and trading screens skirts the issue of single platform trading of consolidated exchanges, which would eliminate the need for separate trading screens (except where there is no consolidation). This lacuna is not fatal because mutual recognition is a versatile approach, applicable to both increased market access and foreign linkages in general and single platform consolidation in particular.

119. Tafara & Peterson, *supra* note 6, at 55.

120. Scott, *supra* note 23, at 212.

121. Tafara & Peterson, *supra* note 6, at 55.

122. *Id.* at 68.

123. *See* Pan, *supra* note 14, at 163. Discussing how the proposal fails to indicate that the U.S. regulatory system would need to make significant modifications to be more consistent with foreign systems.

124. *See generally* Pan, *supra* note 14.

125. *Id.* at 140.

126. *See supra* note 105 and accompanying discussion.

127. Eur. Comm'n, Financial Services, Implementing the Framework For Financial Markets: Action Plan, Nov. 5, 1999.

128. Alexandre Lamfalussy et al, Comm. of Wise Men, Final Report of the Committee of Wise Men on the Regulation of European Securities Markets 2001, *available at* http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/final-report-wise-men_en.pdf. The Lamfalussy Report further refines the Financial Services Action Plan. Both proposals advocate the same objective of single market integration, but the Lamfalussy Report focuses on regulatory restructuring, which it deems necessary to bring the initiative to fruition. The Lamfalussy Report makes various recommendations for establishing a new hierarchical process of securities law decision-making.

129. European Commission, The EU Single Market, Prospectus Directive, http://ec.europa.eu/internal_market/securities/prospectus/index_en.htm (last visited Nov. 1, 2009).

130. European Commission, The EU Single Market, Transparency Obligations of Publicly Traded Companies, http://ec.europa.eu/internal_market/securities/transparency/index_en.htm (last visited Nov. 1, 2009).

131. Even prior to MiFID, the long-standing European emphasis on convergence and mutual recognition enabled the successful merger resulting in the formation of Euronext, the rare cross-border exchange that operates on a single platform—the true epitome of consolidation.

132. Although the U.S.-EU (or EU-U.S.) Financial Markets Regulatory Dialogue holds potential for future integration, these contacts between the United States and the European Union on financial regulations have been more discussion-oriented. *See* The United States Mission to the European Union, *U.S.-EU Dialogue Focuses on Financial Markets Regulation* (Oct. 27, 2009), http://useu.usmission.gov/Dossiers/Economic_Relations/Oct2609_Regulatory_Dialogue.asp. The discussions have resulted in some modifications (e.g., relaxation of the Sarbanes-Oxley Act for foreign companies); however, they have not substantially advanced market integration or mutual recognition.

133. *See* Scott, *supra* note 23, at 147. Mutual recognition "creates basic inequities for domestic issuers and has not worked well in the European Union, which has the advantage of supranational institutions, despite much fanfare about the single passport."

134. *Id.* at 212.

135. *Id.* at 212-13.

136. See Coffee, *supra* note 8, for a discussion of variable enforcement intensity. The United States is characterized as a strong enforcer. *Id.* at 244-45.

137. Pan, *supra* note 14, at 161-62.

138. Pan, *supra* note 20, at 76-77. Perhaps the financial crisis has derailed the SEC's intention to devote much time in 2008-2009 to this initiative.

139. For example, liability under U.S. civil law and antifraud statutes still apply to securities issued under MJDS. Scott, *supra* note 23, at 137. Additionally, the SEC may require further supplementation of registration materials, and other U.S. requirements on the distribution of securities still apply. *Id.* at 138.

140. Indeed, after announcing its "next steps" for implementation of mutual recognition, the SEC made little movement. *Id.* at 139. Although the SEC reached a mutual recognition agreement with Australia (to provide a framework for regulatory exemptions that would permit U.S. and eligible Australian stock exchanges and broker-dealers to operate in both jurisdictions without dual regulation), scant information is available on the status of this agreement. Press Release, SEC, Australian Authorities Sign Mutual Recognition Agreement (Aug. 25, 2008), *available at* http://www.sec.gov/news/press/2008/2008-182.htm.

141. *See* Dombalagian, *supra* note 67, at 1093. Explaining the origins of self-regulation.

142. Poser, *supra* note 15, at 534-35.

143. But it should be noted that the European Union is currently re-evaluating its utilization of self-regulation in another financial context, namely the regulation of credit rating agencies, in light of the financial crisis. Eur. Comm'n , Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies 3 (2008). Conversely, the United States has employed a more top-down approach in regulating credit agencies. This difference provides further support for the argument that differences in the regulatory philosophies of the United States and the European Union are not irreconcilable, and approaches vary by context. *See also* note 109.

144. Under this arrangement, the participating securities firms are licensed and regulated by their respective home agencies, and Euronext itself has a central market surveillance department. Euronext also develops common rules to govern listing qualifications and disclosure requirements, which arise from contractual arrangements among participants rather than a government agency. Poser, *supra* note 15, at 538. "This suggests that self-regulation has the ability to finesse the problems of national sovereignty and differing legal systems that stand in the way of developing and enforcing common governmental regulatory standards." But Euronext is not a full SRO like the Financial Industry Regulatory Authority (FINRA), or to the extent of the NYSE prior to the formation of FINRA.

145. *Id.* at 538-39.

146. *See* Dombalagian, *supra* note 67, at 1094.

147. Poser, *supra* note 15, at 537-40. "Dependence upon self-regulation to keep the markets honest and competitive, and to continue to retain the confidence of investors, is likely to increase, if only for the absence of any feasible alternative to it." *But see infra* Part III.D.

148. Saylor, *supra* note 14, at 700-01. *Contra* Poser, *supra* note 15, at 536-39. For a more extensive discussion of self-regulation and some attendant problems, see Dombalagian, *supra* note 67.

149. Fleckner, *supra* note 11, at 2592-95.

150. *Id.*

151. Scott, *supra* note 23, at 639.

152. Dombalagian, *supra* note 67, at 1091.

153. Scott, *supra* note 23, at 147.

154. Poser, *supra* note 15, at 534.

155. *See id.* at 537-38. *But see* Pan, *supra* note 14, at 164. Faulting Tafara and Peterson's proposal for suffering from the same malady in the simpler bilateral context, as the international agreements predicate to the system are difficult to draft and negotiate, and lack the flexibility demanded by the fast-moving securities markets. *See also* Choi & Guzman, *supra* note 31, at 915-16. Arguing that agreements between countries are often difficult and time-consuming to obtain, and if they are reached, require countries to expend resources to monitor compliance. Additionally, "[o]ver time, national regulatory bodies may take over the agreement, adding provisions and increasing the complexity of the regime to enhance the importance of the regulatory agencies."

156. *See* Poser, *supra* note 15, at 534.

157. As a technical matter, EU single market integration and implementation of MiFID are not conducted through a singular transnational organization, but are based upon linkages between various transnational bodies envisioned by the Lamfalussy procedure. *See generally* Lamfalussy et al., *supra* note 128. Notwithstanding this division of labor, considering this approach and its initiatives as a single overarching process is still relevant to the discussion of international securities regulation.

158. *See supra* notes 133-36 and accompanying discussion.

159. Nelson D. Schwartz, *The European Single Market is Showing its Seams*, N.Y. Times, Apr. 2, 2009, *available at* http://www.nytimes.com (noting increasing insularity as European countries implement recoveries from the damage wrought by the financial crisis). Additionally, this critique of the EU system as a paradigm for multilateralism is also relevant to the prospects of transatlantic coordination because home state reform will facilitate international cooperation. This point was stressed in Part III.B *supra* in the context of necessary reforms in the United States.

160. This suggestion was first presented to me by Professor Eric Pan of the Cardozo School of Law, N.Y., N.Y. (Mar. 2009).

161. Saylor, *supra* note 14, at 713.

162. International Organization of Securities Commissions (IOSCO), Objectives and Principles of Securities Regulation (May 2003) *available at* http:// www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf.

163. Pan, *supra* note 20, at 78. Discussing the need for a strengthened international body in terms of empowering an existing one or creating a new one is really just a matter of semantics.

164. Saylor, *supra* note 14, at 713-15. Under Saylor's proposal, such an organization would be quasi-governmental and require authorization through a treaty or multiple treaties ratified and binding upon member countries. Each country would appoint a member representative to participate in the organization's promulgation of binding rules and regulations, which would be implemented in the form of a treaty. Each exchange would then adopt the rules through issue listing requirements, and continue to serve as chief enforcers of such rules. This proposed organization could also deal with issues particular to a specific exchange through separate treaties with the affected Member States.

165. This proposal's accommodation of smaller negotiations among individual countries is an important feature of the plan, but somewhat detached from the notion of the transnational organization. Indeed, this latter carve-out should be the dominant foreground predicated on mutual recognition, while the international body should merely help to establish the background context.

166. Pan, *supra* note 14, at 164. CESR acts in an advisory role to the European Commission, particularly in the drafting of implementing measures of EU framework directives in the field of securities. CESR also has the designated functions of improving communication among securities regulators, and working to ensure more consistent and timely day-to-day implementation of community legislation in the Member States. Thus, CESR assists in implementation of MiFID. For more information on CESR, see CESR, http://www.cesreu.org/index.php?page=cesrinshort&mac=0&id= (last visited Nov. 1, 2009).

167. Pan also shrewdly notes that Tafara and Peterson failed to consider the importance of institutional linkage through an international organization. *Id.* ("The solution is to establish an international body that will serve as a focal point for regulatory coordination. This body will be based on treaty law, and its decisions enforced on participating countries.").

168. Scott, *supra* note 23, at 147. Scott proffers his solution as almost a complete replacement of Regulation S, a U.S. rule which deals with the issuance of securities abroad. Essentially, Regulation S does not require registration for the offer and sale of securities occurring outside of the United States, and specifies safe harbor conditions for exemption. 17 C.F.R. §§ 230.901-230.905 (2008).

169. This word was carefully selected since the composite plan this article proffers is less investor-focused than the SEC's current approach, but still considers investor protection as an important factor.

170. The omission of convergence by the issuer choice option is even further off the mark because the portable reciprocity proposal also does not require bilateral agreements, which this article advocates as central to ensuring comparability in the most efficient and flexible manner of negotiation.

171. Tafara & Peterson, *supra* note 6, at 56. For example, substituted compliance may even "permit the United States and other countries with similar regulatory philosophies to leverage their regulatory strengths" and "may encourage other jurisdictions to adopt high regulatory standards.…"

172. Edward F. Greene, Citigroup Corp. and Inv. Banking, *The Sixth Annual A.A. Sommer, Jr. Lecture on Corporate, Securities, and Financial Law,* 11 Fordham J. Corp. & Fin. L. 697, 717 (2006). In the United States, eligible participants would be Well-Known Seasoned Issuers (WKSIs). This proposal entails mutual access to U.S. and EU capital markets by large companies based upon compliance with home country disclosure, accounting and prospectus requirements, but would still subject companies to liability and

market-abuse regimes from the host country. Such a system should succeed because "[t]here can be no doubt that there is equivalence of disclosure, in part driven by the market for these well-followed companies." *Id.*

173. In terms of expanding the original CESR to facilitate coordination between the United States and the European Union, it may not be feasible for the United States to simply join the EU bandwagon through membership in CESR. Inclusion of the United States as the sole transatlantic partner would add a new complication to a system that is already quite complex. Additionally, a true international organization should not be limited to U.S. and EU membership. But, perhaps something less than full-CESR membership would be more realistic, at least until the formation of a truly global securities organization with the structure outlined in this article.

174. Notwithstanding doubt about whether the industry SRO will be close enough to exchanges to exercise efficient regulation, on balance the industry SRO represents a good compromise; an industry SRO would have advantages over government regulation and resolve the major conflict of interest concern of pure self-regulation. If restricted to a single jurisdiction, there should not be any concerns about proximity to the exchanges, especially in light of the availability of technology.

175. *See* Brummer, *supra* note 12, at 1489. Noting the lack of a "definitive answer as to the optimality of regulatory competition."

176. Pan, *supra* note 20, at 77. Basing this conclusion on the size and depth of the EU market.

177. *See, e.g.*, Grant, *supra* note 1.

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# SEC Initiatives to Make the U.S. Capital Markets More Attractive to Foreign Private Issuers

By Guy P. Lander

## Introduction

### Decline of Competitiveness of U.S. Capital Markets

The U.S. capital markets have become much less attractive to foreign issuers over the past several years. The U.S. share of global IPOs (by value) fell from 36.8 percent in 2000 to 6.9 percent in 2008. In the first two quarters of 2008, 1.7 percent of global IPOs by value occurred in the U.S.

### Reasons for Decline in U.S. Capital Markets

The reasons for the decline of the U.S. capital markets are as follows:

1. The expansion of many foreign markets in Europe and Asia, especially in London,[1]
2. America's regulatory scheme is considered excessively burdensome by foreign companies that are not used to the U.S. regulations;
3. Increased costs of listing in U.S. markets;
4. The litigious attitude in America;
5. Improved technology and communication systems have allowed real-time transactions to occur anywhere in the world; and
6. Stricter immigration laws in the United States than in Britain.

### Rise of Rule 144A Market

The costs of Sarbanes-Oxley Act compliance have attracted foreign issuers to the U.S. private markets, which has led to the growth of PORTAL. In August 2007, Nasdaq re-launched its PORTAL market for restricted securities that are resold under Securities Act of 1933 (Securities Act) Rule 144A. PORTAL has become an attractive means of raising capital: equity issuers raised $282 billion through U.S. Rule 144A private placements in 2007, more than the amount raised in the U.S. public markets. This represents an increase of 27.6 percent over 2006 and four times the amount raised in 2002, while total Rule 144A offerings (including debt) remained relatively steady at $1.5 trillion.

PORTAL is a desirable source of capital because it is lightly regulated, i.e., less than the AIM Market. PORTAL permits "qualified institutional buyers" (QIBs) to resell Rule 144A securities to other QIBs without individual person-to-person negotiations. PORTAL offers electronic negotiations, execution, trade reporting, and clearance and settlement. These capabilities have greatly increased liquidity in the Rule 144A securities market.

### Globalization of U.S. Markets

Sarbanes-Oxley and competitive pressures have also resulted in the U.S. exchanges acquiring non-U.S. exchanges and affiliates in an effort to better compete for listings.

### SEC Response

In response to the decreased listings by foreign issuers, the Securities and Exchange Commission (SEC) has undertaken a series of wide ranging initiatives. The SEC has adopted or amended the following rules:

1. Cutbacks in Sarbanes-Oxley Section 404 internal controls
2. IFRS—International Financial Reporting Standards (the death knell of U.S. GAAP)
3. Deregistration from Securities Exchange Act of 1934 (Exchange Act) reporting
4. Exchange Act Rule 12g3-2(b): the information supplying exemption from Exchange Act registration
5. Foreign private issuer reporting and disclosure requirements
6. Cross-border business combinations
7. Beneficial ownership reporting by non-U.S. institutions
8. Securities Act Rules 144 and 145
9. Forms S-3 and F-3: eligibility for shelf offerings

The SEC has also addressed other issues, including:

1. Proposed amendments to Exchange Act Rule 15a-6 for non-U.S. broker-dealers
2. Oil and gas reporting
3. Mutual recognition with Canada and Australia

### Cutbacks in Section 404 Internal Controls

In 2007 the SEC took a number of steps to ease the burden of compliance with Section 404 of Sarbanes-Oxley for all issuers, including foreign private issuers. The SEC:

1. issued interpretive guidance to help management reduce unnecessary costs in evaluating and assessing internal controls over financial reporting by permitting management to use a top-down risk-based approach;

2. approved Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 5 (AS 5) (replacing AS No. 2), which permits tailoring and scaling of evaluations and audits according to relevant facts and circumstances and adopts a top-down approach similar to the guidelines for management; and

3. updated the Section 404 Frequently Asked Questions to address certain concerns of foreign private issuers.

### Costs of Section 404 Internal Controls

Accurate information about the effect of PCAOB AS 5 and the related SEC interpretive guidance is not yet available. AS 5 applies to filings for fiscal years ending after November 15, 2007 (effectively for financial statements for the 2007 fiscal year, the work for which was done in the first quarter of 2008).

According to a survey conducted by Financial Executives International (FEI), the average cost of Section 404 compliance was $1.7 million in fiscal 2007. This represented a 41 percent decrease over the $2.8 million average cost in fiscal 2006, which in turn represented a 24 percent decrease over the $3.8 million average cost in fiscal 2005.[2] Because the FEI survey considered overall compliance costs, it is impossible to determine the extent to which the cost decrease for 2007 resulted from AS 5 and the SEC's guidance, as opposed to other factors.

Much of the decrease may have resulted from companies having gained an additional year of experience in coping with Section 404.

According to an unreleased Deloitte & Touche LLC study, 63 percent of surveyed financial executives expect that AS 5 will reduce their compliance costs by less than 15 percent. This pessimistic view may result from reluctance on the part of companies already compliant with AS 2 to invest in changing their compliance processes to take advantage of AS 5, even though opportunities for substantial cost savings may exist.

## IFRS–Death Knell of U.S. GAAP

### SEC Eliminated U.S. GAAP Reconciliation Requirement for Foreign Private Issuers that Adopt International Financial Reporting Standards

The SEC adopted rules to permit foreign private issuers to file financial statements using International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board ("IASB") in London without a reconciliation to U.S. generally accepted accounting principles (GAAP). The SEC's rules apply to foreign private issuers that file their annual reports on Form 20-F.

Foreign private issuers that elect to provide IFRS financial statements must state explicitly and unreservedly in the notes to their financial statements that their financial statements are in compliance with IFRS as issued by the IASB. Also, the foreign private issuer's independent auditor must provide an unqualified report that states that the issuer's financial statements comply with IFRS as issued by the IASB.

### U.S./Canada Multijurisdictional Disclosure System

Canadian accounting standards will allow the use of IFRS as issued by the IASB as the basis of accounting for Canadian public issuers in 2011. This gives Canadian companies time to develop three years of comparable financial statements.

## Deregistration from Exchange Act Reporting System

### Introduction

In June 2007, the SEC adopted rules to liberalize the deregistration process for foreign private issuers (FPIs). Under the previous rules, eliminating the Exchange Act reporting requirements was difficult.

1. 2007: 100 FPIs filed Form 15-F withdrawing from the Exchange Act reporting system (under 9 percent), 53 percent from the European Union

2. 2008: 15 FPIs filed Form 15-Fs

3. 2007: 75 new FPIs—SEC staff hopes this will continue

This rule change is intended to assure companies that are considering listing securities on a U.S. stock exchange or raising capital through a U.S.-registered offering that there is a reasonable means of terminating ongoing reporting obligations. The new rules also facilitate cross-border exchange offers by foreign private issuers where the target's shares are listed in the U.S.

### Successor Issuer Status—Effect on M&A Transactions

Under the new rules, a foreign private issuer that, after a business combination where shares are used as consideration for the purchase price, has succeeded to the U.S. registration or reporting obligations of another issuer will be able to assume the reporting history of the acquired company and deregister immediately after that acquisition if:

- *the acquired company* has met the prior Exchange Act reporting conditions; and
- *the acquirer* meets the other deregistration conditions

Consequently, if a foreign private issuer that is not an Exchange Act reporting company acquires a company that is an Exchange Act reporting company and uses its own shares as consideration in the acquisition, the acquirer will be able to deregister without regard to the trading volume of the acquired company because only the acquirer's trading volume will be relevant for meeting the trading volume threshold and the home-country listing requirement. This removes what was in effect a "poison pill" impeding the acquisition of U.S. public companies by non-U.S. companies.

However, if acquirer shares issued in a business combination must be registered under the Securities Act, the one-year dormancy condition will still have to be met. Consequently, the ability to use the reporting history of the acquired company will only be useful in M&A transactions where the shares that are issued as consideration for the purchase price are exempt from registration under the Securities Act (e.g., under Rule 802 or Section 3(a)(10)).

### Rule 12g3-2(b): Exemption from Exchange Act Registration

The SEC has adopted rules to allow foreign private issuers who have previously obtained an Exchange Act Rule 12g3-2(b) exemption, or who obtain it by application to the SEC, to meet their obligation of furnishing disclosure documents by posting them on their web site or through an electronic information delivery system generally available to the public in their primary trading market.

The SEC also (1) rendered the Rule 12g3-2(b) exemption automatic rather than subject to a written application, (2) amended the eligibility and maintenance requirements for the exemption, including requiring that the issuer's securities are listed on an exchange outside the United States that constitutes the primary trading market for those securities, and (3) eliminated paper submissions, instead requiring an issuer to publish electronically in English specified non-U.S. disclosure documents.

### Foreign Issuer Reporting Enhancements

The SEC revised its rules to enhance the information available to investors. The amendments:

1. Permit foreign issuers to test their eligibility to use the forms and rules available to foreign private issuers once a year, on the last business day of their second fiscal quarter, rather than continuously as the SEC formerly required.
2. Accelerate the deadline for foreign private issuers filing annual reports on Form 20-F under the U.S. Securities Exchange Act from six months to four months after the foreign private issuer's fiscal year-end, for fiscal years ending on or after December 15, 2011 (i.e., after a three-year transition period).
3. Amend Form 20-F to eliminate an option that permits certain foreign private issuers to omit segment data from their financial statements otherwise fully in compliance with U.S. GAAP financial statements.
4. Amend Form 20-F to eliminate the availability of the limited U.S. GAAP reconciliation option that is contained in Item 17 of Form 20-F for foreign private issuers (but that option will remain available for third-party financial statements required to be included in Form 20-F). Under the amendments, foreign private issuers that are required to provide a U.S. GAAP reconciliation must to do so under Item 18. However, third-party financial statements required to be included in Form 20-F may continue to be prepared under Item 17 of Form 20-F.
5. Amend Form 20-F to require foreign private issuers to disclose additional information about:
    a. changes in the issuer's certifying accountant;
    b. the fees and other charges paid by holders of American Depositary Receipts (ADRs) to depositaries, as well as the payments made by the depositary to the foreign issuer whose securities underlie the ADRs; and
    c. the significant differences in corporate governance practices of the foreign private issuer compared to those for U.S. companies under the relevant exchange's listing standards.

Canadian Multijurisdictional Disclosure System Issuers using Form 40-F must test their eligibility as foreign private issuers at the end of their second fiscal quarter and continue to test their eligibility to file annual reports on Form 40-F as of the end of their fiscal year.

### Cross-Border Business Combinations

The SEC amended its rules for cross-border business combinations and rights offerings to address conflicts between U.S. and non-U.S. regulations and to encourage bidders and issuers to permit U.S. security holders to participate in these transactions on the same terms as other target security holders. The amendments are intended to enhance the usefulness of these rules by addressing practical difficulties encountered since they were adopted in 1999.

Overall, the amendments result in easier determinations of U.S. ownership (due to the new methods of calculating ownership), fewer conflicts between U.S. and home-country requirements (due to the multiple offer options, back-end withdrawal rights and subsequent offering periods), more flexibility for non-U.S. persons to purchase securities outside U.S. tender offers (due to the revisions to Exchange Act Rule 14e-5) and increased clarity when applying the rules (due to the increased availability of the exemption from Exchange Act Rule 13e-3 and technical changes on Schedule TO and Forms F-4 and S-4). The amendments have codified a number of the SEC's prior no-action relief grants, providing bright-line rules that will make the applicability of the U.S. rules more predictable, thereby facilitating cross-border business combinations.

### Beneficial Ownership Reporting by Non-U.S. Institutions

Exchange Act Rule 13d-1(b)(1)(ii) now permits non-U.S. financial institutions that are substantially comparable to the U.S. financial institutions listed in the Rule to file a Schedule 13G instead of Schedule 13D. To qualify for using Schedule 13G, the non-U.S. institution must:

1. Certify that it is subject to a regulatory scheme comparable to the regulatory scheme applicable to its U.S. counterparts;
2. Undertake to provide the SEC staff, upon request, with the information it would otherwise be required to provide in a Schedule 13D; and
3. Confirm that it acquired and holds the Registered Securities in the ordinary course of business and not with the purpose or effect of influencing or changing control of the issuer.

Exchange Act Rule 16a-1(a)(1) now also exempts eligible non-U.S. institutions so that these institutions are not deemed to be beneficial owners of securities held for the benefit of third parties or in customer or fiduciary accounts. Therefore, these non-U.S. institutions will not be subject to Exchange Act Section 16 reporting or liability.

### Rules 144 and 145

The SEC amended Securities Act Rules 144 and 145. These amendments are intended to increase the liquidity of privately sold securities, make private offerings more attractive to investors and decrease the cost of capital for all issuers.

### Form S-3 and F-3 Eligibility for Shelf Offerings

The SEC amended the eligibility criteria for using Forms S-3 and F-3 for registered securities offerings. These forms enable U.S. and non-U.S. issuers to register primary securities offerings (i.e., offerings by issuers), including shelf offerings, without regard to the size of their public floats or the ratings of their debt.

### Proposed Amendment of Exchange Act Rule 15a-6 for Non-U.S. Broker-Dealers

The proposed rule would expand the category of U.S. investors to whom a non-U.S. broker-dealer could provide research and with whom a non-U.S. broker-dealer could interact.

### Oil and Gas Reporting

The definitions and classifications used in Canada National Instrument 51-101 form the basis, in large measure, for the new SEC rules. However, one important difference is that the SEC rules would continue to require the use of historical, rather than forecasted, prices and costs in pricing reserves.

### Mutual Recognition

In March 2008, the SEC announced that it would explore the possibility of a limited mutual recognition arrangement with one or more foreign regulatory counterparts, and that those arrangements could provide the basis for the development of a more general approach to mutual recognition through rulemaking.

Any eventual mutual recognition arrangement with any individual country would be based upon a comparability assessment by the SEC and by the foreign authority of each other's securities regulatory regime.

The SEC intends to:

1. Identify countries with like-minded regulators;
2. Assess the comparability of securities regulation;
3. Enter into a formal process agreement; and
4. Develop a framework for dialogue with regulators on the subject of limited mutual recognition to give exchanges and financial services providers greater freedom to operate in the U.S. under home-country regulation.

### Schedule Announced for Completion of U.S.-Canadian Mutual Recognition Process Agreement

The chairmen of four Canadian securities regulators and the Chairman of the SEC announced a schedule for the completion of a process agreement that would open the way for discussions of a potential U.S.-Canada mutual recognition arrangement.

## Australia and Europe

The SEC has also announced that it is in discussions concerning a possible mutual recognition arrangement with Australia, and that it is pursuing a process agreement, similar to the proposed agreement with Canada, with the European Commission and the Committee of European Securities Regulators.

## Conclusion

Whether these rules help restore the high market share for IPOs historically enjoyed by the U.S. capital markets remains an open question. Whether companies will choose to list their securities in the United States will depend on a variety of factors, such as the evaluation by CEOs and CFOs of which market will offer their companies the lowest cost of capital. For example, in the past, the cost of capital used to be low for companies in some countries because institutions in those countries were generally required to invest in domestic companies. Second, CEOs and CFOs will seek to ascertain which market will offer their companies the highest valuation. Third, CEOs' and CFOs' decisions will be greatly affected by whether or not they have a sufficiently liquid market for their shares elsewhere and whether they need a U.S. listing to obtain financing. They will also weigh the cost and regulatory burdens of a U.S. listing.

Unfortunately, the SEC does not dedicate economists to analyze and monitor adopted rules to ascertain whether those rules are effective in achieving their intended goals. Until the next cycle is well under way, we probably will not know whether the U.S. markets have recaptured any significant market share, and whether CEO and CFO behavior has unfolded in ways that were not anticipated.

## Endnotes

1. Committee on Capital Markets Regulation, *Interim Report of the Committee on Capital Markets Regulation* (2006); Senator Charles Schumer & Mayor Michael Bloomberg, *Sustaining New York's and the US' Global Financial Leadership* (2007); U.S. Chamber of Commerce, *Commission on the Regulation of U.S. Capital Markets in the 21st Century* (2007).
2. However, the study authors cautioned that the average cost data for these three years are not directly comparable, because the group of responding companies changed from year to year. Additionally, the average cost data are based on voluntary responses by surveyed companies, which may introduce bias.

**Guy P. Lander is a partner at Carter Ledyard & Milburn LLP in New York City, where he practices corporate and securities law for international and domestic companies and financial institutions. Over the years, his practice has emphasized a wide range of financial transactions, including U.S. and international public and private offerings, listing foreign companies on U.S. exchanges, mergers and acquisitions. Mr. Lander also devotes a significant part of his time to regulatory matters for financial services firms. He advises securities brokerage firms, money managers and hedge funds on their structuring, documentation, compliance, business activities and significant transactions.**

**Mr. Lander is the author of the highly regarded treatise, *U.S. Securities Law for International Financial Transactions and Capital Markets*, 3 Vols., West Group. He is also the author of three other books on securities law. Mr. Lander is the former Chair of the Committee on Securities Regulation of the New York State Bar Association's ("NYSBA") Business Law Section and the former Chair of NYSBA's Business Law Section.**


## Banking Law Committee

The Banking Law Committee met in January during the Bar's Annual Meeting. The primary focus was the Wall Street Reform and Consumer Protection Act of 2009 (H.R. 4173), passed by the House in December. Our guest speakers were Michael Campbell, Counsel, Federal Reserve Bank of New York and Chair of the Banking Law Committee of the City Bar Association; Marjorie Gross, General Counsel of the New York State Banking Department; Rosanne Notaro, the Department's Deputy Counsel; and Committee member Kathleen Scott, Counsel with Arnold & Porter in New York City.

Ms. Scott set the stage with a thorough and informative outline of the bill and its provisions. Mr. Campbell focused on bank and bank holding company regulatory changes in the bill, privacy law, and corporate governance. He also commented on merchant banking investments by financial holding companies, consumer protection rules for the sale of insurance products through banks, and rules requiring disclosures to consumers under the Fair Credit Reporting Act. With respect to holding companies, Mr. Campbell noted that the bill would establish a system for resolving "systemically significant" firms, regardless of whether they were currently subject to federal oversight. Another key provision is "skin in the game"—i.e., requiring lenders to retain portions of loans that they distribute through securitizations to encourage responsible lending. Mr. Campbell also provided perspective on the questions of whether financial oversight would take the form of supervision or regulation and the inherent tension in banking regulation between safety and soundness when weighed against the need to protect consumers.

Ms. Gross and Ms. Notaro offered a number of insights into the potential effects of H.R. 4173 on state banking regulation. Their comments described the further improvements to the regulation of bank holding companies and depository institutions, including enhanced oversight of some types of institutions that have been exempt (e.g., industrial development banks), reports and exams, restrictions on affiliate transactions and troubled institutions, capital levels, examination of small institutions, relation to state law, enforcement powers of the states, existing contracts, and preemption.

Future meetings will deal with issues including permissible messenger service activities under New York State branching rules and derivatives regulation under the proposed financial reform legislation.

**—David L. Glass, Chair**

## Consumer Financial Services Committee

The Consumer Financial Services Committee meeting on January 30 focused on current issues in consumer credit reform and new and proposed laws and regulations. Our guest speakers were Michael Campbell, a senior attorney with the Federal Reserve Bank of New York, and Marla Tepper, General Counsel of the New York City Department of Consumer Affairs. Both spoke of their organizations' efforts to help low- and middle-income consumers with home foreclosures and financial education issues. The Department of Consumer Affairs is also investigating a series of consumer-facing businesses such as credit repair organizations, payday lenders, and auto dealers for possible violations. The Fed is actively engaged with mortgage lenders in attempting to restructure mortgages and keep low- and middle-income people in their homes. Contrary to some national studies, their experiences with homeowners who are given a legitimate "second chance" (frequently by lowering the loan amount or monthly payments in exchange for the lender getting a share of the equity upon a sale of the home in the future) has been very favorable. We also discussed the proposed Consumer Financial Protection Agency ("CFPA"), now proposed to be an office of the Federal Reserve Board in the U.S. Senate regulatory relief bill. The Committee Chairman explained the proposed workings of the CFPA and some of the issues that it raises, such as rolling back federal preemption in certain areas and having an agency not beholden to those it regulates write consumer-protection regulations and take enforcement actions. We also discussed the 2009 CARD Act that prohibits credit card issuers from assessing certain charges and engaging in practices such as dual-cycle billing and applying raised interest rates to outstanding balances. We briefly discussed the status of the interchange antitrust class action pending in the Eastern District of New York and federal legislative initiatives to promulgate an arrangement for the establishment of interchange through a mediation process between card issuers and merchant groups, as well as a bill to standardize data security breach notice standards and notice forms. Finally, we briefly discussed new laws and regulations impacting mortgage financing, including RESPA and TILA disclosures and initiatives to regulate mortgage brokers associated with lenders to whom they steer business. A related issue discussed was "yield spread premiums" in which rates are marked up to consumers to compensate mortgage brokers and other middlemen.

**—Randy Henrick, Chair**

## Franchise, Distribution and Licensing Law Committee

The Franchise, Distribution and Licensing Law Committee hit the ground running in 2010. We met as a Committee on January 27, 2010. The meeting was attended by approximately 20 members. The meeting featured a presentation from Bruce Schaeffer of Franchise Valuations Ltd. in New York City, regarding recent tax law developments affecting franchising in New York and across the nation. In addition, the Committee also discussed the status of its Report (the "Committee's Report") concerning proposed changes to the New York Franchise Act to make it more consistent with both the recently amended federal FTC Franchise Rule and the franchise laws and regulations in the thirteen other states that regulate the offer and sale of franchises. The Committee's Report recommends wholesale changes to the New York Franchise Act which was enacted in 1981.

On January 28, 2010, Tom Pitegoff (immediate past chair of the Committee) and I presented the Committee's Report to the Executive Committee of the New York State Bar Association. Following the presentation, the Executive Committee of the New York State Bar approved the Committee's Report and passed a resolution recommending passage of the amendments to the NY Franchise Act to take into account the FTC's revised trade regulation rule on franchising. Given the New York Attorney General's statutory role in administering and overseeing the New York Franchise Act, the New York State Bar and the Committee have been working closely with the Attorney General's Office to obtain its support for the changes recommended by the Committee in the Committee's Report.

**—David W. Oppenheim, Chair**

## Securities Regulation Committee

The Securities Regulation Committee has continued its monthly meeting programs addressing a wide range of matters of importance to securities law practitioners. Our dinner meetings tend to foster lively discussions, and afford Committee members an opportunity to discuss "hot topics" with persons closely associated with them. Among the topics presented at our recent meetings were:

1. Proposed Amendment to SEC Rule 163(c), which would allow underwriters of "well-known seasoned issuers" (WKSIs) to contact investors prior to the filing of a registration statement
2. Expert Networks—How Hedge Funds and Other Investors Can Get the Inside Track Legally (and how to avoid violating Rule 10b-5 and Reg FD)
3. New Developments in Federal and Corporate Law, Shareholder Activism and Annual Meeting Procedures, Loss of Broker Voting, Proxy Enhancement Rules, and Proxy Access
4. New York's Power of Attorney Legislation
5. Environmental disclosures and the recent SEC climate change risk guidance
6. The SEC's recent equity market structure initiatives, including dark pools (i.e., trading systems for trading large blocks of stock between institutions off-exchange and out of public view) and short sales
7. Recent amendments to Regulation SHO, the new short-sale rule and its implications
8. Developments in Investor Relations for Public Companies and Alternative Asset Managers

**—Howard Dicker, Chair**

## Technology and Venture Law Committee

Members of the Technology and Venture Law Committee (the TechVenture Law Committee) continued their efforts in support of bills to repeal the LLC Publication Requirement by launching an online petition in conjunction with the New York Tech Meetup (http://nytm.org/why-2k/). The campaign, dubbed "Why-$2K?," was written up in *Crain's Insider* in early April.

In April, the Committee hosted an event on Mobile Apps at New York Law School. Panelists came from leading mobile companies such as Mobile Streams, Dada Entertainment, Polar Mobile and OMGICU. Issues discussed included developer contracts, intellectual property protection, corporate law and user privacy as applied to this unique and burgeoning business. CLE credit was provided.

At the Spring Meeting, the TechVenture Law Committee offered a CLE program on Cloud Computing, examining legal issues presented by shifting such services to the Cloud, including data security and privacy concerns, regulatory compliance issues, jurisdictional considerations and unique contractual issues. Panelists included expert private practitioners and both in-house counsel and chairman-level managers from well-known companies operating in this space.

In June, the committee hosted a CLE panel on mobile advertising and promotions, which discussed how the links in this value chain connect and examined the legal issues involved in running a successful mobile campaign.

The committee is also leveraging Facebook, Twitter and the Meetup.com online platform to bolster new member outreach and further promote its event. You can find out more at http://www.meetup.com/LawTalk/.

**—Steven Masur, Chair**

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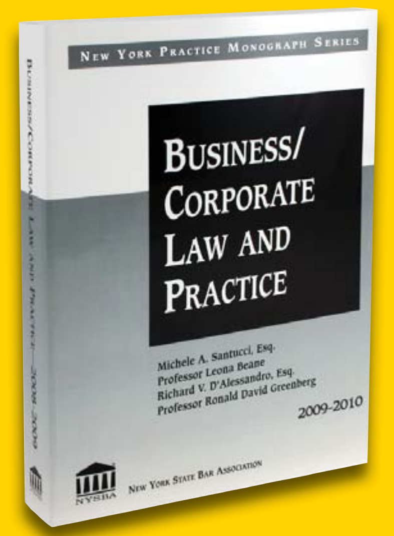


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