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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To enter, the student should submit an original, unpublished manuscript in Word format to David L. Glass, Editor-in-Chief, NYSBA *NY Business Law Journal* (david.glass@macquarie.com).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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A longstanding initiative of the NYSBA Business Law Section came to fruition in December, when Governor Cuomo signed the Nonprofit Revitalization Act of 2013 into law. The new law, which became effective July 1, 2014, is designed to "streamline the incorporation process for non-profit organizations in New York, modernize the oversight and corporate governance laws to prevent conflict of interest problems and fraud, enhance public trust in the non-profit sector, provide guidance to non-profit organizations' boards of directors, and reduce burdens on non-profit organizations." In consultation with the NYSBA's officers, the Section has now established a new Not-For-Profit Corporations Committee as a forum for attorneys who represent these organizations. The Committee's first Chair, appropriately, is Frederick Attea of Phillips Lytle in Buffalo, who has long spearheaded the Section's efforts to achieve this important reform. These developments are discussed in more detail in the report by outgoing Section Chair Jay Hack (see Committee Reports on page 48).

The Section continues its efforts to reform New York's Limited Liability Company Law (LLCL). Section 206 of the law requires a new LLC to publish a notice, within 120 days of its formation, in two general-circulation newspapers (one daily, one weekly) in the county where the LLC was formed. The notices must run once a week for six weeks and include extensive information concerning the LLC and its formation. If the LLC fails to publish the requisite notices, under the law its authority to do business in New York can be suspended. The cost of publication varies around the state, but can be as much as $1,600 in New York County. This archaic and burdensome requirement is obviously a barrier to small business formation in the State, and has the adverse effect of driving new businesses to form in friendlier states, such as Delaware. But the handful of newspapers that benefit from the requirement have successfully blocked reform to date.

In this regard, practitioners advising new businesses in New York may want to consider the effect of *In re Empire Equities Capital Corp.*, a 2010 Southern District bankruptcy case (not reported in the Bankruptcy Reporter, but available through services such as Lexis and Westlaw). The *Empire* case involved a foreign LLC, which is subject to publication requirements under Section 802 of the LLCL that are substantially identical to those applicable to New York LLCs under Section 206. The debtor filed in bankruptcy after making a deposit in escrow under a real estate option contract it had entered into with the LLC. The contract provided that the escrow deposit belonged to the seller, the foreign LLC, if the buyer, the debtor in bankruptcy, failed to perform. However, it turned out that the foreign LLC did not fulfill the publication requirement within 120 days of qualifying to do business in New York, as required by the statute. Accordingly, the debtor argued that the LLC was barred from recovering for breach of the option contract and was not entitled to the security deposit because, not having published the required notices, it lacked authority to enter into the contract in the first place.

The court rejected the debtor's argument, essentially on two grounds. First, while mandating publication of the required notices, Section 802 of the LLCL also expressly provides that the failure to comply with the publication requirement "shall not limit or impair the validity of any contract or act of [the foreign LLC], or any right or remedy of any other party under or by virtue of any contract, act or omission of such…limited liability company." Thus, the court held that the plain language of the statute makes clear that the contract may be enforced, notwithstanding the failure of the LLC to publish the notices. Note that while the LLC in this case was foreign, the language of Section 802 is substantially identical to Section 206 which applies to domestic LLCs. Second, although the law provides for suspension of the foreign LLC's authority to do business, it also expressly provides that the suspension is terminated when the LLC files documentation of its substantial compliance with the publication requirement—in effect, the failure to publish can be cured after the fact, retroactive to the date the LLC started doing business. Since the LLC published the required notices after commencing the litigation, the court concluded that it was "no harm, no foul." Again, while this case involved a foreign LLC, the statute is identical in all material respects for domestic LLCs, and those New York state courts that have considered similar arguments in cases involving New York LLCs have reached the same conclusion. So while failure to publish the required notice puts your client LLC in breach of the law, it appears that all is not lost; at the least, the failure can be remedied after the fact with no substantive harm resulting.

The ability of criminals to use increasingly sophisticated tools to hack into computer systems and steal valuable personal data, including credit and debit card numbers of unsuspecting customers, has come to the fore as an issue of prime importance for all businesses and their attorneys. In recent months the large discount retailer, Target, has itself been the target of a major attack, compromising the financial security of some 30 million customers. Other well-publicized attacks have been made on the Neiman Marcus department store and the Las

Vegas Sands casino. At the New York State level Governor Cuomo has made cybersecurity a top priority, while the bank regulatory authorities have placed it at the top of their agenda for forthcoming examinations of institutions under their jurisdiction. The issue is especially compelling for banks; when the Electronic Funds Transfer Act was enacted in the 1970s, the banks made a deliberate policy choice, reflected in the language of the law, to shoulder the responsibility for any losses that were incurred by consumers and businesses, regardless of fault. The concern was that the public would not accept and use the new technology otherwise.

All of which makes this issue's lead article especially timely and valuable for New York business lawyers and their clients. In "Data Breach? The Best First Responder Is a Law Firm," Scott Aurnou clearly and cogently explains the role of attorneys in a data breach situation. Mr. Aurnou, an attorney and information security consultant based in New York City, notes that while it may seem natural for a business to call a security or forensics expert first, the better first call is to the company's outside law firm. The reason is that, especially with the likelihood of litigation looming in the background, promptly interposing the firm's attorney will establish and maintain privilege. Mr. Aurnou also outlines the role of security consultants, and that of the company's in-house counsel.

Even when there is no data breach, one's personal information may be readily available online. When this information is voluntarily posted on social media such as Facebook, it would seem that there should be no ongoing privacy issues. (One thinks of the famous quote from Scott McNealy of Sun Microsystems a decade or more ago: "You have no privacy. Get over it!") But the issue is not that simple, far from it: increasingly users of social media are having "poster's remorse" as they come to realize the far-reaching ramifications of online information for their careers and personal lives. Are their online postings there forever, or can the website in question be compelled to remove it? In short, is there a "right to be forgotten"?

A recent decision of the European Union's highest court found that there was such a right, at least under the EU's Data Protection Directive. In "European Court of Justice Finds 'Right to Be Forgotten' and Compels Google to Remove Links to Lawful Information," attorneys William Long, Edward McNicholas, Alan Raul, and Geraldine Scali of Sidley Austin discuss the significance of this holding and its international ramifications, noting that it is extraterritorial in application, since it applies to non-EU businesses that sell to EU consumers. Among other things, the authors note that the EU decision is fundamentally at odds with the American approach to balancing free speech and privacy concerns, since the latter places greater emphasis on free speech with respect to dissemination of information over the internet.

The collapse of Enron in 2001, followed by the global financial crisis of 2008, dramatically increased the pressure on public companies and financial institutions to enhance the independence of their boards of directors in overseeing the actions of their management, and how the firm's officers are compensated. In "Two Reminders for the Compensation Committee," Howard Dicker of Weil, Gotshal & Manges in New York City discusses rules issued last year by the New York Stock Exchange and the NASDAQ Stock Market, aimed at assuring that certain key factors are considered in establishing that an adviser is truly independent. Mr. Dicker is currently Second Vice-Chair and Fiscal Officer of the Business Law Section, and a past chair of its Securities Regulation Committee.

In its landmark 2010 ruling in *Morrison v. National Australia Bank*, the Supreme Court abruptly reined in the expanding application of the securities laws to extraterritorial transactions by the lower federal courts, holding that, since the securities laws do not expressly apply to foreign transactions in foreign securities, there is a presumption against their extraterritorial application. As it must, the Court's mandate has now filtered down to the lower federal courts. In "Second Circuit Holds That *Morrison* Precludes Securities Fraud Claims for Cross-listed Securities," Steven Gatti and Steven Nickelsburg, partners in the securities litigation and enforcement group of Clifford Chance, discuss the recent holding of the Second Circuit in *City of Pontiac Policeman's and Firemen's Retirement System v. UBS A.G.*, in which the court was called upon to consider whether the ban on extraterritoriality applies to a foreign security, even if it is cross-listed on a U.S. exchange, and even if the buy order was placed in the United States. Messrs. Gatti and Nickelsburg also discuss the background and significance of the *Morrison* case, and the impact of both cases on potential liability for foreign issuers under the antifraud provisions of the Securities Exchange Act of 1934.

Although *Morrison* and its progeny have lightened the burden for foreign issuers to some extent, access to the U.S. capital markets for smaller domestic issuers has been problematical, due to the cost and potential liability of registering securities offerings. In this regard, the Securities & Exchange Commission (SEC) has proposed some new rules that offer welcome relief. In "Regulation A: Easier Access to the U.S. Securities Markets Is Coming," Guy Lander of Carter Ledyard & Milburn discusses the proposed new rules, which would enable U.S. and Canadian companies that are not already SEC-reporting issuers to issue up to $50 million in securities in the U.S. markets without the costs and burdens of SEC registration and the attendant liability. Mr. Lander, a former Chair of the Business Law Section and frequent contributor to the *Journal*, notes that while it is currently possible for non-registered companies to sell limited amounts of securities through a private placement, the proposed new Regulation A offering would enable free transfer of the securities after they are issued, unlike privately placed securities. The article clearly outlines the advantages and disadvantages of a Regulation A offering as compared to a registered offering.

A mainstay of the *Journa*l, and one of its most popular features, is the comprehensive "Inside the Courts" prepared by the attorneys of Skadden Arps in New York. The current issue is no exception. Leading off with a review of the Supreme Court's decision in *Lawson v. FMR LLC*, which held that the "whistleblower" protections of the Sarbanes-Oxley Act (SOX) apply not just to the employees of a public company, but also to the employees of a private company that contracts with the public company, "Inside the Courts" goes on to provide concise summaries of some 25 significant cases in areas of corporate law ranging from fiduciary duty, to bankruptcy, to securities litigation. It is required reading for all business practitioners.

Another ongoing feature of the *NY Business Law Journal* is its ability to draw upon the work of talented law students to provide in-depth analysis of new and cutting-edge developments. A case in point is the eponymous Volcker Rule, named for its original proponent, the former Federal Reserve Chairman Paul Volcker. Simply stated, the Rule, enacted by Congress as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"), seeks to prevent deposit-taking institutions, which benefit from the safety net of FDIC insurance and access to the Federal Reserve discount window, from engaging in proprietary ("prop") trading and hedge fund management—in effect, preventing them from risking depositor funds on ostensibly speculative trading activities in securities and derivatives. Another aspect of Dodd-Frank aimed at reducing systemic risk in the financial markets is the so-called Lincoln Amendment, which forbids these institutions to act as swap dealers, effectively compelling them to "push out" this activity into an affiliated company that is not under the federal safety net.

But as always, the devil is in the details, and the attempts of the Federal Reserve and other regulatory authorities to translate these seemingly simple mandates into specific rules and regulations have proven to be extraordinarily complex. Among other things, the Federal Reserve has had to decide where to draw the line between prop trading and trading on behalf of a client, which is permitted, and between transactions with a U.S. nexus, which are covered by the Rule, and those that take place "wholly outside the United States," which are not. In "The Counterintuitive Effects of the Volcker Rule and the Push-Out Rule," Richard Jones illustrates how in practice these two provisions, and the way they have been implemented, can force financial firms to make counterintuitive choices in the way they conduct their activities. Along the way Mr. Jones, a candidate for the LLM degree in Financial Services Law at New York Law School, provides a useful and comprehensive survey of the origins of these rules and the concerns they were meant to address.

Concluding this issue is the *Journal*'s ethics guru, Evan Stewart of Cohen & Gresser in New York City. In "'Positively 4th Street': Lawyers and the 'Scripting' of Witnesses," Mr. Stewart asks the not-so-rhetorical question: has he been wrong all along in believing what most lawyers understand to be a bright-line rule, that it is not ethical to provide a witness with a written script of the answers you want her to give? Mr. Stewart first reviews Federal Rule of Evidence 612, which requires that writings given a witness to refresh her memory must be shared with the other side, even if provided "before testifying." In his usual lucid and entertaining style, rife with references to song lyrics and popular culture, he then discusses the circumstances in which courts will require production under Rule 612—and how close the "refreshing" document can skate to being a "script" including answers as well as questions.

David L. Glass

Data Breach? The Best First Responder Is a Law Firm

By Scott Aurnou

News reports and articles concerning high profile data breaches have been hard to miss in recent months. The highly publicized cyber attacks against Target,[1] Neiman Marcus[2] and Las Vegas Sands[3] are just a taste of what's to come.

As you might expect, a data breach—high profile or not—can be a nasty surprise to deal with. In addition to potentially negative publicity (sometimes *very* negative), there are often significant costs associated with a breach. These include forensic analysis of the victimized organization's electronic systems to figure out what happened, taking steps to fix the problem, notifying clients/customers that their data has been potentially compromised, possible statutory fines, and extra costs like credit monitoring services for the affected clients and/or customers and engaging public relations and crisis management firms to try to mitigate the damage done to the organization's brand.

Upon discovery of a data breach, it may seem natural for an organization to contact forensics and security experts (and possibly other vendors) immediately in an effort to sort out the inevitable problems ahead. But that's actually a mistake. A breached organization's *first* call should be to an outside law firm with cybersecurity expertise. Doing so can greatly mitigate an organization's ultimate exposure, not only by ensuring that the seemingly endless patchwork of state, federal and perhaps international laws are properly addressed, but also for two critical and frequently overlooked reasons: (1) attorney client privilege; and (2) the work product protection.

What Is the Lawyer's Role?

In recent years, data breaches have also increasingly led to lawsuits (Target already has plenty[4]). Engaging an outside law firm with cybersecurity expertise at the outset of a breach will preserve privilege in the face of those lawsuits. Otherwise, every panicked email, detailed investigative report and potentially embarrassing internal memo could be subject to discovery in a subsequent government investigation or lawsuit and in the hands of class action plaintiffs' attorneys determined to make that organization pay. On the other hand...

If a data breach victim starts by retaining an outside law firm (a number of firms even have dedicated data breach response teams), that firm can then hire the information security, computer forensics, public relations and crisis management firms needed to address, analyze and recover from the attack. Attorney-client privilege will protect the organization struck by the data breach from the discovery process during a subsequent investigation or any ensuing litigation.

Attorney Roberta Anderson, a partner with K&L Gates' cybersecurity practice group, agrees: "A company's decision to retain outside counsel at the outset is critical, since the results of a breach investigation may be pivotal in avoiding or minimizing liability in subsequent litigation and regulatory investigations." She adds that a company "must be vigilant to ensure those results are protected from discovery."

Likewise, the communications and materials exchanged between lawyers and the various firms they engage on a victimized company's behalf would be protected from discovery as attorney work product or material prepared in anticipation of litigation. On the other hand, direct communications, reports, presentations and other materials exchanged between the company and any forensic, security or other firms it may engage directly will not have those protections to a large extent.

As a result, the crisis management, forensic, security and other personnel working to help the victimized organization recover from the attack can be compelled to turn over investigative reports, correspondence and other materials revealing inadequate security practices and/or procedural mistakes that can be used against it in court (or to exact a larger settlement from the organization). Anderson adds that "the retention of outside counsel sends a clear message that the company sought advice in anticipation of potential litigation."

A Caveat

While any attorney-client relationship can give rise to the aforementioned privilege protections, a law firm that doesn't actually have the proper cybersecurity expertise can both exacerbate the damage suffered by the victimized organization and expose itself to liability—malpractice and otherwise—for any additional harm arising out of the mishandling of the breach response (typically a fast-moving situation that can go wrong in more than a few ways).

What if an Organization Has Its Own In-House Counsel?

If an organization has in-house legal counsel, you may be wondering if its communications with internal or external IT, security or forensic personnel would be entitled to the same protections. It's *possible*, though a number of courts have limited the scope of privilege for those types of communications. In *Upjohn Co. v. United States*,[5] the U.S. Supreme Court ruled that the communications *could* be privileged if 1) the communications pertain to matters within the scope of the employee's corporate duties, and 2) the employee is aware that the information is being furnished to the attorney to enable him or her to provide legal advice to the corporation. While this may sound sufficient, a number of courts have construed the privilege more narrowly with respect to in-house counsel. For example, the New York Court of Appeals has reasoned that it should be limited[6] if the counsel has both legal and business responsibilities within the company and the advice is part of an ongoing business relationship (as opposed to periodic requests for legal advice). The short answer is: it's probably not worth the risk. If a court rules against the victimized organization in subsequent litigation, it could have a tremendous (and expensive) effect on the outcome of the lawsuit.

"The risk may be amplified in a data breach case," Anderson notes, "given the technical issues associated with figuring out what happened, which could strike a court as more 'business' than 'legal.'"

Not Just in Response to a Breach

In addition to those potentially chaotic hours immediately after a data breach has been discovered and the subsequent investigation, attorney-client privilege can also serve to shield communications and associated materials with respect to security-related compliance and due diligence practices under various state and Federal laws, rules and regulations. It can also be used with respect to compliance with industry standards like the Payment Card Industry Data Security Standard (aka PCI DSS), as well as the negotiations for and purchase of cyber liability insurance coverage. That way, an organization can limit its disclosures to what is required by law, rather than being subject to potential "fishing expeditions" in the future. Anderson adds that "outside counsel can assist in preserving information that will assist the company, while avoiding the potential spoliation issues—and considerable potential sanctions—that can be especially prevalent when companies are dealing with electronic records."

It's critical for any organization with the potential to suffer a data breach (i.e., *every* organization) to understand the potential impact of the first phone call after a data breach is discovered.[7] Going through an outside law firm with the proper cybersecurity expertise will allow those organizations a measure of control over potentially damaging information that can be used against them in subsequent litigation. Control they won't be able to get back later.

Endnotes

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4. Joel Schectman, *Target Faces Nearly 70 Lawsuits Over Breach*, Wall Street Journal, Jan. 15, 2014, available at http://blogs.wsj.com/riskandcompliance/2014/01/15/target-faces-nearly-70-lawsuits-over-breach/.
5. *Upjohn Co. v. United States*, 449 U.S. 383 (1981).
6. *Rossi v. Blue Cross & Blue Shield of Greater N.Y.*, 73 N.Y.2d 588 (1989).
7. Scott Aurnou, *Suffer a Data Breach? Your 1st Call Should Be to…a Lawyer*, The Security Advocate, Jan. 27, 2014, available at http://www.thesecurityadvocate.com/2014/01/27/suffer-a-data-breach-time-to-call-a-lawyer/.

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This article originally appeared in the Spring/Summer 2014 issue of Inside, *published by the Corporate Counsel Section of the New York State Bar Association.*

European Court of Justice Finds "Right to Be Forgotten" and Compels Google to Remove Links to Lawful Information

By William RM Long, Edward R. McNicholas, Alan Charles Raul and Geraldine Scali

A recent judgment of the highest court in the European Union announced that search engines within the court's jurisdiction must respond to "right to be forgotten" requests. This authoritative interpretation of the existing data protection laws may create significant issues for Internet intermediaries and exacerbate the differences between the European privacy-based "right to be forgotten" and the United States' free-speech based "right to remember." This judgment will have a significant impact not only on search engine companies and publishers, but also on many other industries, including financial services and life sciences, that need to maintain data on individuals for legitimate business reasons, often for lengthy periods.

Case Facts

The case arose in 2012, when the Audiencia Nacional (the Spanish National High Court) referred a series of questions to the Court of Justice of the European Union (the "CJEU") on the interpretation of articles of the Data Protection Directive 95/46/EC (the "Directive")—specifically, on its material and territorial scope, data subject rights, and Articles 7 and 8 of the EU Charter of Fundamental Rights (the "Charter").

This request was made in the context of a case initiated by a Spanish citizen against Google Inc. and Google Spain SL, relating to his request for deletion of information about him displayed in Google results. The information at issue was an announcement of the Spanish citizen's name in connection with a real-estate auction of a property seized for non-payment of social security contributions that was published in a Spanish newspaper in 1998. The complaint made was that the information should now be removed from the Google search result links because the debts had been satisfied and reference to them was no longer relevant.

Decision

The CJEU issued its judgment on May 13, 2014.

In a judgment welcomed by EU Justice Commissioner Viviane Reding, the court found that:

- The activity of a search engine is the processing of personal data within the meaning of the Directive. To be specific, the CJEU found that search engines automatically, constantly and systematically search for information published on the internet by third parties, index it automatically, save it temporarily and make it available in a specific order. It then held that these actions are "processing personal data" within the meaning of the Directive when that information contains personal data.
- The operator of a search engine is a "controller" of that data within the meaning of the Directive regarding such processing of personal data.
- Processing personal data "in the context of the activities of an establishment" of a data controller on the territory of an EU Member State subjects it to EU jurisdiction under the Directive. That is, the search engine's operation of a branch or subsidiary intended to promote and sell advertising space offered by that engine, with activity oriented towards the inhabitants of that Member State, results in the processing of personal data by the search engine operator acting as a controller in the context of the activities of an establishment in a Member State. Such processing should therefore fall under the scope of the Directive.
- The Directive must not be "interpreted restrictively" in light of its objective to ensure effective and complete protection of the fundamental rights of persons, in particular their right to privacy.

Individuals have a right "to be forgotten." It found this right on the basis of the rights of individuals under the Directive to obtain, as appropriate, the rectification, erasure or blocking of data which do not comply with the provisions of the Data Protection Directive, in particular because of the incomplete or inaccurate nature of the data,[1] and the right to object to the processing of their personal data.[2]

Given this reasoning, the CJEU ruled that search engine operators are obliged to remove from the list of results displayed following a search made on the basis of a person's name, links to web pages even if the publication itself on those web pages is lawful.

In its judgment, the CJEU also referred to the right of an individual to have respected his or her private and family life, home and communications[3] and a right to the protection of personal data concerning him or her[4] under the Charter, and observed that in light of these rights, individuals may request that information about them no longer be made available. The CJEU, however, held that a "fair balance" should be sought between the legitimate interest of internet users potentially interested in having access to that information, and the data subject's fundamental rights. The court held that, "the data subject's rights…override, as a general rule, that interest of internet users [to access information]."

In addition, the CJEU noted that there could be a preponderant interest of the public in having access to the information that could justify the retention of that link, such as if the data subject is a public figure.

Freedom of Expression Mentioned Only Once

Interestingly, the judgment does not discuss the fundamental right to freedom of expression under Article 11 of the Charter and Article 9 of the Directive, under which Member States shall provide for "exemptions or derogations" from the Directive "for the processing of personal data carried out solely for journalistic purposes or the purpose of artistic or literary expression only if they are necessary to reconcile the right to privacy with the rules governing freedom of expression." This provision is cited only once in the decision and is the sole reference to the right to freedom of expression.

Sharp Contrast to United States Approach

This is a significant contrast to the U.S. approach, where freedom of speech, including corporate communications, would be weighed much more heavily against privacy concerns, as national legislation and precedent at the Supreme Court demonstrate. For example, Congress insulated internet operators from responsibility for the content others posted on their web pages in the Communications Decency Act Section 230. The Act, one of the most seminal protections for the Internet, was passed to enhance Internet service providers' ability to delete or otherwise monitor online content without themselves becoming publishers and thereby subjecting themselves to heightened liability. This law reflects the significant weight accorded to free speech in the United States, and the importance of intermediary immunity to the development of the Internet.

Similarly, the Supreme Court held in *Sorrell v. IMS Health*[5] in 2011 that a Vermont statute that restricted the sale, disclosure and use of records that revealed the prescribing practices of individual doctors violated the First Amendment. The Supreme Court held that companies' First Amendment right to speech trumped Vermont's claim that the law was necessary to protect medical privacy.

Consistency with European Proposals

This CJEU decision has been widely seen within the EU as predictable and in line with the will of the EU Commission and Parliament to strengthen protection of personal data of Europeans; indeed, it was declared a "victory" by Viviane Reding.

Although an interpretation of the existing Directive, the decision is also consistent with at least some versions of the proposed EU Data Protection Regulation. The proposed Regulation would purport to protect the personal data of EU citizens whether processed in or outside the EU—giving it a massive extra-territorial application to businesses established in the EU but also to businesses outside the EU that offer goods or services to European customers.

Although the CJEU found an implied right to be forgotten, the proposed Regulation includes a similar express right for individuals to have personal data erased where no longer necessary or where they withdraw consent. The proposed Regulation, however, does not expressly contemplate such a stark intermediary liability provision as results from the CJEU judgment.

Significance of the Decision

The decision is arguably the starkest conflict yet between privacy efforts in the United States and the European Union, and will likely have a deep impact on search, advertising, credit and Internet intermediary industries as well as many other industries such as financial services and life sciences. The decision may constitute the high-water mark of EU data protection efforts, and it remains to be seen whether the decision will change how Google and its competitors operate in the U.S. and globally. Whatever the impact on business, this decision will present significant difficulties for the global presentation of online information by international Internet companies.

In terms of European law, it certainly marks a significant derogation from the fundamental right of freedom of expression, including the fundamental right of Internet users to receive a free flow of information (Article 11). While the court indicated that some balancing of individual privacy and the rights of Internet users was appropriate, it provided precious little guidance on how or when to strike that balance. The court was also entirely dismissive of Google's economic interests, notwithstanding the fundamental rights expressed in Articles 16 (right to conduct a business) and 17 (protection of property). Moreover, because the court expressly found that the original publication of the relevant information by the Spanish newspaper was proper, and need not be taken down, the "right to be forgotten" obligations were imposed only on search engines. This decision also creates a host of conflicts of laws issues, including complicating the proposed "one stop shop" for the European Data Protection Regulation, given that it recognized Spanish authority to proceed with a complaint against a company whose servers are located outside of Spain.

More generally, it may prove difficult to reconcile this decision with general expectations in the Information Age, and it may result in less consensus on the proposed Regulation. It will be interesting to see whether this decision will be accepted by technology companies and citizens in Europe. In effect, the court's judgment can be argued as allowing and even encouraging pervasive censorship of the Internet by self-interested individuals who would prefer that truthful, public information be edited out of the historical record. Given that the case related to the non-payment of apparently justly owed debts, it could also impact the ability of companies to "remember" customers in their records, such as where a particular customer failed to pay them previously, or to share such information with other companies through credit reports.

In sum, the decision signifies the most striking point of departure yet between the U.S. and EU over data protection—with the decision raising not only fundamental privacy issues but also concerns as to freedom of expression, the right to communicate, and the right to remember historical facts. The transatlantic divide on these issues may be in the process of expanding, rather than narrowing, with the prospect of global commerce being caught in the chasm.

Endnotes

1. Article 12(b) of the Data Protection Directive.
2. Article 14(a) of the Data Protection Directive.
3. Article 7 of the Charter.
4. Article 8 of the Charter.
5. 131 S. Ct. 2653.

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Two Reminders for the Compensation Committee

By Howard Dicker

Since July 1, 2013, the New York Stock Exchange and the NASDAQ Stock Market have required that a compensation committee of a listed company may *select or obtain advice* from a compensation consultant, legal counsel or other adviser only after considering six enumerated factors relating to adviser independence. The compensation committee should ensure that, in addition to considering the independence of any new adviser, it reconsiders the independence of existing advisers on at least an annual basis as suggested by the SEC.

A compensation committee is not precluded from obtaining advice from a non-independent adviser, and the listing standards do not require disclosure of whether an adviser is independent. However, since January 1, 2013, SEC rules require disclosure of conflicts of interest of any compensation consultant, taking into account the same six factors.

Listed companies should consider the most appropriate time to consider and/or reconsider adviser independence for 2014 and add this to the compensation committee's annual calendar. In order to prepare, companies will need to gather information from advisers to the compensation committee, as well as directors and executive officers. Year 2 of the independence assessment may also be an appropriate time for the committee to review and refresh the procedures it has in place to ensure that the six independence factors are considered prior to retaining or receiving advice from an adviser.

Other Key Reminders:

- In affirmatively determining the independence of any director that serves on the compensation committee, the board of directors of NYSE and NASDAQ-listed companies must consider all factors specifically relevant to determining whether the director has a relationship to the company which is material to that director's ability to be independent from management in connection with the duties of a compensation committee member, including but not limited to (1) sources of compensation and (2) affiliate status. This requirement applies effective as of the 2014 annual meeting or October 14, 2014, whichever is earlier.
- The charters of NYSE and NASDAQ-listed companies must include certain enumerated responsibilities and authority articulated in the listing standards, including the compensation committee's responsibility to consider the independence of its advisers.
  - While NYSE-listed companies should have implemented any necessary changes by July 1, 2013, NASDAQ-listed companies that do not yet have a compensation committee or formal written charter will need to have them in place by their 2014 annual meeting or October 14, 2014, whichever is earlier.
- NASDAQ-listed companies must submit a one-time certification to NASDAQ within 30 days of the 2014 annual meeting or October 14, 2014, whichever is earlier, certifying that the company has complied with requirements relating to the compensation committee charter and committee composition. The certification form is available at https://listingcenter.nasdaqomx.com.
- NYSE-listed companies must continue to submit an annual written affirmation and a CEO certification within 30 days of their annual meeting (or within 30 days of the filing of the Form 10-K if no annual meeting is held).

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Second Circuit Holds That *Morrison* Precludes Securities Fraud Claims for Cross-listed Securities

By Steve Gatti and Steve Nickelsburg

The U.S. Court of Appeals for the Second Circuit recently issued an important ruling restricting the courts' authority over securities fraud cases involving securities listed on foreign exchanges—even if those securities are cross-listed on exchanges in the United States. *See City of Pontiac Policeman's and Firemen's Retirement System v. UBS A.G.*[1] The case followed the landmark U.S. Supreme Court decision in *Morrison v. National Australian Bank Ltd*,[2] in which (upsetting years of lower court precedent) the Court held that the civil fraud provision of the Securities Exchange Act of 1934 ("Section 10(b)") does not apply to claims by *foreign* investors against *foreign* issuers to recover losses from purchases on *foreign* securities exchanges (so-called "foreign-cubed" claims). The *Morrison* Court applied a "presumption against extraterritoriality" to reach this result, requiring a clear indication of congressional intent to allow a federal statute to apply to conduct outside the United States. Finding that Congress made no such clear statement with respect to Section 10(b), the Court held that Section 10(b) is only available for "transactions in securities listed on domestic exchanges and domestic transactions in other securities."

In a case of first impression, the Second Circuit considered whether the *Morrison* bar on the extraterritorial application of Section 10(b) applied (1) to securities purchased on foreign exchanges that are cross-listed in the United States, and (2) to purchases made by U.S. investors of foreign securities listed on foreign exchanges (so-called "foreign-squared" transactions).

Morrison[3]

In *Morrison,* the Supreme Court considered the extraterritorial reach of U.S. securities laws in the context of a "foreign-cubed" class action—"foreign plaintiffs suing foreign and American defendants for misconduct in connection with securities traded on foreign exchanges." To address this question, the Supreme Court relied on the longstanding principle that "when a statute gives no clear indication of an extraterritorial application, it has none." The Court then determined that Congress provided "no affirmative indication in the Exchange Act that Section 10(b) applies extraterritorially," and therefore held that "it does not."

In so holding, the Court rejected the less stringent "conduct and effects" test developed by lower courts in the decades preceding *Morrison*. Under that test, federal courts generally treated extraterritoriality as a question of jurisdiction and concluded that they possessed the power to decide a securities fraud claim if the plaintiff alleged either: (1) that a significant portion of the allegedly fraudulent conduct occurred in the United States or (2) that a significant effect of the conduct was felt in the United States. In the wake of *Morrison*, courts have foregone that complex analysis and simply barred Section 10(b) claims unless they involved a purchase or sale in the United States or a purchase or sale anywhere of a security listed on a domestic exchange.

City of Pontiac

In *City of Pontiac*, the Second Circuit considered whether the bar on the extraterritorial application of U.S. securities laws precludes (1) claims arising out of foreign-issued securities purchased on foreign exchanges, even if the securities are also cross-listed on a domestic exchange, and (2) claims arising out of "foreign-squared" transactions involving foreign securities, foreign exchanges, and U.S. purchasers. Plaintiffs, a group of foreign and U.S.-based institutional investors, alleged that UBS, a Swiss bank, certain of its officers and directors, and members of its underwriting syndicate violated Sections 10(b) and 20(a) of the Exchange Act by making fraudulent statements in connection with the issuance of "ordinary shares" of UBS.

The trial court dismissed the claims of three foreign investors and one domestic investor who "purchased their UBS (foreign-issued) ordinary shares on a foreign exchange."[4] Those plaintiffs appealed, arguing that the *Morrison* bar is limited to claims arising out of securities not listed on a domestic exchange at all, and not to cross-listed securities. Under this "listing theory," plaintiffs argued that *Morrison* should be read to permit claims based on purchases of cross-listed securities because such securities are "listed on a domestic exchange," even if the purchases at issue were made on a foreign exchange.

The Second Circuit rejected plaintiffs' "'listing theory'" as "irreconcilable with *Morrison* read as a whole." The court observed that *Morrison* emphasized the location of the securities transaction at issue—i.e., where the securities were purchased—and not "the location of an exchange where the security *may* be dually listed." Thus, the technicality that shares are cross-listed should not subject a wholly foreign transaction to the civil fraud provision of the Exchange Act. The Second Circuit also noted that the shares at issue in *Morrison* were also traded via American Depositary Receipts listed on the NYSE and thus were similar to the cross-listed UBS shares. The Second Circuit concluded that "*Morrison* does not support the application of § 10(b) of the Exchange Act to claims by a foreign purchaser of foreign issued shares on a foreign exchange simply because those shares are also listed on a domestic exchange."

As for the "foreign-squared" claim, the U.S.-based plaintiff asserted that it had placed a "buy order" for the shares in the United States and thus had made an actionable "purchase…of [a] security in the United States." The Second Circuit rejected this argument based on its own precedent in *Absolute Activist Value Master Fund Ltd. v. Ficeto*, which held that a "securities transaction is domestic [for purposes of *Morrison*] when the parties incur irrevocable liability to carry out the transaction within the United Sates or when title is passed within the United States."[5] The Second Circuit held that the mere allegation that the purchaser placed a "buy order" in the United States was insufficient to establish that a party incurred irrevocable liability within the United States.

Conclusion

It remains to be seen if the Supreme Court will examine the Second Circuit's decision in *City of Pontiac*. For the time being, however, the plaintiffs' effort to subject foreign issuers to civil suit under U.S. securities law merely because the securities are also listed on U.S. exchanges has failed. The *City of Pontiac* decision gives foreign issuers greater certainty that cross-listing their shares on U.S. exchanges will not subject them to liability to civil plaintiffs for claims involving shares listed on foreign exchanges. The Second Circuit's rejection of "foreign squared" liability similarly limits the risk that foreign issuers may be subject to liability under U.S. securities laws merely because buy orders are placed in the United States.

Endnotes

1. *City of Pontiac Policeman's and Firemen's Ret. Sys. v. UBS A.G.*, No. 12-4335-CV, 2014 WL 1778041 (2d Cir. May 6, 2014).
2. *Morisson v. Nat'l Australia Bank*, 561 U.S. 247 (2010).
3. *See* Clifford Chance June 2010 Client Memorandum, "F-Cubed Gets an F Grade from US Supreme Court" for further discussion of *Morrison*.
4. *City of Pontiac*, 2014 WL 1778041, at *1.
5. *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60, 69 (2d Cir. 2012).

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Regulation A: Easier Access to the U.S. Capital Markets Is Coming

By Guy P. Lander and Bruce A. Rich

In December 2013, the U.S. Securities and Exchange Commission (SEC) proposed new rules that would permit U.S. and Canadian companies that are not SEC reporting issuers ("Reg A Issuers") to sell up to $50 million of their securities in any rolling 12 month period with reduced regulation and related expense, and immediate subsequent public trading of the purchased securities. This proposed Regulation A offers access to capital and the U.S. capital markets with reduced initial and ongoing expenses, reduced legal liability, potentially higher valuations, increased capital raising possibilities and improved currency for acquisitions and employee compensation, and with limited subsequent SEC reporting and without ongoing SOX compliance. In contrast to a private placement, Regulation A offers "free trading" securities and could be used as either a transitional stage on the road to becoming a full-fledged public company or simply as a means to accessing the U.S. capital markets with reduced fees and concomitant expense.

The proposed Regulation A consists of:

Tier I Offerings:	Up to $5 million in a rolling 12 month period, $1.5 million of which may be sold by stockholders.
Tier II Offerings:	Up to $50 million in a rolling 12 month period, $15 million of which may be sold by stockholders.[1]

For offerings up to $5 million, issuers may use Regulation A Tier I or Tier II, Regulation D or another Securities Act exemption under the U.S. Securities Act of 1933 (the "Securities Act").

Regulation A offers significantly reduced ongoing reporting and compliance obligations compared to a registered offering. The following reporting and compliance obligations would NOT apply to Regulation A companies (and their directors, officers and stockholders):

- the SEC's proxy statement rules;
- the SEC's tender offer rules and going private rules;
- Section 16 shareholder reporting by directors, executive officers and 10% stockholders, related short swing profit recapture and prohibition on "short" transactions;
- Section 13 D/G market alert disclosure by 5% stockholders;
- audit committee independence requirements of SOX;
- SOX Sec. 404 internal controls;
- director and officer loan prohibitions under SOX;
- CEO/CFO SOX certifications;
- conflict minerals and resource extraction disclosures under the Dodd-Frank Act; and
- pay ratio disclosure under the Dodd-Frank Act.

Eligible Issuers

The Regulation A exemption would be available to any company that is *both* organized in and has its principal place of business in the United States or Canada, but is NOT:

- subject to reporting under the Securities Exchange Act of 1934 (the "Exchange Act");
- an investment company;
- a development stage company with no specific business plan or purpose or whose business plan is to engage in a merger or acquisition with an unidentified company (e.g., SPACs, BDCs, blank check and shell companies);
- disqualified under the "bad actor" provisions of the proposed rules (similar to Reg. D Rule 506(d)); or
- an issuer of fractional undivided interests in oil or gas rights, or similar interests in other mineral rights.

Additionally, issuers conducting Regulation A offerings under the proposed rules must also:

- have filed the ongoing reports required by the proposed rules (described below) during the preceding two years of filing a new Regulation A offering statement; and
- not be subject to an SEC order revoking their registration under the Exchange Act under Section 12(j) of that Act during the preceding five years.

Eligible Securities

Offerings under proposed Regulation A must consist only of equity securities, debt securities and debt securities convertible into or exchangeable for equity securities, including any guarantees of those securities. Asset-backed securities will not be eligible to be offered under the proposed rules.

Eligible Transactions

Transactions permitted under Regulation A would include:

- primary capital raising offerings;
- offerings by stockholders;
- offerings under a dividend or interest reinvestment plan or an employee benefit plan;
- securities issuances upon the exercise of outstanding options, warrants or rights or conversion of outstanding securities;
- pledging of securities as collateral; and
- continuous offerings in an amount expected to be sold within two years, as long as the offering begins within two days after the offering statement has been qualified.

The proposed rules would not be available for at-the-market offerings or business combination transactions.

Investment Limitation on Purchasers

The proposed rules would limit the amount of securities that a potential investor may invest in a Tier II offering to 10% of the greater of the investor's annual income or net worth, calculated in accordance with Regulation D guidelines. There is no similar limit for a Tier I offering. Tier II issuers would be able to rely on an investor's representation of compliance with these limitations unless the issuer knew at the time of sale that the representation was false. However, there is no limit on how much an investor may purchase in the open market after the offering.

Integration of Safe Harbors

Regulation A offerings will not be integrated with:

- prior offers or sales of securities (outside Regulation A); or
- subsequent offers and sales of securities that are:
  - registered under the Securities Act, except as provided in Rule 254(d);
  - made under Rule 701;
  - made under an employee benefit plan;
  - made under Regulation S;
  - made more than six months after completion of the Regulation A offering; or
  - crowdfunding offers (once rules are adopted).

Offering Process

To offer securities under Regulation A, a company must file an "offering statement" with the SEC via EDGAR for both Tier I and Tier II offerings, and the SEC must affirmatively "qualify" the Offering Statement. For a company that has not previously sold securities under either Regulation A or an effective registration statement under the Securities Act, confidential, non-public review of draft offering statements would be permitted before filing. However, the non-public documents would have to be publicly filed no later than 21 days before qualification. This enables Regulation A issuers to maintain confidentiality through road shows. In contrast, emerging growth companies must come out of confidential treatment before road shows.

A company pursuing a Regulation A offering would be able to "test the waters," i.e., seek indications of interest, from any potential investors before filing the offering statement. The company would be required to file any solicitation materials as an exhibit to its offering statement. See "Solicitation Communications" below.

As with a registered offering, if underwriters are participating in the Regulation A offering, the offering statement and underwriting arrangements would be required to be filed with and approved by FINRA, unless an exemption is available.

Although the process for filing, review and qualification of Regulation A offering statements would be similar to that for full-blown registration statements, given the reduced disclosures, the Regulation A offering process should be somewhat faster and less costly than a full-blown registration statement. However, that remains to be seen.

Offering Statement

The Regulation A offering statement would be filed on Form 1-A and consist of three parts: Part I (Notification), Part II (Offering Circular) and Part III (Exhibits). Part I provides notice of certain basic information about the company and its proposed offering, including disclosure of issuer eligibility, "bad actor" disqualification, unregistered securities sold within the past year, and a summary of key issuer financial information and offering details. Part II, the offering circular, is similar to a prospectus in a registered offering, and Part III is similar to the exhibit requirement in a registration statement.

As proposed, disclosure required in the offering circular would cover substantially similar information to that required on a Form S-1 for the IPO of an emerging growth company, including two years of audited financial statements for Tier 2 offerings, MD&A, risk factors, a three-year description of the business, compensation information for the three most highly paid officers or directors, and related-party transaction disclosure. The information required is intended to be similar to that required of smaller companies in a prospectus, but more limited in certain respects.

Pricing can be done by supplement rather than an amendment, which is easier.

Financial Statement and Audit Requirements		
Type of Offering	**Tier I**	**Tier II**
Financial Statements	Two years financial statements (or since inception if less than 2 years)	Two years financial statements
Audits Required?	No, only required to the extent that they were prepared for other purposes	Yes, required
Audit Standard	U.S. GAAS or PCAOB standards	PCAOB standards
Auditor Independence	Must meet Rule 2-01 of Regulation S-X Need not be PCAOB-registered	Must meet Rule 2-01 of Regulation S-X Need not be PCAOB-registered

Financial Statements

Under the proposed rules, issuers conducting Tier I and Tier II offerings will be required to comply with the financial statement and auditing requirements as set forth in the table above.

Canadian issuers can use IFRS instead of U.S. GAAP.

Continuous or Delayed Offerings

The proposed rules permit continuous or delayed offerings for, among other types of offerings, secondary offerings, securities offered and sold under dividend reinvestment plans or employee benefit plans, securities issued upon the exercise of options, warrants or rights, and certain other continuous offerings. The proposed rules also require amendments to the offering statement to be filed and requalified annually to include updated financial statements and fundamental changes to the information in the offering statement.

Solicitation Communications—Test the Waters Expanded to Pre- and Post-Filing of Offering Statement

An issuer using Regulation A could "test the waters," i.e., seek indications of interest, from all types of potential investors both before and after filing the offering statement, unlike EGCs, which are limited to qualified institutional buyers and institutional accredited investors. Any solicitation materials would need to be filed with the SEC and must also contain certain disclaimers and legends indicating that sales under Regulation A would be contingent on qualification of the offering statement by the SEC, and the delivery of a final offering statement. Any solicitation materials used after filing of the offering statement with the SEC would have to be preceded or accompanied by a preliminary offering circular or contain a notice informing potential investors where and how the most current preliminary offering circular can be obtained (including by providing a URL link to the offering circular or offering statement on EDGAR).

The preliminary offering circular would have to be delivered at least 48 hours in advance of a sale. A final offering circular would have to be delivered within two business days after the sale in cases where the sale was made in reliance on the delivery of a preliminary offering circular. Issuers and intermediaries would be able to satisfy the delivery requirements for the final offering circular under an "access equals delivery" approach when the final offering circular is filed and available on EDGAR.

The proposed rules would amend Rule 254(d) to provide that where an issuer decides to register an offering after soliciting interest in a contemplated, but abandoned, Regulation A offering, any Tier I or Tier II offers made pursuant to Regulation A would not be subject to integration with the subsequent registered offering, unless the issuer engaged in solicitations of interest in reliance on Regulation A to persons other than qualified institutional buyers (QIBs) and institutional accredited investors. An issuer soliciting interest in either a Tier I or Tier II offering to persons other than QIBs and institutional accredited investors must wait at least 30 calendar days between the last solicitation of interest and the filing of the registration statement with the SEC.

Ongoing Reporting and Compliance

Tier I issuers would be required to file electronically with the SEC certain information about their offerings within 30 days after completion or termination of the offering on a new Form 1-Z, which is an exit report. Tier II issuers would be required to file annual, semiannual and current reports with the SEC via EDGAR until the company becomes a reporting company or, subject to certain exceptions, until there are fewer than 300 holders of record of the securities of the class sold per Regulation A.

For Tier II issuers:

- **Annual reports on Form 1-K** would be required for the fiscal year in which the offering statement became qualified and for every fiscal year thereafter. The annual report would update the information contained in the company's offering circular, including two years of annual audited financial statements. The annual report would be filed within 120 days of the company's fiscal year end (compared to the Form 10-K filing deadline of 60 to 90 days, depending on the size of the company).
- **Semiannual reports on Form 1-SA** covering the first half of each fiscal year of the company would be required beginning with the first fiscal year for which financial statements relating to the first half of that

year were not included in the offering circular. The semiannual report would consist primarily of unaudited financial statements and MD&A. The semiannual report would be filed within 90 days of the end of the second quarter (compared to the Form 10-Q deadline of 40 or 45 days, depending on the size of the company) and would be filed only once a year (compared to three times for Form 10-Q).

- **Current reports on Form 1-U** would be required upon the occurrence of certain specified events, and would be filed within four business days of the event (similar to the Form 8-K filing requirement). Form 1-U reportable events are a reduced number of Form 8-K events, including bankruptcy; material modification to the rights of security holders; changes in accountant; non-reliance on previous financial statements; changes in control; departure of the principal executive officer, principal financial officer or principal accounting officer; and unregistered sales of 5% or more of outstanding equity securities. Additionally, any "fundamental change" to the nature of the company's business would trigger a Form 1-U filing. The fundamental change required to be reported would be major and substantial changes in the issuer's business or plan of operations or changes reasonably expected to result in such changes, such as significant acquisitions or dispositions, or the entry into, or termination of, a material definitive agreement that has or will result in major and substantial changes to the nature of an issuer's business or plan of operations.
- **Exit Reports** on Form 1-Z could be filed by a Tier II issuer to exit the ongoing reporting regime at any time after completing reporting for the fiscal year in which the offering statement was qualified if the securities of the relevant class are held of record by fewer than 300 persons and offers and sales under a qualified offering statement are not ongoing and it is current in its Regulation A filing obligations.

Secondary Markets

Securities sold under Regulation A would have the status of "free trading" securities and would not be "restricted securities" under Rule 144 under the Securities Act (unlike securities sold in Regulation D or Rule 144A private placements). Additionally, the ongoing reports required after a company's Tier II offering would satisfy a broker-dealer's obligations under Rule 15c2-11 to maintain records of basic information about the company and its securities. This would permit broker-dealers to publish quotes for the company's stock, which should facilitate secondary market activity in Regulation A securities.

State "Blue-Sky" Laws Preempted

State "blue sky" laws would be preempted for both the offer and sale of securities in Tier II offerings, which is a significant benefit. For Tier I offerings, state "blue sky" laws would not be preempted. Blue sky laws would also continue to cover fraudulent conduct in both Tier I and Tier II transactions. The proposed rules accomplish this preemption by defining "qualified purchaser" under Section 18(b)(3) of the Securities Act to include all offerees in a Regulation A offering, and all purchasers in a Tier II offering.

Securities That Are "Widely Held" Trigger Exchange Act Registration Under Section 12(g)

Under the proposed rules, when the securities of a Regulation A issuer become "widely held," the issuer may become subject to registration and periodic reporting under Section 12(g) of the Exchange Act. The Section 12(g) threshold is: an issuer having total assets exceeding $10 million and a class of securities held of record by either 2,000 persons, or 500 persons who are not accredited investors. For purposes of determining holders of record, beneficial owners who hold their shares through a broker are not counted. Such shares are instead counted at the broker level, so that each broker who is a record holder for one or more beneficial owners holding their shares in "street name" would constitute one shareholder of record (i.e., no "look through" to beneficial owners).

Canadian issuers using Regulation A could rely on the Rule 12g3-2(b) information supplying exemption from Exchange Act registration.

Liability

Under the proposed rules, sellers of securities would not be subject to liability under Section 11 of the Securities Act. However, they will be subject to liability to investors under Section 12(a)(2) for any offer or sale by means of an offering circular or an oral communication that includes a false or misleading statement of fact. Additionally, other anti-fraud and civil liability provisions of the securities laws would apply, including Section 17 of the Securities Act, Section 10(b) of the Exchange Act and related Rule 10b-5. As a result, underwriters in a Regulation A offering would probably require due diligence comparable to a registered offering.

Conclusion

The proposed Regulation A offers a real opportunity for U.S. and Canadian issuers to access the U.S. capital markets and obtain the benefits of "registered" securities with less regulation and ongoing expense.

Endnote

1. All sales by selling security holders under either Tier I or Tier II will be aggregated with all other sales of Regulation A securities by the issuer and other security holders for purposes of calculating the maximum permissible amount of securities that may be sold during any 12-month period. Additionally, affiliates can use these rules.

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Inside the Courts

Prepared by Attorneys at Skadden Arps

U.S. SUPREME COURT

Supreme Court Clarifies Scope of Sarbanes-Oxley Whistleblower Protections to Include Employees at Private Firms That Contract With Publicly Traded Companies

***Lawson v. FMR LLC*, 134 S. Ct. 1158 (2014)**

In a 6-3 decision, the U.S. Supreme Court held that the Sarbanes-Oxley Act's whistleblower protections apply to employees of a public company's private contractors and subcontractors. The question presented was whether Section 1514A of Sarbanes-Oxley, which protects employees of public companies from retaliation for reporting potential misconduct, extends to employees of a private company that works as a contractor for a public company. Two employees of a private investment advisor sought protection under Section 1514A. The employees alleged retaliation after they raised concerns related to the cost-accounting methodologies and SEC disclosures of a family of public mutual funds.

The court held that the plain language of the Act "shelters employees of private contractors and subcontractors, just as it shelters employees of the public company served by the contractors and subcontractors." In addition, the statute's language and enforcement mechanisms indicated that Congress expected the retaliator to be the purported whistleblower's employer, rather than a contractor hired specifically to avoid the statute's provisions as the investment advisor argued. The Court reasoned that its textual interpretation aligned with Congress's objectives of avoiding "another Enron debacle." Congress recognized that certain of Enron's contractors had retaliated against employees who objected to Enron's practices. Without the provision's protections, a contractor's employees "would be vulnerable to retaliation by their employers for blowing the whistle on a scheme to defraud the public company's investors, even a scheme engineered entirely by the contractor."

Supreme Court Decides Scope of SLUSA "in Connection With" Requirement

***Chadbourne & Parke LLP v. Troice*, 134 S. Ct. 1058 (2014)**

In a 7-2 decision, the U.S. Supreme Court held that the Securities Litigation Uniform Standards Act (SLUSA)—which bars state law class action lawsuits based on misrepresentations "in connection with the purchase or sale" of nationally traded securities (covered securities)—did not prevent a class of purchasers of certificates of deposit in a Ponzi scheme from asserting claims under state law, even though the CDs were supposedly backed by nationally traded stocks and bonds. The Court explained that SLUSA's "basic focus" is on the regulation of securities traded on a national exchange, and both parties agreed that the CDs were not covered securities. Although investors were induced to purchase the CDs by misrepresentations about securities that would have been covered by SLUSA had they existed, for purposes of the "in connection with" requirement, the Court held that the "connection matters where the misrepresentation makes a significant difference to someone's decision to purchase or to sell a covered security, not to purchase or to sell an uncovered security, something about which the Act expresses no concern." In addition, the Court held that the person purchasing the covered securities cannot be the fraudster himself. The Court's opinion balanced the federal interest in standardized litigation concerning nationally traded securities against the preservation of state law remedies for fraud traditionally regulated by the states.

CLASS CERTIFICATION

Texas District Court Denies Class Certification Because Proposed Methodology for Calculating Class-Wide Damages Did Not Track Plaintiffs' Theories of Liability

***In re BP P.L.C. Secs. Litig.*, MDL No. 10-md-2185, 2013 WL 6388408(S.D. Tex. Dec. 6, 2013)**

Judge Keith P. Ellison of the U.S. District Court for the Southern District of Texas denied the plaintiffs' motion for class certification in a case alleging that British Petroleum misled investors through a series of misstatements made before and after the Deepwater Horizon spill. The alleged misstatements concerned BP's progress in implementing safety procedures, its ability to respond to and contain a catastrophic deepwater oil spill, and the magnitude of the spill. The defendants opposed class certification, arguing, among other things, that the plaintiffs could not make the required showing of predominance under FRCP 23(b)(3) because they could not show class-wide damages consistent with their theory of the case. In support of their class certification motion, the plaintiffs indicated that they would use an event study to calculate class-wide damages, but did not explain in detail how the study would be conducted.

In response, the defendants argued that the plaintiffs' proposed event study methodology would violate the Supreme Court's requirement in *Comcast Corp. v. Behrend*, 133 S. Ct. 1426 (2013), that class-wide damages must conform to plaintiffs' theories of liability. The defendants submitted their own event study, similar to the type used by the plaintiffs' expert in other securities fraud cases, to illustrate potential disconnects between an event study and the frauds alleged by plaintiffs. The defendants' study revealed multiple ways in which the plaintiffs' proposed methodology for calculating damages was inconsistent with the plaintiffs' theories of liability. In denying class certification, the court, applying *Comcast*, held that it was the plaintiffs' burden to show that damages could be measured on a class-wide basis consistent with their theories of liability and that the plaintiffs failed to meet that burden. Noting that the *Comcast* decision "signals a significant shift in the scrutiny required for class certification," the court explained that "[w]ithout a more complete explication of how Plaintiffs propose to use an event study to calculate class members' damages, and how that event study will incorporate—and, if necessary, respond to—the various theories of liability, the Court cannot certify this litigation for class action treatment."

S.D.N.Y. Denies Class Certification in RMBS and CDO Exposure Dispute

IBEW Local 90 Pension Fund v. Deutsche Bank AG, No. 11 Civ. 4209 (KBF), 2013 WL 5815472 (S.D.N.Y. Oct. 29, 2013)

Judge Katherine B. Forrest of the U.S. District Court for the Southern District of New York denied class certification on claims that a bank violated Section 10(b) of the Securities Exchange Act by allegedly misrepresenting its exposure to residential mortgage-backed securities and collateralized debt obligations. The plaintiffs' expert on market efficiency was rejected as unqualified because he lacked relevant academic and career experience other than that gained while serving as an expert in prior litigation. In addition, the expert failed to sustain the plaintiffs' burden of establishing that the market for the bank's global registered shares was efficient. The plaintiffs' expert failed to consider the efficiency of the German market for the bank's shares, which the bank's experts demonstrated was an influential determinant of the pricing of those shares in U.S. markets. Further, the expert failed to take into account unique circumstances affecting the financial industry generally at the time of the alleged conduct, such as the U.S. and German bans on short-selling. The expert also chose, inappropriately, to test market efficiency only on certain days on which the bank released earnings numbers. Because plaintiffs must demonstrate an efficient market (rather than defendants establishing inefficiency), they were not entitled to the fraud-on-the-market presumption of reliance, and individual issues of reliance predominated. Moreover, the lead plaintiff was not typical of the class because its "in-and-out" trading strategy likely subjected it to unique defenses related to causation and reliance.

DEMAND FUTILITY

California Appeals Court Affirms Dismissal of Shareholder Derivative Action Against Yahoo! Officers and Directors for Failure to Adequately Allege Demand Futility

Leyte-Vidal v. Semel, No. H037762 (Cal. Ct. App. Oct. 23, 2013)

The Court of Appeal of California affirmed the dismissal of the third amended complaint in a shareholder derivative action brought against Yahoo! officers and directors on the grounds that the plaintiff did not adequately plead demand futility. The court agreed that the complaint failed to allege that at least half of Yahoo!'s 12 directors were not disinterested and independent, which would have excused demand.

The original complaint, naming 15 defendants, contained numerous allegations, including insider trading, improper financial reporting, abuse of control, gross mismanagement and waste. Following demurrer, however, the plaintiff abandoned all causes of action except those involving insider trading.

At the time the action commenced, only five of the "Insider Selling Defendants" held seats on the 12-director board. The trial court agreed with the plaintiff that those five directors were not disinterested and independent. However, because the plaintiff needed to plead that at least half of the directors could not consider a demand, the plaintiff still had to identify an additional director who was not disinterested and independent for demand to be excused.

The plaintiff focused on two directors, who had been the subject of the now-abandoned allegations of mismanagement and improper financial reporting. The trial court concluded, and the court of appeal agreed, that the reference to those allegations was insufficient to call into question those directors' disinterest and independence. As an initial matter, those allegations were "insufficient to ascribe bad faith to the directors." Moreover, the plaintiff had abandoned those allegations after the initial complaint, and the court refused to allow the plaintiff to subsequently reintroduce them. The plaintiff further argued that demand was excused because the other directors were dominated and controlled by Yahoo!'s co-founder, and therefore could not exercise their judgment in an independent and disinterested manner. To the court of appeal, that allegation was "circular and conclusory." The complaint lacked any "particularized facts that permit an inference that because of [the co-founder's] *relationship* with each director, each acted under [his] influence in making the challenged decisions." The allegations demonstrated merely that the plaintiff disagreed with the decisions made by the co-founder and the other directors.

EXCHANGE ACT

Ninth Circuit Reverses Dismissal of Section 10(b) Claims in British Petroleum Alaska Oil Spill Case, Holding Plaintiffs Adequately Pled Scienter Against BP and One Executive

***Reese v. Malone*, No. 12-35260 (9th Cir. Feb. 13, 2014)**

The U.S. Court of Appeals for the Ninth Circuit reversed in part the dismissal of a federal securities claim brought against British Petroleum (BP) and certain executives of the company.

In March 2006 an oil leak in one of BP's Alaskan pipelines spilled 200,000 gallons of oil onto the Alaskan tundra in Prudhoe Bay. A second leak occurred five months later in a different BP oil line in Prudhoe Bay. In this purported class action, BP shareholders alleged the company made false and misleading statements prior to and in the wake of the first spill regarding the condition of the pipelines and BP's pipeline maintenance and leak detection practices. The district court granted the defendants' motion to dismiss with prejudice. Although the district court found some of the statements false or misleading, it dismissed the claims because the plaintiffs did not sufficiently plead scienter.

On appeal, the Ninth Circuit reviewed four allegedly false and misleading statements. First, the panel considered a statement made two weeks after the first spill by a BP-Alaska executive in charge of operations in the region. The executive stated that, a year earlier, the pipe was corroding at a "low manageable" rate. The panel agreed with the district court that, based on the allegations and the facts that later came to light, the statement was demonstrably false. However, the panel reversed the district court as to scienter. The court stated that, given the executive's position, she "had every reason to review the results of BP-Alaska's corrosion monitoring to understand what happened.… Evidence of high levels of corrosion would be central to this inquiry." Furthermore, the executive "had a clear motive for omitting information about the detection of high corrosion levels." Finally, because the executive specifically addressed corrosion rate data in her statement, it was unlikely she was unaware of the true corrosion rate.

Second, the court considered statements by the same executive in the wake of the first spill that "'[s]imilar problems have not been found in other lines downstream and elsewhere in Prudhoe Bay.'" These statements were false, the panel explained, because other pipelines, including the line that produced the second leak, did exhibit similar problems. The court also concluded that the plaintiffs adequately alleged scienter. The court analyzed scienter from two perspectives: (i) evidence of contemporaneous knowledge and (ii) the "core operations inference." As to evidence of contemporaneous knowledge, the executive had received a report from a federal agency that drew comparisons between the construction, operation and maintenance of the two pipes. In addition, later disclosures contradicting the executive's statement "can be circumstantial evidence of scienter." Under the "core operations" analysis, the court considered two factors. First, the court asked whether it would be "absurd" to suggest that management was without knowledge of the matter. The court answered this inquiry in the affirmative, concluding that it was "absurd" to think the head of Prudhoe Bay operations did not know the comparable conditions of the two pipes. Second, the court asked whether the allegations "'suggest that [the] defendants had actual access to the disputed information.'" Again, the court answered in the affirmative, determining that the executive's specific statements indicated that she likely had access to the disputed information. Because the allegations were sufficient under the "absurdity" and "actual access" analyses applied by the court, the panel held that the plaintiffs adequately alleged scienter under the "core operations inference."

Third, the court considered a statement by BP's CEO that the first spill occurred "'in spite of the fact that we have both world class corrosion monitoring and leak detection systems.'" While that statement appeared to be false, the plaintiffs did not allege facts showing, directly or circumstantially, that the CEO knew of the problems when he made the statement. Therefore, there was no strong inference of scienter.

Finally, the panel considered a statement in BP's annual report, issued nearly four months after the first oil spill, that "Management believes that the Group's activities are in compliance in all material respects with applicable environmental laws and regulations." As to this statement, the panel said it could find "no reasonable basis for management's 'belief' that BP was in material compliance with applicable …laws and regulations." In addition, "we find it most unlikely that top management was unaware of facts undermining its belief in compliance." BP argued that its statement was not false because it prefaced the statement with management "believes," and used the qualifier "material" to describe its level of compliance. The court disagreed. The court acknowledged that BP's ongoing discussions with regulators suggested some "effort" to achieve compliance, but stated that those efforts did not negate the "pre-existing, significant violations" alleged in the complaint. As to scienter, the panel once again inquired whether it would be "absurd" to suggest that management was without knowledge of the matter. The court noted the "significant federal and state government intervention into BP's operations after the March…[oil] spill." Further, the annual report itself discussed the spill. Moreover, the former CEO requested updates on BP's response to the spill, which the court viewed as "direct evidence of its prominence in the eyes of BP's top management." Given that, the panel said, "we find it 'absurd' that management was not aware of BP's significant, existing compliance issues that rendered the statement misleading." Put in context, the panel said, the statement appeared to be made with the intent to downplay BP's noncompliance with regulations, which further raised the inference of scienter.

The panel remanded the case to the district court for further proceedings.

Northern District of California Denies in Part Motion to Dismiss, Holding That Defendants' Failure to Disclose Certain Adverse Reactions Rendered Statements About Drug's Safety False and Misleading

***Bartelt v. Affymax, Inc.*, No. 13-01025 (N.D. Cal. Jan. 21, 2014)**

Judge William H. Orrick of the U.S. District Court for the Northern District of California granted in part and denied in part the defendants' motion to dismiss claims brought under Rule 10b-5. The plaintiff alleged that Affymax, a pharmaceutical company, and four Affymax officers violated federal securities laws by making false and misleading statements about the company's primary drug, which eventually was recalled because of safety concerns. The company's stock dropped following the recall.

The allegations focused on three instances in which the defendants made statements about the drug's safety and efficacy despite knowing "that there were serious adverse reactions" to the drug, including patient death. The court held that the first two statements could not support a 10b-5 claim. The defendants made the first statement prior to the time they allegedly learned of the "adverse reactions," so they could not have knowingly misrepresented the seriousness or impact of the adverse reactions. The second statement was neither false nor misleading because the statement contained accurate and specific disclosures regarding the drug, negating any purported falsity.

The court held that the third statement could support a 10b-5 claim because the plaintiff adequately pleaded it was materially false and misleading. In that statement, the defendants said that the drug's "safety and efficacy were established," and, according to the plaintiff, implied that the issue with the drug was simply dose efficacy, rather than safety. According to the plaintiff, this statement was misleading because the defendants knew about the adverse reactions and failed to disclose them. The defendants argued that they did not have a duty to disclose information about the adverse reactions because the occurrence of adverse reactions is not a material fact. A fact is material "'when there is 'a substantial likelihood that the disclosure of the omitted fact would have been viewed by [a] reasonable investor as having significantly altered the "total mix" of information made available.''" The defendants cited *Matrixx Initiatives Inc. v. Siracusano*, 131 S. Ct. 1309 (2011) for the proposition that the "mere existence of reports of adverse events" does not alter the "total mix of information" available. In *Matrixx*, the Supreme Court explained that "[t]he fact that a user of a drug has suffered an adverse event, standing alone, does not mean that the drug caused that event." Rather, "something more is needed" to make the existence of reports of adverse events something a reasonable investor would view as altering the "total mix of information made available." According to the defendants, the plaintiff failed to establish the "something more."

The court disagreed. In *Matrixx*, the Supreme Court held that it was substantially likely that a reasonable investor would have viewed adverse event reports "about more than 10 patients who had lost their sense of smell after using [a drug]" as having significantly altered the total mix of information because "in some cases…reasonable investors would have viewed reports of adverse events as material even though the reports did not provide statistically significant evidence of a casual link." Using the same rationale, the court here determined that it was "substantially likely that a reasonable investor would have viewed over two dozen fatal, life-threatening and other adverse reactions to" the drug as altering the total mix of information made available. Therefore, the plaintiff had adequately pleaded that the statement was materially false and misleading.

Finally, the court rejected the defendants' argument that the company made adequate public disclosures in other ways, such as on the drug's package insert, so as to negate the misleading nature of the statement at issue.

Northern District of California Denies Motion to Dismiss Exchange Act Claim, Holding Plaintiff's Contractual Right of First Refusal Could Qualify as a Contract to Sell or Purchase Securities

***Integral Dev. Corp. v. Tolat*, No. 12-06575 (N.D. Cal. May 30, 2013)**

Judge Jeffrey S. White of the U.S. District Court for the Northern District of California granted in part and denied in part a motion to dismiss claims brought by a software development company against its former employee. The court refused to dismiss the plaintiff's Rule 10b-5 claim, but dismissed the state securities claims brought under California law.

Tolat, the defendant employee, left plaintiff Integral after negotiating employment terms with one of Integral's competitors. Integral had a right of first refusal to purchase shares held by Tolat when he left the company. When discussing with Integral the right of first refusal to purchase his shares, Tolat allegedly failed to disclose to Integral that the price the competitor was offering for the shares in the competitor's stock purchase agreement was artificially inflated. As a result of the fraudulently inflated price presented to Integral, Integral allegedly was not able to exercise its right of first refusal. In his motion to dismiss, Tolat argued that because no actual contract to purchase securities was formed and no actual purchase of securities was ever consummated, Integral lacked standing to bring a claim under 10b-5. In addition, Tolat argued that Integral could not allege damages because it never actually purchased his shares. The court disagreed, holding first that Integral's contractual right of first refusal could qualify as an underlying contract to sell or purchase securities. Moreover, Integral sufficiently pleaded facts that it suffered economic loss as a result of Tolat's conduct to survive a motion to dismiss.

As to Integral's state securities claim, the court explained that the relevant California Code sections do not provide a private right of action unless there is a completed sale of a security. Because Integral could not allege a completed sale or securities purchase, Integral lacked standing to sue under California law.

FIDUCIARY DUTIES

Books and Records

Delaware Court of Chancery Denies Books and Records Review in Connection With HP's Acquisition of Autonomy

***Cook v. Hewlett-Packard Co.*, No. 8667-VCG (Del. Ch. Jan. 30, 2014)**

Vice Chancellor Sam Glasscock III of the Delaware Court of Chancery denied a Section 220 request by a Hewlett-Packard Co. (HP) shareholder seeking to review books and records related to government investigations into the company's acquisition of Autonomy Corp. (Autonomy). The government investigations stemmed from HP taking a goodwill impairment charge after the acquisition due to accounting improprieties that occurred at Autonomy prior to the acquisition.

The plaintiff's stated purposes for requesting the documents were to (i) investigate wrongdoing at HP, (ii) communicate with HP's board about possible wrongdoing and (iii) determine whether HP's board was disinterested and acted in accordance with its fiduciary duties when acquiring Autonomy. HP voluntarily produced some board-level documents, but the plaintiff demanded more. The court held that documents "necessary and essential to the Plaintiff's stated purpose of investigating wrongdoing on the part of HP's officers and directors are the documents that the Plaintiff ha[d] already received: board and committee minutes for meetings at which the board discussed the Autonomy acquisition, and documents reflecting presentations given at those meetings." The court denied the plaintiff's request for additional broader categories of documents, including "all documents produced by, or sought from, the Company by all government authorities investigating wrongdoing *by the acquired entity*," stating that the requests "amount[ed] to a fishing expedition."

Derivative Litigation

Eighth Circuit Holds *Colorado River* Abstention Inappropriate in Shareholder Derivative Suits Alleging Securities Exchange Act Violations

***Cottrell v. Duke*, 737 F.3d 1238 (8th Cir. 2013)**

The U.S. Court of Appeals for the Eighth Circuit held that *Colorado River* abstention was not appropriate in a case in which shareholders alleged that Wal-Mart corporate officers violated Section 14(a) of the Securities Exchange Act because the federal courts have exclusive jurisdiction over such claims. The shareholders claimed that the defendants violated the Securities Exchange Act and breached their fiduciary duties by causing Wal-Mart to disseminate false and misleading statements regarding the effectiveness of oversight over compliance issues at Wal-Mart, permitting the company to violate foreign and federal laws and participate in a cover up, among other actions. Because shareholder derivative lawsuits were brought in both state and federal court, Wal-Mart moved to stay the federal court proceedings in deference to the ongoing state court case. The district court granted the motion, citing both *Colorado River* principles of abstention and the court's inherent power to control its docket.

Citing holdings in the U.S. Courts of Appeal for the Second, Seventh and Ninth Circuits, the Eighth Circuit held that *Colorado River* abstention is not appropriate when a plaintiff raises a claim over which federal courts have exclusive jurisdiction, such as a claim under the Securities Exchange Act. The Eighth Circuit noted it could not find a circuit court that has held otherwise, and also rejected the defendants' attempt to avoid precedent from other circuits by pointing to the derivative claims. The court reasoned that, although the pleading requirements for derivative actions incorporate a state-law demand requirement, it could not simply assume that state demand requirements would dispose of the controversy for the purpose of determining that the state and federal actions were sufficiently "parallel" for *Colorado River* abstention to apply. Further, the Eighth Circuit held that the district court abused its discretion by using its inherent power to control its docket as an alternative justification for the stay.

Mergers and Acquisitions

Delaware Court of Chancery Dismisses Claims That Answers Corp. Board Acted in Bad Faith to Sell the Company

***In re Answers Corp. S'holders Litig.*, No. 6170-VCN (Del. Ch. Feb. 3, 2014)**

Vice Chancellor John W. Noble of the Delaware Court of Chancery granted the defendants' motion for summary judgment and dismissed claims of breach of the duty of loyalty in connection with a merger. The plaintiffs claimed that the board of Answers Corp. breached its fiduciary duties by acting in bad faith to sell the company by (i) purposefully engaging in a limited shopping process; (ii) failing to act in the interests of the company's stockholders after circumstances changed to indicate the offer price was too low and (iii) exerting willful blindness to ignore alternatives to the transaction.

The court rejected all of these claims and granted the defendants' motion for summary judgment. The court stated that it "generally grants boards latitude to determine how to conduct an appropriate sale process. Thus, a board may reasonably prefer 'a discreet approach relying upon target marketing by an investment bank' to conducting a public auction. Prior decisions also support some leeway in determining which potential acquirers to target. Finally, a plaintiff's inability to explain a Board's motivation to act in bad faith may also be relevant in analyzing bad faith claims." With respect to the plaintiffs' claims that the market check was flawed, the court remarked that "*Lyondell* counsels that there is a vast difference between a flawed, inadequate effort to carry out fiduciary duties and a conscious disregard for them." Thus, even a limited market check that lasted only two weeks over the holidays and only focused on strategic buyers "does not constitute a complete abandonment of fiduciary duty and thus is insufficient to survive a bad faith abandonment of duty claim." Moreover, the court found that the board could take a variety of factors into account about the company's financial prospects when determining whether to accept a deal, remarking that "[s]uch considerations are within the purview of a disinterested Board in assessing whether to pursue the proverbial bird in hand over the one in the bush; particularly here, because no allegations have been made concerning the Board's motives for favoring [one] bidder or presenting some other motive for failing to maximize shareholder value." Ultimately, the court concluded that "[a]lthough Plaintiffs identify a variety of ways in which they believe the process could have been better conducted, they offer no evidence of that extreme set of facts required to show that the board utterly failed to attempt to comply with its duties." The court also dismissed claims that certain board members were interested or were dominated and controlled and lacked independence. The court also rejected claims for aiding and abetting against the buyer.

Delaware Court of Chancery Rules That Pre-merger Communications Pass to Transaction's Surviving Corporation

***Great Hill Equity Partners IV, LP v. SIG Growth Equity Fund I, LLLP*, 80 A.3d 155 (Del. Ch. 2013)**

Chancellor Leo E. Strine Jr. of the Delaware Court of Chancery held that, pursuant to Section 259 of the Delaware General Corporation Law (DGCL), the buyer of a Delaware corporation owned and controlled pre-merger privileged communications between the selling corporation's outside counsel and its stockholders and representatives regarding the negotiation of the transaction, which were contained in the corporation's computer systems. The opinion arose from an ongoing dispute wherein the buyer claimed that it was fraudulently induced to acquire the Delaware company.

Chancellor Strine noted that this case presented an issue of statutory interpretation in the first instance. Under Section 259 of the DGCL, following a merger, "all property, rights, privileges, powers and franchises, and all and every other interest shall be thereafter as effectually the property of the surviving or resulting corporation…." Chancellor Strine reasoned that if the Delaware legislature had intended to exempt attorney-client privileged communications from the property and rights to be transferred under Section 259, it would have so provided. He also distinguished a decision of the New York Court of Appeals, *Tekni-Plex, Inc. v. Meyner & Landis*, 674 N.E.2d 663 (N.Y. 1996) relied on by the seller, which concluded (without citation to Section 259) that pre-merger attorney-client communications regarding the merger negotiations did not pass to the surviving corporation for policy reasons under New York attorney-client privilege law.

Chancellor Strine further explained that "the answer to any parties worried about facing this predicament in the future is to use their contractual freedom in the manner shown in prior deals to exclude from the transferred assets the attorney-client communications they wish to retain as their own. …Absent such an express carve out, the privilege over all pre-merger communications—including those relating to the negotiation of the merger itself—passed to the surviving corporation in the merger, by plain operation of clear Delaware statutory law under § 259 of the DGCL."

Offerings

Northern District of Illinois Dismisses Suit Alleging Breach of Fiduciary Duty Against REIT Board

***Becker v. Inland Am. Real Estate Trust, Inc.*, No. 13-cv-3128, 2013 WL 6068793 (N.D. Ill. Nov. 18, 2013)**

Judge Harry D. Leinenweber of the U.S. District Court for the Northern District of Illinois dismissed with prejudice a case against the Board of Inland American Real Estate Trust, Inc., a public, nontraded REIT incorporated in Maryland, alleging that the company's directors breached their fiduciary duties by selling shares through a dividend reinvestment program "at inflated prices that did not reflect the true value of Inland American." The shareholders also brought claims for a constructive trust and unjust enrichment. The court rejected these claims, concluding that the directors acted in their managerial capacity when they established the price charged for shares, and thus that Maryland law imposed on them only the duties of loyalty, good faith and reasonable care. The plaintiffs' allegations did not support a determination that the directors breached these fiduciary duties because the prospectus cautioned investors that the stock offering prices were "arbitrarily determined by [the] board of directors" and that the real value could be higher or lower than their estimate and because plaintiffs did not contend that any of the financial information disseminated by the board was false. The court also rejected the shareholders' claims for a constructive trust and unjust enrichment because these rested upon the claim for breach of fiduciary duty.

MATERIALITY

Second Circuit Affirms Dismissal of Claims Alleging Canadian Solar Recognized Revenue From a Sham Transaction

***Tabak v. Canadian Solar Inc.*, No. 13-1681, 2013 WL 6697923 (2d Cir. Dec. 20, 2013)**

The U.S. Court of Appeals for the Second Circuit affirmed by summary order the dismissal of claims that Canadian Solar Inc. violated Section 10(b) of the Securities Exchange Act by allegedly recognizing revenue from a sham transaction. Because the manufacturer's alleged inflation of earnings was *de minimis*—only 2.7 percent of the company's third quarter revenue and .9 percent of its total annual revenue—the alleged misstatements were immaterial as a matter of law. The plaintiffs also pointed to other alleged false statements concerning improper revenue recognition from other sham transactions and the timing of a stock offering in relation to the alleged misrepresentations. The plaintiffs, however, failed to allege any facts to support their allegations that the additional transactions were shams, and thus failed to meet the fraud pleading requirements under the PSLRA. Further, the timing of the stock offering did not affect materiality. In addition, the plaintiffs failed to adequately plead scienter, because the alleged attempts to avoid stock dilution by company insiders were not sufficient to demonstrate motive to defraud investors.

MISREPRESENTATIONS

District of Rhode Island Upholds Section 10(b) Claims Against CVS in Connection With Caremark Merger

***City of Brockton Ret. Sys. v. CVS Caremark Corp.*, No. 09-cv-554, 2013 WL 6841927 (D.R.I. Dec. 31, 2013)**

Judge Joseph L. Laplante of the U.S. District Court for the District of New Hampshire (sitting by designation in the District of Rhode Island) upheld claims brought against CVS for alleged violations of Section 10(b) of the Securities Exchange Act for purportedly misrepresenting the success of the company's computer system integration following its merger with Caremark. The district court's prior determination that the plaintiffs failed to sufficiently alleged loss causation was reversed in part and remanded by the U.S. Court of Appeals for the First Circuit for consideration of whether the plaintiffs also properly pleaded an actionable misrepresentation or omission and scienter. On remand, the district court held that the plaintiffs had adequately alleged that CVS's statement that its re-pricing was unrelated to service issues was misleading, given CVS's alleged re-pricing of half of its contracts to retain customers dissatisfied with its post-merger service. In addition, even though several other alleged misstatements potentially were inactionable puffery, the court declined to make that determination on a motion to dismiss where the plaintiffs had alleged at least one misrepresentation. The court further determined that the plaintiffs adequately alleged sufficient facts to infer that CVS's CEO acted with the requisite state of mind when he denied that the unsuccessful system integration caused the re-pricing of certain accounts.

District of Vermont Dismisses Section 10(b) Claims Against Green Mountain Coffee Roasters

***La. Mun. Police Emps. Ret. Sys. v. Green Mountain Coffee Roasters, Inc.*, No. 11-cv-289 (D. Vt. Dec. 20, 2013)**

Judge William K. Sessions of the U.S. District Court for the District of Vermont dismissed with prejudice claims that Green Mountain Coffee Roasters violated Section 10(b) of the Securities Exchange Act by allegedly misrepresenting the company's inventory levels and obsolescence reserves. The company's representations that it was increasing production capacity and inventory to meet higher product demand were not false because the plaintiffs failed to allege that the company's financial disclosures understated the inventory levels the company maintained when those statements were made. Even if the company's statements about inventory status were inconsistent with actual inventory levels, the court could not credit the plaintiffs' reliance on various confidential witnesses because the allegations based on confidential witnesses' accounts were not linked to specific statements made during the class period. Furthermore, the confidential witnesses' accounts were not sufficiently particularized because the plaintiffs failed to show that the witnesses had the requisite knowledge to demonstrate the falsity of the statements.

The court also dismissed claims that statements about the company's reported obsolescence reserves were false for the same reasons. In addition, the court determined that the plaintiffs failed to adequately allege a "cogent and compelling inference of scienter." Stock trades made by company insiders amounting to approximately $50 million were not unusual because in both absolute and percentage values the sales were relatively small, and the trades were made pursuant to 10b5-1 trading plans several months before the alleged misstatements occurred. Nor did the company's secondary stock offering support an inference of scienter because a stock offering to raise cash generally does not support a motive to commit fraud. Further, company executives were not reckless because reliance on the core operations doctrine was insufficient where plaintiffs failed to allege supplemental facts supporting the theory. While the Second Circuit has neither accepted nor rejected the core operations doctrine following the passage of the PSLRA, the court noted that pleading a core operations theory, without more, is insufficient to support scienter. This decision has been appealed to the Second Circuit.

PSLRA

Lead Plaintiff

S.D.N.Y. Holds That Grouping Unrelated Plaintiffs Would Defeat Goals of PSLRA Appointment Process

***In re Lightinthebox Holding Co.*, No. 13 Civ. 6016 (S.D.N.Y. Nov. 21, 2013)**

Judge P. Kevin Castel of the U.S. District Court for the Southern District of New York denied motions to appoint a group of investors as lead plaintiffs in a securities fraud action against a Chinese online retailer. Two groups of individual investors (each referring to themselves as the LightInTheBox Investor Group) proposed to join together as a single group with the largest financial stake in the litigation for purposes of becoming lead plaintiffs. The group proposed to make decisions regarding the litigation by majority vote. Although the PSLRA does not expressly prohibit groupings of unrelated plaintiffs, the court held that appointing such a group as lead plaintiffs would defeat the goals of the PSLRA's appointment process. Doing so would encourage lawyers to direct the litigation by hand-selecting groups of smaller plaintiffs to compete with larger, more sophisticated investors for lead plaintiff appointment. Moreover, allowing decisions to be made by majority vote of the group would result in plaintiffs with smaller financial stakes voting together to control the litigation to the exclusion of the investors with the largest losses.

Pleading Standards

Magistrate Judge Says Preliminary Injunction Does Not Satisfy PSLRA's Heightened Pleading Standard

***Takiguchi v. MRI Int'l, Inc.*, No. 13-01183 (D. Nev. Dec. 11, 2013)**

Magistrate Judge Cam Ferenbach of the U.S. District Court for the District of Nevada held that the prior issuance of a preliminary injunction does not satisfy the PSLRA's heightened standard for lifting the automatic stay of discovery that is triggered when a defendant files a motion to dismiss.

The plaintiffs accused defendants of running a Ponzi scheme for more than 15 years. When the alleged scheme purportedly came to light, the plaintiffs sued under the Securities Act, the Exchange Act and various Nevada state laws. The district court judge issued a preliminary injunction, freezing the defendants' assets and ordering expedited discovery for 90 days because there was reason to believe defendants might hide money or destroy documents.

The question before the magistrate judge was whether the plaintiffs could continue to conduct discovery after the 90-day period ended. Under the PSLRA, discovery is permitted "only after the court has sustained the legal sufficiency of the complaint." The plaintiffs argued that the district court's granting of the preliminary injunction satisfied that standard because that court decided that the plaintiffs were "likely to succeed on the merits" of their state and federal claims. The magistrate judge rejected that argument. First, the court dispatched the plaintiffs' argument that "because its policy objectives have been satisfied, the PSLRA does not require any discovery stay." The court reasoned that policy concerns and pleading standards are different issues that trigger separate inquiries. Second, in this case, the preliminary injunction and the PSLRA pleading standard focused on different moments in time. To satisfy the heightened PSLRA pleading standard, the complaint must have alleged that the defendants actually knew a statement was false when made. The preliminary injunction, on the other hand, was predicated on the defendants' failure to comply with regulatory freezes on defendants' assets. Finally, the court noted that the preliminary injunction largely focused on the plaintiffs' state law claims without examining the securities claims in detail.

SCIENTER

Second Circuit Affirms Eastman Kodak Officers Did Not Misrepresent Company's Liquidity Position

***Jones v. Perez*, No. 13-2195-cv (2d Cir. Dec. 26, 2013)**

The U.S. Court of Appeals for the Second Circuit affirmed by summary order the dismissal of claims that officers of Eastman Kodak Company violated Section 10(b) of the Securities Exchange Act by misrepresenting the company's liquidity position. Although the company ultimately declared bankruptcy despite previous optimistic statements by company officers, the plaintiffs failed to adequately allege facts giving rise to a strong inference of scienter. Statements indicating that the company was comfortable with its liquidity were not intentionally misleading and did not require the company to disclose that a portion of its cash was committed overseas, that certain patents were proving difficult to sell or that the company missed certain internal revenue targets. In addition, a press release indicating that the company had "no intention to file for bankruptcy" was not analogous to a guarantee that the company never would do so, and allegations that the company actually intended otherwise were based on information from confidential witnesses without direct knowledge of the matter. Moreover, the statement was forward-looking and accompanied by sufficiently meaningful cautionary language; thus, it was protected by the PSLRA safe harbor. Further, the plaintiffs failed to sufficiently allege the defendants believed that certain statements of opinion were false when made, even though the officers' predictions about the company's year-end cash position and ability to sell its patent portfolio and transition its business from film to digital photography products subsequently proved to be incorrect.

SECURITIES ACT CLAIMS

Second Circuit Affirms Dismissal of RMBS-Related Sections 11 and 12(a)(2) Claims Because of Statute of Limitations Expiration

***Freidus v. ING Groep, N.V.*, No. 12-4514 (2d Cir. Nov. 22, 2013)**

The U.S. Court of Appeals for the Second Circuit affirmed the dismissal of claims that a financial services company violated Sections 11 and 12(a)(2) of the Securities Act for allegedly misrepresenting the quality of loans in the pools underlying certain residential mortgage-backed securities. The panel held that the claims were untimely under the applicable one-year statute of limitations. Information disclosed by the company in September 2007 was sufficient for a reasonably diligent plaintiff to discover the alleged misstatements related to a June 2007 offering. The plaintiff did not file suit, however, until February 2009. Additionally, the plaintiffs failed to plausibly allege that ING did not believe its opinion that the loans underlying its residential mortgage-backed securities were of "relatively high quality" when it made the statement, even though the statement may have subsequently proved to be inaccurate or incomplete.

SECURITIES FRAUD PLEADING STANDARDS

S.D.N.Y. Upholds Claims That Former MF Global Directors, Executives and Advisors Violated Section 10(b)

***In re MF Global Holdings Ltd. Sec. Litig.*, No. 11 Civ. 7866 (S.D.N.Y. Nov. 12, 2013)**

Judge Victor Marrero of the U.S. District Court for the Southern District of New York upheld claims that former directors, executives and advisors of the now-bankrupt MF Global violated Section 10(b) of the Securities Exchange Act and Section 11(a) of the Securities Act by misrepresenting the company's exposure to certain European sovereign debt holdings and its liquidity and by the untimely reporting of a valuation allowance against deferred tax assets. The plaintiffs' complaint sufficiently identified the allegedly misleading statements and the reason each statement was false and misleading, including the date, publication and speaker of each. In addition, although the company's statements regarding its deferred tax assets were subject to a "very subjective standard" and thus were opinions, the plaintiffs sufficiently alleged that the statements were false and that executives actually knew that the company should have taken a valuation allowance but did not. Further, general risk disclosures were not sufficient to render the allegedly false opinions immaterial given the specific information allegedly known by executives but concealed from investors. Additionally, allegations regarding the risks related to the company's investments in European sovereign debt were not fraud-by-hindsight because market players affirmatively reacted when the risks were disclosed, and the complaint alleged particular knowledge of the risks that was concealed by executives. The plaintiffs also sufficiently alleged a strong inference of scienter by circumstantial evidence, including the executives' knowledge of GAAP standards (for claims arising from the company's treatment of deferred tax assets) and internal reports criticizing the company's internal controls and liquidity management (for claims arising from the company's exposure to European debt and the liquidity crisis). Finally, the underwriter defendants' affirmative defense, based on reasonable reliance on the company's public filings, was not a basis for dismissal at this stage because the plaintiffs sufficiently alleged "red flags" that the underwriter defendants could have discovered. However, the affirmative defense could be reconsidered at summary judgment.

STANDING

Second Circuit Vacates Summary Judgment in Favor of Bankrupt Hedge Fund's Auditor in Connection With Alleged Section 10(b) Violation

***CILP Assocs., L.P. v. Lipper Convertibles, L.P.*, Nos. 11-4904-cv, 11-4905-cv, 11-5104-cv, 11-5106-cv (2d Cir. Nov. 8, 2013)**

The U.S. Court of Appeals for the Second Circuit vacated summary judgment in favor of a bankrupt hedge fund's auditor on claims that the auditor violated Section 10(b) of the Securities Exchange Act. The plaintiffs—limited partners in the fund—alleged that they had relied on the auditor's audit opinions stating that the fund's allegedly inflated financial statements complied with GAAP and GAAS when purchasing their interests in the fund. The district court granted summary judgment to the auditor on the sole ground that the plaintiffs had not suffered any injury distinct from the fund's injuries and so lacked standing to bring direct claims.

The Second Circuit vacated summary judgment, holding that the plaintiffs' evidence created a factual dispute as to whether they were directly injured when they purchased their interests in the fund. Although the fund's financial statements indicated that it used a particular fair value methodology for valuing its securities portfolios, the fund's principal trader—who was responsible for valuations—previously had admitted that he deliberately used his own unique methodology that valued the securities differently. In addition, an independent report of the fund's assets, which concluded that the fund was overvalued in each year between 1995 and 2001, was evidence of direct injury, even though the report failed to specifically value the fund at particular dates and times. A jury reasonably could find that the report's own methodology for valuing securities during the relevant period was reliable because it was relied upon by a New York state court during related bankruptcy proceedings. Further, at summary judgment, the plaintiffs were not required to demonstrate the precise valuation of the securities at each relevant date, and the report included month-to-month valuations that indicated significant inflation during the relevant period.

WHISTLEBLOWER PROTECTIONS

Second Circuit Holds That the False Claims Act Does Not Relieve Attorneys of Ethical Duty to Maintain Client Confidentiality

***United States v. Quest Diagnostics, Inc.*, No. 11-1565-cv (2d Cir. Oct. 25, 2013)**

The U.S. Court of Appeals for the Second Circuit affirmed the dismissal of a *qui tam* action brought pursuant to the False Claims Act alleging that a medical laboratory violated the federal Anti-Kickback Statute by offering certain discounted services to induce referrals for services billable to Medicare and Medicaid. The district court had dismissed the action because one of the *qui tam* plaintiffs—the laboratory's former general counsel—violated his ethical duty of confidentiality by divulging information gained through his position. The Second Circuit affirmed, holding that the False Claims Act does not relieve an attorney of his ethical duty to maintain client confidences and that the attorney violated New York's ethical rule prohibiting an attorney from using confidential information to the disadvantage of a former client. Although an exception to the rule allows for the release of information an attorney reasonably believes is necessary to prevent a client from committing a crime, the court held that the information disclosed—including information dating back to far before the beginning of the alleged misconduct—exceeded what was necessary under the circumstances. Certain documents alone, if disclosed to the government, would have provided a sufficient basis for the government to prevent further criminal conduct. The attorney need not have participated in the *qui tam* action at all, much less made broad disclosures of confidential information throughout discovery and in his deposition. Further, the district court's decision to dismiss the entire action was justified because the prejudice to the defendant likely would continue through the remaining plaintiff and counsel who were privy to the wrongfully revealed confidential information, even though those parties did not violate any ethical duties.

The Counterintuitive Effects of the Volcker Rule and the Push-Out Rule: Discrimination Against Illiquid Assets and Hedging Exemptions Increasing Systemic Risk

By Richard Jones

Introduction

Two pieces of legislation that are meant to answer the ills of moral hazard are section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act[1] ("Dodd-Frank Act"), the so called Volcker Rule, and section 716 of the Wall Street Transparency and Accountability Act,[2] i.e., the Lincoln Amendment or the "Push-Out Rule." These sections operate in tandem to delineate the scope and the procedures covered banking entities must take in dealing with derivatives and other financial instruments. Statutory support for this contention is seen when one looks at 716(m) of the Push-Out Rule, which states that an insured depository institution[3] shall comply with the prohibition on proprietary trading in derivatives as required by section 619 of the Dodd-Frank Act.[4] Both these provisions, since their inception and even now, have been subject to attack by the financial services industry and Congress. For example, the Volcker Rule's repeal has been used as a bargaining chip by some Congressmen as a condition precedent to allowing new Wall Street reforms to be implemented,[5] and a massive lobbying effort was mounted by the financial services industry five days before the Volcker Rule's notice of proposed rule making's (NPR) deadline.[6] Similarly, some members of Congress have considered repealing the Push-Out Rule.[7] Given the fact that both these pieces of legislation address proprietary trading, some discussion about their effects seems warranted.

At its most basic level there are three types of laws: reactionary, preventative and those laws which are a combination of both. Reactionary laws are often enacted due to a loophole that has been abused in a particular legal regime. On the other hand, preventative laws are enacted for fear or concern that a particular practice will spiral out of control. Lastly, there are hybrid laws which combine elements of both. To understand what category the Volcker Rule and Push-Out Rule fall into, consideration must be given to the "but for cause" of both provisions, i.e., the financial crisis of 2007-2008.

Roots of the Financial Crisis

Essentially, investment banks and insurance companies started pooling together residential subprime mortgages and dissecting them into tranches of mortgage backed securities. The final product was the collateralized debt obligation (CDO). Issuers of these CDOs erroneously thought that the housing market would not go down in the foreseeable future due to misleadingly high evaluations from credit rating companies, and they began issuing credit default swaps (CDS).[8] A counter party investing in a CDS paid a premium to the protection seller to guarantee that the CDO would not fail. The protection buyer did this to hedge against defaulting loans or alternatively to bet that the CDO would fail, and the protection seller did this since it believed the housing market would not fail and thus that it would in effect, by collecting premiums, be able to enjoy receiving free money. Because the protection seller believed the housing market would not fail, it did not reserve sufficient capital to honor its guarantees.[9] Consequently, when the housing bubble burst, the issuers of the CDS could not pay the principal of the amount they guaranteed. Moreover, since the CDS market and the derivatives market in general were largely unregulated, the government and the financial community really had no idea of the size of the CDS market, which ultimately led to a credit squeeze.[10] Thus, the OTC market in CDS set the fuse for the mortgage crisis, the credit crisis and the systemic financial crisis that might have destroyed the U.S. economy had it not been for a multi-trillion dollar taxpayer intervention.[11]

Was Proprietary Trading Central to the Crisis?

After all the dust settled after the 2007-2008 financial crisis, the president on January 21, 2010 stated that the 2007-2008 crisis began when banks took huge reckless bets in pursuit of quick profits and massive bonuses, i.e., proprietary trading.[12] However, this contention was severely weakened when the Volcker Rule's namesake, Paul Volcker, stated that proprietary trading played virtually no role in the crisis even though he had prophesized that proprietary trading would cause the next financial crisis.[13] In fact, conventional wisdom, as mentioned above, suggests that the cause of the financial crisis was unbridled optimism in the subprime housing market.[14]

Surprisingly, banking organizations that have significant proprietary trading revenues have very small bank deposit arms;[15] conversely, most banking organizations with significant deposit bases have insubstantial trading profits.[16] The firms most affected by the rule would be Goldman Sachs, Morgan Stanley, Citigroup, JP Morgan and Bank of America with their proprietary trading revenues at 7%, between 2-3%, less than 2%, less than 1%, and less than 1% respectively.[17] Even more telling is the fact that a government study on proprietary trading revealed that four out of the six bank holding companies studied profited from proprietary trading.[18] Nonetheless, despite the relatively small amount of revenue that is derived from these activities, the losses sustained during the financial crisis were large.[19] With this information, it appears the Volcker Rule and the Push-Out Rule take a more preventative than reactionary approach due to the infamy that credit default swaps achieved during the 2007-2008 financial crisis.

Justification for the Volcker and Push-Out Rules

The Volcker Rule

Despite the above information, some have justified the restrictions on proprietary trading as follows: continuing explicit and implicit support by the Federal government of commercial banking organizations can only be justified to the extent those institutions provide essential financial services, and speculative trading for the benefit of limited groups of highly paid employees and of stockholders does not justify the taxpayer subsidy implicit in routine access to Federal Reserve Credit, FDIC deposit insurance or other emergency support.[20] In other words, leaving proprietary trading untouched would exacerbate moral hazard rather than eliminate or reduce it.

The Push-Out Rule

According to its author, Senator Blanche Lincoln, the Push-Out Rule was designed to put a halt to the speculative mindset of banks using risky swaps.[21] In her view, banks were never intended to perform these activities, which have been the single largest factor to these institutions growing so large that taxpayers had no choice but to bail them out in order to prevent total economic ruin.[22] In light of this, the Push-Out Rule has two goals: (1) getting banks back to performing duties that they were meant to perform (taking deposits, making loans for mortgages, small businesses and commercial enterprises) and (2) separating out the activities that imperil these financial institutions.[23]

Mechanics of the Volcker Rule

Under the Volcker Rule, or 12 U.S.C. § 1851, banking entities[24] are prohibited from proprietary trading. Proprietary trading is defined as "engaging as principal for the trading account of the banking entity or financial company in any transaction to purchase or sell or otherwise acquire or dispose of any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the regulators may by rule determine."[25] Central to the definition of proprietary trading is the definition of a trading account. The statutory scheme defines trading account as "any account used for acquiring or taking positions in securities and instruments principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements) and any other account determined by the regulators."[26] However, there are several permitted activities, such as dealing in government securities, hedging, market making and transactions done on behalf of customers on the theory that these permitted activities are relatively safe or tied to traditional banking activities.[27] These permitted activities and exceptions are subject to several requirements. However, even permitted activities may not be conducted if such activities result in any of the following: a material conflict of interest, a material exposure to high risk assets or high risk trading strategies as defined in rule making, a threat posed to the safety and soundness of the banking entity or a threat posed to U.S. financial stability.[28] Furthermore, once a violation of the Volcker Rule becomes known to the banking entity, the banking entity must terminate such activity. Similarly, the same must be done after a successful enforcement action by the applicable agencies.[29]

Mechanics of the Push-Out Rule

Section 15 U.S.C. § 8305 codifies the Push-Out Rule. Essentially, the Push-Out Rule states that no federal assistance may be provided to any insured depository institution (which would include certain banking entities) that is a swaps dealer.[30] Nonetheless, even if an insured depository institution is a swap or security-based swap dealer, it will not be subject to the prohibition against federal assistance if it limits its swap activities to the following: (1) hedging or similar risk mitigation directly related to its activities, or (2) making a market in swaps involving rates[31] or reference assets that are permissible under the National Banking Act,[32] other than un-cleared credit default swaps.[33] Failure to limit swap activities to these purposes results in the banking entity losing its access to federal assistance. However, the prohibition on federal assistance does not prevent an insured depository institution from establishing a swap entity affiliate provided that the insured depository institution is part of a bank holding company or savings and loan company that is supervised by the Federal Reserve ("Fed") and the swaps entity affiliate follows Federal Reserve Act sections 23A and 23B and any other requirements that the Commodity Futures Trading Commission, the Securities and Exchange Commission and the Fed deem necessary and proper.[34] Additionally, the Push-Out Rule only applies to insured depository institutions after the end of the transition period,[35] which means pre-transition swaps are grandfathered. Lastly, the insured depository institution must comply with the prohibition on proprietary trading in derivatives mandated by the Volcker Rule.[36]

Joint Effect of Both Rules

As a result, the Volcker Rule and the Push-Out Rule combined state that any swap-dealing banking entity that receives federal assistance must divest its impermissible swap-dealing activities into a separately capitalized affiliate or lose federal assistance while complying with the Volcker Rule. Practically, as this article will demonstrate, swap-dealing banking entities that receive federal assistance may lawfully engage in proprietary trading only if they do so without using derivatives. Consequently, the Push-Out Rule limits the types of swaps a swap dealer can make a market with or hedge with while the Volcker Rule details the compliance regime the swaps entity must follow to avoid the stigma of being labeled a proprietary trader. The rest of this article will discuss the trading account definition of the Volcker Rule, the interaction that the Push-Out Rule has with the Volcker Rule, how the Volcker Rule compliance regime is filled with uncertainty as far as less liquid instruments are concerned, and how the Volcker Rule and Push-Out Rule, while addressing moral hazard, still leave opportunities for systemic risk by affecting particular markets in the financial services industry.

Trading Account Definition

As per section 619 of the Dodd-Frank Act and now 12 U.S.C. § 1851, central to the definition of proprietary trading is the definition of a trading account. A trading account is any account used for acquiring or taking positions in securities and instruments principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements) and any other account as determined by the Federal Banking Agencies, the CFTC or the SEC.[37] Under the Volcker Rule's notice of proposed rule-making (NPR),[38] the trading account definition is subject to three prongs (the "intent test"; the "market risk test"; and the "registration test") with only the "intent test" being subject to a rebuttable presumption. Each will be discussed in turn.

The Intent Test

The intent prong holds that a trading account is "any account that is used by a covered banking entity to acquire or take one or more covered financial positions principally for the purpose of short-term resale; benefiting from actual or expected price movements; realizing short-term arbitrage profits or hedging any of the foregoing."[39] The intent test largely tracks the statutory definition and is the least problematic.

If a banking entity were to engage in arbitrage with securities for its own account or even have the purpose to engage in arbitrage profits, this would be prohibited proprietary trading unless the covered financial positions were government securities under 12 U.S.C. § 1851 (d)(1)(A). However, the Volcker Rule NPR does not seem to allow trading in options or other derivatives referencing enumerated government obligations. This supposition is further bolstered by the fact that the agencies have requested comment on whether this should be permissible.[40] Here is an example of the interaction between the Push-Out Rule and the Volcker Rule. Despite proprietary trading being allowed in government instruments, swap dealing banking entities are prohibited from proprietary trading in derivatives referencing such government securities.[41] Treasury bond futures are derivatives, and thus the remorseless effect of section 716(m) of the Push-Out rule is apparent: a banking entity may not engage in proprietary trading with derivatives even if they reference government securities.

Along with the intent prong is the accompanying rebuttable presumption effectively stating that when a position is held for 60 days or less, that position is presumed to be a trading account.[42] This means that if a banking entity were to hedge interest rate risk with a derivative called a plain vanilla interest rate swap with a tenor of five years and then close it out because of a change in heart on the future of interest rates within 45 days, it may rely on this rebuttable presumption.[43] To rebut it, the banking entity would presumably use the swap agreement itself as evidence over a hearsay objection since this would qualify as a legally operative fact.[44]

The Market Risk Test

The Volcker Rule NPR's market risk test was issued in contemplation of the Final Market Risk Capital Rules being promulgated. As a result, the applicable regulators have stated that they do not plan on applying the Volcker Rule in a manner that lacks short-term intent.[45] Under the Volcker Rule NPR, the market risk test defines a trading account as follows: "any account used by a covered banking entity to acquire or take one or more covered financial positions, other than positions that are foreign exchange derivatives, commodity derivatives, or contracts of sale of a commodity for future delivery, that are market risk capital rule covered positions, if the covered banking entity, or any affiliate of the banking entity that is a bank holding company, calculates risk based capital ratios under the market risk capital rule."[46] Essentially, this means that a trading account includes any account used to acquire or take one or more covered financial positions other than positions that are (1) foreign exchange derivatives, (2) commodity derivatives (3) or contracts for the sale of a commodity for future delivery unless the position is otherwise held with short-term intent if such positions are subject to market risk capital charges.[47] The applicable regulators justify the market risk test on the theory that the Volcker Rule's statutory definition of trading account is substantially similar to the "covered position" definition under the proposed revisions of the market risk capital rules (MRCR).[48] The agencies emphasize that they will not apply this rule in a way that lacks short-term intent for the purposes of the Volcker Rule.[49]

Despite this substantial similarity, this article would argue that they are different in several respects. First, the fact that under the proposed MRCR foreign exchange derivatives are treated as covered positions without regard to short-term intent, whereas short-term intent is a condition precedent to trading account status under the Volcker Rule NPR, should highlight how different the congressional intent is between the statutory Volcker Rule and the MRCR. Arguably, this fact alone should indicate that the MRCR exceeds the congressional intent to focus on short-term gain as the dispositive factor in identifying a trading account.

During the Volcker Rule NPR, the agencies stated that they would avoid using the MRCR in ways that contradict short-term intent and that they were basing the market risk test on the definition of covered position.[50] As the final market risk capital rules have been issued, a discussion is warranted.[51] Under the final MRCR there are two principal definitions relevant to the market risk test: trading positions and covered positions. Each will be discussed in turn.

Trading positions under the final MRCR are positions held by the bank for the purpose of short-term resale or with the intent of benefiting from actual or expected short-term price movements or to lock in arbitrage profits.[52] Covered positions are trading assets or liabilities, whether on or off balance sheet, as reported on the schedule RC-D, or the Call Report or the Schedule HC-D of the FR Y-9C that are (1) trading positions or function as hedges for covered positions assuming the position is free of restrictive covenants on its tradability, or the bank is able to hedge the material risk elements of the position in a two-way market; or (2) a foreign exchange or commodity position, regardless of whether the position is a trading asset or liability (excluding any structural foreign currency positions that the bank chooses to exclude with prior supervisory approval).[53] However, (1) and (2) are not subject to covered position status if they meet any of seven criteria, one of which is an equity position that is not publicly traded, other than a derivative that references a publicly traded equity.[54]

Under the Volcker Rule NPR, covered financial positions apply to *any* security. The use of the word *any* is meant to capture publicly traded securities and interests as well as equity that is not publicly traded. However, under the market risk test a dispositive factor, in determining covered position status, could be whether or not the security is publicly traded.[55] These differences further illustrate why the market risk test should be deleted. Ultimately, the deletion of the Volcker Rule's market risk test would not affect the NPR's trading account or proprietary trading definition since in any event the market risk test, whenever it contradicted short-term intent, would not be applied.

Again, the intent test gives trading account status to any account used to acquire or take covered financial positions principally for the purpose of short-term resale; benefiting from actual or expected price movements; realizing short-term arbitrage profits or hedging any of the foregoing. Similarly, under the MRCR, covered positions are positions held by the bank for purpose of short-term resale or with the intent of benefiting from actual or expected short-term price movements or to lock in arbitrage profits or hedges of any of the foregoing.[56] The only immediate difference between the two is that the Volcker Rule's intent test uses the word principally, whereas the MRCR does not. Since the statutory Volcker Rule is functionally reflected more in the intent test than the final market risk rules and the agencies will not apply the market risk rules in a manner that contradicts short-term intent, if there is conflict between the two, the intent test should win. Therefore, the market risk test, whether implemented in its MRCR NPR form or final MRCR form, is superfluous in light of the intent test, and its deletion will hardly change the trading account definition.

The Registration Test

The registration test of the trading account definition is the most problematic. Unlike the previous two tests it does not even appear to focus on short-term intent. Under the registration test a trading account is "any account that is used by a covered banking entity to take at least one covered financial position for any purpose if the covered financial position is either a dealer in securities or municipal securities, a government securities dealer, a swap dealer registered with the CFTC or a securities-based swap dealer registered with the SEC only to the extent such activities cause such a dealer to be registered as such."[57] Simply put, if the activities of the banking entity cause it to be registered as an interest rate swap dealer, then the registration test would only apply to the extent that interest rate swap dealing activity caused the banking entity to be registered as such. However, if the interest rate swap dealer were to enter into a foreign currency swap, then the registration test would not apply. Nevertheless, the intent test and the market risk test may very well apply.

The policy justification for this treatment is that all assets or other positions held by firms that register or file notice as securities or derivatives dealers as part of their activity are *generally* held for sale to customers upon request or otherwise to support the firm's trading activities and so would appear to involve the requisite short-term intent and be captured within the statutory definition of a trading account.[58] However, such an overgeneralizing interpretation leads to untenable results. For instance, long-dated swaps have a minimum tenor of one year.[59] Throughout the Volcker Rule NPR, the "near term" is not defined by asset class, despite the Financial Stability Oversight Council's (FSOC) recommendation to do so.[60]

Nonetheless, there are two parts of the Volcker Rule NPR that shed light as to the duration of short-term intent. The first is found in the market risk test. Under this prong the agencies state that relevant accounting standards indicate that short term is measured in days or hours rather than months and years.[61] The second part of the Volcker Rule NPR that sheds light on short-term intent is the rebuttable presumption under the intent test that holds that any position held for 60 days or less is presumed to have short-term intent.[62] On its face, neither of these parts even addresses investment durations that are at least one year, as is the case with long-dated swaps. Consequently, this part of the trading account is overly inclusive and exceeds congressional intent. Hopefully, the registration test is recalibrated to focus on short-term intent (or at least less than one year) in the finalized Volcker Rule. Otherwise, swap and security dealers may find themselves having trading accounts, and if they assume any risk as principal, then they risk being labeled proprietary traders.

Permitted Activities

Under the Volcker Rule there are several permitted activities that banking entities are allowed or even encouraged to engage in. These permitted activities are justified on the ground that they are perceived to be relatively safe or tied to traditional banking activities.[63] For the purposes of detrmining permitted trading on behalf of customers, the market making related activity exemption will be discussed to indicate how the Volcker Rule discriminates against illiquid assets. Additionally, the two rules' hedging exemptions will be discussed to show how they have the potential to threaten the financial stamina of a banking entity rather than strengthen it.

Permitted Trading on Behalf of Customers

Under the "permitted trading on behalf of customers" exception, the term customer is not defined. However, if a client, counterparty or customer appears to fall into any of the three safe harbors,[64] the entity is deemed to be a customer. For the purposes of this article, the "riskless principal customer exception" will be discussed. As per the Volcker Rule NPR, the prohibition on proprietary trading does not apply to the purchase or sale of one or more covered financial positions if the covered banking entity is acting as riskless principal in a transaction in which the covered banking entity, (1) after receiving a customer order to purchase or sell one or more covered financial positions, (2) purchases or sells the covered financial position for its own account to (3) offset a contemporaneous sale to (or purchase from) the customer.[65]

The apparent policy behind this provision is to address the ills of embedded proprietary trading in the context of positioning. Positioning is the process whereby a bank fills in an order for a customer but does not purchase an offsetting position.[66] Sometimes, not entering into an offsetting trade or order is associated with betting against the customer's market expectations in a process known as "embedded proprietary trading."[67] Under the "permitted trading on behalf of a customer's" exception, the contemporaneous offsetting position requirement effectively eliminates this type of activity. However, entering into a contemporaneous offsetting transaction assumes there is one to enter into. In highly liquid markets this condition is easily satisfied; however, with illiquid instruments the answer is not as definitive.

For example, in the OTC derivatives markets a client will initiate a transaction involving a bespoke swap and the banking entity's trading desk will provide a client with a price, and upon execution, will hold the derivative in its portfolio.[68] Since this is a customized derivative, a contemporaneous offsetting transaction is impossible because the parties to the swap are obligated to hold and honor their contractual duties for the tenor of the swap. Moreover, even a matching swap[69] may not happen until the distant future since a counter party must be willing to enter into the swap contract. Therefore, the trading desk as principal would have to dynamically hedge away its exposure to the market during the meantime or face the alternative of being fully exposed to the whims of the market.[70] Despite the fact that this transaction was customer initiated, the lack of a contemporaneous offsetting order or even a contemporaneously matched swap makes this type of transaction ineligible for the "permitted trading on behalf of customers" exemption. Technically, the banking entity could be labeled a proprietary trader since the trading desk is engaged as principal in the purchase or sale of a covered financial position with the requisite short-term intent under the registration test regardless of the tenor of the swap. For this reason there should be a permitted activity definition that unambiguously addresses this void in the Volcker Rule NPR.

A similar problem arises in the context of the corporate bond market. This market is so fragmented and so diversified that a contemporaneous offsetting order may not be available.[71] For example, when a customer wishes to sell a bond, the dealer takes the bond into his inventory, where it is held until it can be resold on reasonable economic terms. During this holding period, the dealer is exposed to the risks the bond carries with it and will try to reduce its exposure to the market by hedging away such risks. Dealers may be left holding these positions for significant periods of time.[72] Although the transaction is initiated by the customer, the lack of a contemporaneous offsetting order ruins reliance on this permitted activity. Consequently, here too the trading desk risks being labeled a proprietary trader.

Market Making Related Activity Exception

As noted above, the Volcker Rule does not necessarily welcome permitted trading on the behalf of customers in less liquid assets. However, there may be some hope for allowing this under the present Volcker Rule NPR. The potential answer lies in the market making related activities exemption. The line between market making and impermissible proprietary trading is often hard to discern in practice. For instance, assume a banking entity, at Hedge Fund Beta's request, goes out and buys a block of securities worth $10 million for Hedge Fund Beta. Assume further that the banking entity believes that another hedge fund, Leveraged Hedge Fund Beta, will purchase the same amount as well. Based on this belief the entity orders $20 million in securities for both hedge funds. Shortly thereafter, Hedge Fund Beta comes to pick up its securities. Furthermore, Leveraged Hedge Fund Beta, as the banking entity's trading desk predicted, requests and comes for its block of the securities as well. The question arises whether this is impermissible proprietary trading?[73]

With regard to the statutory and NPR permitted activity of market making, the answer lies in the clause "not to exceed the reasonably expected near term demands of clients, customers or counter parties."[74] Consequently, the relationship and the reasonableness of how the trading desk acted to respond to the near-term demands of Leveraged Hedge Fund Beta will be dispositive in determining if this is impermissible proprietary trading or not. However, under the Volcker Rule NPR there are other criteria that must be followed.

To qualify for the market related activity exception, several criteria need to be satisfied: (1) there is a vigorous compliance regime to monitor and control market making related activities; (2) the trading desk or other organizational unit that conducts the purchase or sale holds itself out as being willing to buy and sell, including through entering into long and short positions in the covered financial position for its own account on a regular or continuous basis (taking into account differences in asset classes[75]); (3) the market making related activity conducted by the trading desk is not designed to exceed the reasonably expected demands of customers, clients or counterparties; (4) the banking entity relying on the market making exemption is registered or states its reason for exemption under the U.S. securities or commodity laws; (5) the market making related activity of the banking entity is designed to generate revenues primarily from fees, commissions, bid-ask spreads or other income not attributable to appreciation in the value of covered financial positions it holds in trading accounts or the hedging of such positions; (6) the compensation arrangements of the person performing the market making related activity are not designed to encourage proprietary risk taking; and (7) the banking entity uses the metrics provided in Appendix B to distinguish proprietary trading from permitted market making activities.[76] For the purposes of this article, requirements (2) and (5) will be discussed.

Market making related exemption number (2) (the bona fide market making requirement) requires that the market maker make continuous, two sided quotes holding oneself out as willing to buy and sell on a continuous basis; have a pattern of trading that includes both purchases and sales in roughly comparable amounts to provide liquidity; make continuous quotes on both sides of the market; and provide widely disseminated quotes with respect to exchange traded instruments.[77] Again, this approach assumes liquidity of the instrument. With less liquid instruments, the standard for market making involves holding oneself out as willing and available to provide liquidity by providing quotes on a regular, but not necessarily continuous, basis and having transaction volumes and risk proportionate to historical customer liquidity and investment needs.[78] However, a customized interest rate derivative by definition has no quoting system on both sides of the market. Similarly, there may be little to no data on historical customer liquidity and investment. So it would be unduly myopic to use this type of scant historical data as a proxy for determining if impermissible proprietary trading is being conducted in the guise of market making.[79]

The problems bespoke derivatives encounter with the market making related exception are also felt in the securities world in the context of corporate bonds. Unlike the more liquid equities market, corporate bonds are not typically traded on exchanges. Consequently, the secondary OTC market is the dominant epicenter where market making in these bonds typically occurs.[80]

Requirement (5) states that the market making related activity of the banking entity must be designed to generate revenues primarily from fees, commissions, bid/ask spreads or other income not attributable to appreciation in the value of covered financial positions the entity holds in trading accounts or the hedging of such positions. Such a requirement is problematic for several reasons. Opponents claim market makers rarely earn fees or commissions acting as a principal and instead earn these sums acting as an agent, which falls outside the scope of the Volcker Rule.[81] Similarly, the use of the bid/ask spread is problematic since resting firm offers and indicative bids are hard to estimate and are only available for highly liquid securities in relatively small transaction sizes.[82] Indeed, for certain less liquid instruments, a market maker may have to hold onto a security for an extended period of time and profit based on price movements. Here is another example of how the Volcker Rule discriminates against less liquid assets.

Intermediation of customer trading with corporate bonds and one-off bespoke instruments such as swaps is clearly ineligible as permitted trading on behalf of the customer's exception. However, intermediation may be applicable under the theory of bona fide market making in the context of block positioning. Essentially, under the '34 Act, satisfaction of this test would require the following: (a) the entity engages in the activity of purchasing from time to time a block of stock, long or short, for a customer where the stock has a current market value of $200,000 or more in a single transaction or several transactions at approximately the same time; (b) the entity has determined in the exercise of reasonable diligence that the block could not be sold or purchased by others on fair and equivalent terms; and (c) the entity sells the shares comprising the block as rapidly as possible commensurate with the circumstances.[83]

At the outset it is important to note that the agencies would use this as guidance in the context of financial intermediation.[84] If a strict interpretation were adopted, this interpretation would be inapplicable to swaps since the hallmark of stock is that it can be pledged, hypothecated and confer voting rights.[85] Consequently, a broad interpretation must necessarily be construed to support intermediating customer trading with these financial instruments. Part (a) of the block position requirement could be satisfied if the agencies adopt a lower dollar threshold for the notional amount of the bespoke swap in light of the infrequency of the transaction. Moreover, the agencies have stated that the size of a block will vary among asset classes, and thus such an approach is consistent with the language appearing in the preamble.[86] Broadly construed, part (c) could be satisfied with the requirement that with customized derivatives the trading desk will seek to enter into a matched swap as quickly as possible to reduce the principal risks of the associated swap or will hedge it while it looks for a match. A similar approach should be adopted for other asset classes, such as corporate bonds, taking into account the illiquidity of the instrument and the infrequency of the trades in adjusting the size of the block. In the proposed NPR there is no clear-cut exception for this, so the agencies need to provide certainty on this matter or else banking entities may feel less inclined to enter into these agreements for fear of being labeled a proprietary trader.

Risk Mitigating Hedging Exemption

Another permitted activity is the risk mitigating hedging exemption found in the statute and the Volcker Rule NPR. In an age where systemic risk is a reality, banking entities should be encouraged to hedge risks. Indeed, the FSOC study notes that "hedging is an integral part of the market making function that is permitted under the Volcker Rule and that it functions as a tool of firm-wide risk management."[87] Nonetheless, it is quite easy to disguise proprietary trading as hedging.[88] To address these concerns several criteria must be met to satisfy the hedging exemption: (1) there must be a vigorous internal compliance program to support hedging activity; (2) the hedged transaction must be made in accordance with such a compliance regime; (3) the hedged transaction must be designed to hedge or otherwise mitigate one or more specific risks the underlying positions pose; (4) the hedged transaction must be reasonably correlated based on the facts and circumstances to the underlying position's risks; (5) the hedged transaction must not give rise, at the inception of the hedge, to significant exposures that were not themselves hedged in a contemporaneous transaction; (6) any transaction in reliance on the hedging exemption must be subject to continuous review and management after the position is established; and (7) the hedged transactions must not be designed to reward proprietary risk taking.[89] Lastly, for any transaction in which the underlying position is done at a different level than the hedged transaction, the hedged transaction must be contemporaneously documented and must list the specific risk the hedge is designed to reduce with respect to the individual or aggregated underlying positions.[90]

Special attention will be given to requirements (4) and (5). Each will be discussed in turn. Requirement (4) imposes a reasonable correlation—not perfect correlation—requirement based on the facts and the circumstances. While risk management teams may routinely hedge individual risk or aggregated risks posed by their underlying positions at the portfolio level, it is quite common among managers to engage in scenario hedging. Scenario hedging involves hedging against tail risks, i.e., remote but devastating movements in a portfolio of assets that follow events like a major financial institution's collapse.[91]

The problem with Requirement (4) is that low probability tail events may have little or no correlation with the specific risks posed by the underlying positions. Yet banking organizations routinely stress test their balance sheets against these types of scenarios as mandated by the Federal Reserve[92] so it would appear that scenario hedging would be consistent with this practice. Admittedly, this type of hedging could be allowed by the Volcker Rule NPR's Requirement (3) of the hedging exemption if the hedge is established slightly before the disastrous risk.[93] However, the allowance of such hedging only slightly before the risk drastically diminishes the utility of this tool by potentially decreasing the amount of time a risk manager has to implement a risk mitigating plan designed to address the impending tail risk at hand. Consequently, the rule should be rewritten as follows: a position should qualify as a hedge if it is reasonably correlated to a specific risk or the banking entity can sensibly show through its stress testing program that the position reduces tail risk.[94]

Doubtless one can see the opportunity for proprietary trading in disguise in this context; however, the documentation requirement of the hedged transaction's risk mitigating purpose should allay some of those concerns. Moreover, perhaps such hedging strategies are justified based on the fact that such tail risks are typically fatter[95] than they appear to be and banking entities are inhabitants of a "black swan"[96] world. Without such a rule adjustment, the hedging exemption could arguably increase systemic risk or make banking entities more susceptible to such risk.

Requirement (5) has several problems as well that can only be avoided with some interpretative maneuvers since it is arguably meaningless in its present form if taken literally. Requirement (5) of the hedging exemption requires that the hedged transaction must not give rise, at the inception of the hedge, to significant exposures that were not themselves hedged in a contemporaneous transaction.[97] Yet with any hedged transaction there is always one risk at the inception of the hedge that gives rise to new risks that are not themselves contemporaneously hedged, i.e., counter party risk.[98] Counter party risk is significant since the efficacy of the hedge depends on the counter party meeting its obligation and not defaulting. The agencies in trying to address concerns for correlation trading added the condition that the hedged transactions must not give rise to any risks that are not in and of themselves contemporaneously hedged.[99] But this qualification is equally problematic. For instance, assume that a banking entity acquires an underlying position(s) and then subsequently hedges the underlying position(s). Here the banking entity would have counter party risk which is not hedged. Even if the banking entity were to purchase insurance in the form of an un-cleared credit default swap (which is wholly permissible under the Volcker and Push-Out rules) the banking entity is exposed to the insurer's counter party risk.[100] For every insurer of a CDS this problem exists no matter how many insurers the banking entity deals with.[101] Therefore, requirement (5) is impossible to meet. Consequently, requirement (5) should be rewritten as follows: the hedged transaction should not give rise to any new risks that are not in and of themselves hedged, other than counter party risk.

Analysis of the Push-Out Rule

The above discussion of the Volcker Rule is meant to illustrate the interplay between the Volcker Rule and § 716(m) of the Push-Out Rule, which states that an insured depository institution (such as a commercial bank which is also a banking entity) shall comply with the prohibition on proprietary trading as required by § 619 of the Dodd-Frank Act. Similar to the Volcker Rule is an exemption from the mandates of the Push-Out Rule if the insured swap dealing banking entity limits its swap activity to hedging and other similar risk mitigating activities directly related to the banking entity's activities. Since the second exception for the use of swaps referencing rates or assets under 12 U.S.C. § 24, Paragraph 7, has already been mentioned, only the hedging exemption will be discussed in detail below.

The hedging exemption is justified on the ground that "on a firm wide basis banking entities need to hedge interest rate risk and credit risk."[102] Banks generate substantial amounts of interest rate risk by originating loans to businesses and to households. Interest rate risks arise through the mismatches between interest bearing assets (loans) and obligations (debts and deposits).[103] Consequently, banks often use credit and interest rate derivatives to manage credit risk and for business risk management functions.[104] Legal precedent for the use of derivatives can be found by collectively looking at *North Carolina v. Variable Life Insurance Co.*[105] and the OCC's Interpretive Letter 684.[106]

Section 716(d)(2) of the Push-Out Rule allows the use of derivatives in acting as market maker for swaps and security-based swaps with respect to assets listed under 12 U.S.C. § 24, other than un-cleared credit default swaps.[107] Given the notoriety credit default swaps instruments received during the most recent financial crisis, this is prudent legislation. However, from the statutory language, it appears that un-cleared credit default swaps, or any swap for that matter, can be utilized for hedging purposes under § 716(d)(1), and by implication under the Volcker Rule as well.[108]

Historically, the use of derivatives by banking entities has always been qualified by safety and soundness concerns and risk management.[109] Consequently, the exception for un-cleared CDS is quite odd. Clearing houses reduce operational risk and promote market integrity and stability by interposing themselves between the buyers and sellers of OTC transactions traded on a platform by becoming a buyer to every seller and a seller to every buyer.[110] When a buyer expresses an interest in entering into an OTC derivatives contract, the clearing house finds a counter party and interposes itself between the buyer and seller. By migrating trades across a clearing house platform, the clearing house mitigates risk exposure by increasing transparency in the industry.[111] Moreover, it guarantees the obligations of its counter parties, so in theory all is well even if one counter party defaults.

Un-cleared credit default swaps by definition lack the protections of a clearing house platform, but their use as hedging devices directly related to the bank's activities justifies them. It is worth mentioning here that the road to hell is often paved with good intentions. Given the infamy that credit default swaps achieved during the financial crisis, it is questionable whether this is good policy. For instance, in the event the protection seller's business fails, a clearing house is not present to guarantee the obligations of the failing counter party. Consequently, there is a distinct possibility that the protection seller will not make the financial institution whole in the event a credit event occurs, such as the failure of the financial institution. CDS are not the bane of a business's existence, but they still should be subject to clearing requirements so that their use and efficacy as hedging devices utilized by the banking entity are further enhanced.

Again, any swap dealing activity that does not conform to the two permissible swap uses under 15 U.S.C. § 8305 must be pushed out to a separately capitalized affiliate or cease entirely, lest the insured depository institution lose access to federal assistance. Luckily, this ultimatum only applies to swap dealers and security-based swap dealers.[112] Therefore, if the banking entity qualifies for an exception under the swap dealer or security-based swap dealer test, it need not worry about this choice.[113] Similarly, major swap participants and their security-based counterparts are also exempt from this ultimatum only if they are insured depository institutions. However, all insured depository institutions must still comply with the Volcker Rule.

Conclusion

Generally, the aims of the Volcker Rule and Push-Out Rule are admirable; however, the impact these two provisions have on the business of banking seems counterintuitive. Throughout the permitted activities under the Volcker Rule, there is a systematic bias against dealing in less liquid instruments even in the context of a permitted activity. For instance, the permitted trading on behalf of customers is so inflexible that it precludes banking entities from tailoring bespoke financial products for customers or making a market in corporate bonds. Negative externalities of this would entail banking entities being less inclined to make a market with less liquid securities, leading to an increase in volatility for a variety of assets. Furthermore, investor transaction costs would increase, and asset value would decline, since it will be harder to sell in the secondary market.[114] Additionally, the trading account prongs, especially the registration test, have the ability to capture long-term investments (in direct contravention of short-term trading intent), creating an environment of uncertainty in the banking industry.

In the case of bespoke interest rate derivatives, such derivatives are instrumental in providing liquidity needed to allow end-users to manage their interest rate risk effectively. Consequently, a restrictive definition of "on behalf of customers" or "market making" may adversely affect liquidity and the ability of dealers to intermediate interest rate risk transfers from the customer to the market. As banks are within the class of end-users using such interest rate derivatives, this narrow construction could jeopardize the safety and soundness of banking entities managing interest rate risk due to the Volcker Rule's discrimination against such instruments in favor of highly liquid equity markets. Additional externalities include less regulated entities picking up a market share in activities such as murky offshore hedge funds, leaving the U.S. exposed to systemic risk outside U.S. jurisdiction.[115] All this reflects the systematic bias against a banking entity's activities with less liquid instruments.

Both the Volcker Rule and the Push-Out Rule's hedging provisions have the counterintuitive effect of arguably increasing systemic risk rather than reducing it. Scenario hedging is potentially disallowed but for the narrow exception for anticipatory hedging under the Volcker Rule.[116] Moreover, the hedging exemption, if taken literally, would render it useless. Similarly insured depository institutions, despite the benefits of clearing, are still allowed to hedge with un-cleared credit default swaps, which, after the most recent financial crisis, is questionable at the very least and imprudent at the very most. All these effects arise from the belief that derivatives are inherently evil due to their potential for speculation. However, what is systematically neglected under the Volcker Rule is the risk mitigating benefits of derivatives and their ability to satisfy a customer's need for tailor-made instruments to address the risks their assets pose to them. Consistent with the FSOC study, different metrics should be determined by asset classes,[117] or generous interpretations should be entertained in light of the Volcker Rule NPR's one-handed approach for liquid instruments.

Based on the foregoing, the Volcker Rule and the Push-Out Rule, while addressing moral hazard, fail miserably with regard to systemic risk. With regard to moral hazard, the Push-Out Rule does this by forcing a swap dealing entity to make an unpleasant choice between engaging in permissible swap activities or losing its lifeline of federal assistance. The Volcker Rule does this by creating a hard-coded compliance regime with permitted activities in which failure to comply could result in termination of activity or disposal of the investment.[118] This regulatory regime functions as a huge disincentive that could adversely affect particular markets. One can only hope that the finalized Volcker Rule is more amenable to the financial services industry, and more specifically, the business of banking.

Endnotes

1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, H.R. 4173 (effective July 21, 2010).
2. Wall Street Transparency and Accountability Act, Pub. L. 111-203 (effective July 21, 2010).
3. Under the Push-Out Rule it was unclear if uninsured U.S. branches and agencies of foreign bank swap dealers would benefit from the Rule's exemptions since the Rule only applied to "insured depository institutions." However, the Federal Reserve addressed this anomaly with 12 C.F.R. § 237.21, which includes uninsured branches within the definition of insured depository institutions.
4. Wall Street Transparency and Accountability Act.
5. Zach Carter, *Republicans Seek Volcker Rule Repeal In Exchange For New Wall Street Reforms*, The Huffington Post, http://www.huffingtonpost.com/2013/02/12/republicans-volcker-rule_n_2666946.html.
6. Frank Pompa & Denny Gainer, *Who Killed Financial Reform: After three years, key parts of the plan to avert another Wall Street crisis remain undone*, USA Today, June 4, 2013, at 1A (explaining that the reasons behind delay of the Dodd-Frank Act included the well-funded opposition of the finance industry lobby, plus legal battles and resistance in Congress.)
7. Eric Lipton, *House Votes to Repeal Dodd-Frank Provision*, N.Y. Times, http://dealbook.nytimes.com/2013/10/30/house-passes-bill-on-derivatives/?_r=0.
8. *See* Michael Greenberger, *Overwhelming a Financial Regulatory Black Hole with Legislative Sunlight: Dodd-Frank's Attack on Systemic Economic Destabilization Caused by an Unregulated Multi-Trillion Dollar Derivatives Market*, 6 J. Bus. & Tech. L. 128, at 143-46 (2011).
9. *Id.*
10. *Id.*
11. *Id.*
12. President Barack Obama, Remarks by the President on Financial Reform (2011), *available at* http://www.whitehouse.gov/the-press-office/remarks-president-financial-reform.
13. *See* Interview of Scott Alvarez and Kieran Fallon, U.S. Financial Crisis Inquiry Commission, at 67 (March 23 2010) (Proprietary trading played virtually no role in the financial crisis. And Mr. Volcker admits this as well. His position has been: This is the next financial crisis.).
14. *See* Financial Services Regulation Desk Book, ch.. 6: The Volcker Rule, at 6-4 n. 7, (2013), as available on bloomberglaw.com.

15. Julius Loeser, *The "Volcker Rule": Barring Banking Organizations From Proprietary Trading, Fund Investment, and Sponsorship*, 11 Engage: J. Federalist Soc'y Prac. Groups 45, at 47 (Sept. 2010).

16. *Id.*

17. Alex Mackinger, *Developments in Banking and Finance Law: 2010: XI. Proprietary Trading: Market Threat or Political Scapegoat?*, 29 Rev. Banking & Fin. L. 392, at 394 (2010).

18. U.S. Gov't Accountability Office, GAO-11-529, *Proprietary Trading: Regulators Will Need More Comprehensive Information to Fully Monitor Compliance with New Restrictions When Implemented* (2011), *available at* http://www.gao.gov/new.items/d11529.pdf (describing the study being conducted on a total of twenty-seven trading desks within Bank of America, Citigroup, Goldman Sachs, JP Morgan Chase, Morgan Stanley and Wells Fargo) (last visited Dec 2. 2013).

19. *Id.*

20. Paul A. Volcker, *Commentary on the Restrictions on Proprietary Trading by Insured Depositary Institutions*, *available at* http://online.wsj.com/public/resources/documents/Volcker_Rule_Essay_2-13-12.pdf, 1.

21. 156 CONG. REC. S3140 (statement of Senator Lincoln), *available at* http://www.gpo.gov/fdsys/pkg/CREC-2010-05-05/pdf/CREC-2010-05-05-pt1-PgS3121-2.pdf (May 5, 2010).

22. *Id.*

23. *Id.*

24. In 12 U.S.C. § 1851, the term "banking entities" encompasses insured depository institutions (other than certain limited purpose trust institutions), any company that controls an insured depository institution, any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978 and any affiliate or subsidiary of the foregoing to the extent the banking entity does not include hedge funds and private equity funds among its affiliates or subsidiaries.

25. *See* Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds,12 U.S.C. § 1851(h)(4) (defining the term and listing the Securities and Exchange Commission ("SEC"), the Commodity Futures Trading Commission ("CFTC") and the Federal Banking Agencies (the OCC, the FDIC, and the Fed) as the applicable regulators)) (2014).

26. *See id.* at § 1851 (h)(6) (defining the term "trading account").

27. *See* Arthur S. Long, Financial Services Regulation Desk Book, ch. 6: The Volcker Rule, 6.3.1, at 6-1 (2013).

28. *Id.*

29. *See id.* at § 1851(e)(1); *see also* Prohibitions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68846-01 (Nov. 7 2011) (NPR of the SEC and the FDIC, the OCC, the Federal Reserve); *see also* Prohibitions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 77 Fed. Reg. 8332-01, 8435 (Feb. 14, 2012) (NPR of the CFTC).

30. CCH Inc., Dodd-Frank Wall Street Reform and Consumer Protection Act Law Explanation and Analysis 266 (Mark Dorman et al. eds., 2010) (describing federal assistance as the use of advances from a Federal Reserve credit facility or discount window that is not a part of a program or facility with broad-based eligibility under 13(A) of the Federal Reserve Act and FDIC insurance and guarantees for: (1) making a loan to, or purchasing any stock, equity interest or debt obligation of any swaps entity (2) purchasing the assets of any swaps entity (3) guaranteeing any loan to a swaps entity and (4) entering into any assistance (including tax breaks), loss sharing or profits sharing with any swaps entity).

31. *See id.* at 266-67 (examples of rate swaps would include interest rate swaps, currency swaps, and other monetary rates—information retrieved from Further Definition of "Swap Dealer," "Security Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant") 77 Fed. Reg. 30596, at 30662 (May 23 2012).

32. Swaps referencing permissible assets under the National Banking Act would include swaps referencing loans, promissory notes, drafts, bills of exchange, other extensions of credit, foreign currency, bullion, U.S. government and agency securities, shares in investment companies as long as the assets held by the investment companies are themselves bank permissible, and investment grade securities (information retrieved from Financial Services Regulation Desk Book, ch. 9: Derivatives Reform, 9.5.17, at 9-28).

33. *See* Prohibition Against Federal Government Bailouts of Swap Entities, 15 U.S.C. § 8305 (d)(3) (2014) (specifying the limitation of un-cleared CDS for bank permissible assets).

34. *See id.* at § 8305(c).

35. *See* Transition Period for Insured Depository Institutions, 12 C.F.R. § 237.22 (describing the duration of the transition period).

36. *See supra* note 33, at § 8305 (m).

37. *See supra* note 25, at § 1851(h)(6).

38. *See* Prohibitions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68846-01 (Nov. 7 2011) (NPR of the SEC and the FDIC, the OCC, the Federal Reserve); *see also* Prohibitions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 77 Fed. Reg. 8332-01, at 8435 (Feb. 14 2012) (NPR of the CFTC).

39. *See* 77 Fed. Reg. 8332, at 8341–42.

40. *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Covered Funds, 77 Fed. Reg. 8332, 8364 (Commodity Futures Trading Comm'n Feb. 14, 2012) (noting that question 121 specifically requested comments on this issue).

41. *See* 15 U.S.C. 8305(m) (2014).

42. *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Covered Funds, 77 Fed. Reg. at 8345.

43. Spencer A. Winters, Note, *The Volcker Rule's Hedging Exemption*, 111 Mich. L. Rev First Impressions 90, 92–93 (2012).

44. *See* Roger C. Park, David P. Leonard, Aviva A. Orenstein, & Steven H. Goldberg, Evidence Law: A Student's Guide to the Law as Applied in American Trials 258 (3rd ed. 2011) (describing how this particular out of court statement is not hearsay).

45. *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Covered Funds, 77 Fed. Reg. at 8345, n. 111.

46. *See id.* at 8424 (quoting the language to be included in proposed rule_.3(b)(2)(i)(B)).

47. *See id.* at 8344.

48. *Id.* at 8343.

49. *See id.* at 8345, n. 111.

50. *Id.*

51. *See* Risk-Based Capital Guidelines: Market Risk, 77 Fed. Reg. 53060 (Office of the Comptroller of the Currency Aug. 30, 2012). For the codification of the results of this discussion, see 12 C.F.R. §§ 3, 208, 225 (2014).

52. *See* 12 C.F.R. § 3 app. B to pt. 3.

53. *Id.* This is the author's synthesis of the content of this regulation.

54. *See id.* (discussing the exceptions to covered position status and listing an equity position that is not publicly traded).

55. *Id.*

56. *Id.*

57. *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Covered Funds, 77 Fed. Reg. 8332, 8345 (Commodity Futures Trading Comm'n Feb. 14, 2012).

58. *Id.* at 8345.

59. *Long Dated Swap*, globalcustody.net, http://www.globalcustody.net/Long-dated_swap/ (last visited Dec. 21, 2013) (defining the minimum tenor of a long dated swap).

60. Financial Stability Oversight Council, Study and Recommendations on Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds 15 (2011) (stating that in the context of principal trading the "near term" measurement of time may be more appropriately tied to the liquidity of the instrument).

61. *See* Prohibitions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 77 Fed. Reg. 8332, 8344 (Feb. 14, 2012).

62. *Id*. at 8345.

63. Long, *supra* note 14, at 6-9.

64. For those who are interested, the three safe harbors are: trading as a fiduciary for the account of a customer, acting as a riskless principal by purchasing or selling a covered financial position for the banking entity's own account contemporaneously with a sale or purchase from a customer, or acting for an insurance separate account. Prohibitions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 77 Fed. Reg. at 8364).

65. *Id*.

66. Adam J. Krippel, Note, *Regulatory Overhaul of the OTC Derivatives Market: The Costs, The Risks and Politics*, 6 Entrepen. Bus. L.J. 269, 282-283 (2011).

67. *Id.*

68. Financial Stability Oversight Council, *supra* note 60, at 12.

69. The term matched swap is when a dealer enters into a trade with a customer and then enters into the mirror image of the swap with another counter party. Krippel, *supra* note 66, at 282.

70. Financial Stability Oversight Council, *supra* note 60, at 12.

71. Oliver Wyman, The Volcker Rule Restrictions on Proprietary Trading: Implications for Market Liquidity 6 (Feb. 2012), *available at* http://www.oliverwyman.com/insights/publications/2012/feb/the-volcker-rule-restrictions-on-proprietary-trading.html#.U1MytcdRF3U (describing the fragmentation of corporate bonds as resulting from the credit quality of issuers, the maturity of the instrument, the currency in which the security is issued, and a variety of other factors specific to the instrument) (found by typing in the Google search engine "Oliver Wyman" and "Volcker").

72. *Id.* at 30.

73. *See* R. Rex Chatterjee*, Dictionaries Fail: The Volcker Rule's Reliance on Definitions Renders it Ineffective and a New Solution is Needed to Adequately Regulate Proprietary Trading*, 8 BYU Int'l L. & Mgmt. Rev. 33, 53 (2011) (describing a similar example).

74. *See* 12 U.S.C. § 1851 (d)(1)(A) (2010).

75. *See* Prohibitions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 77 Fed. Reg. 8332, 8356 (Feb. 14, 2012) (stating the test for liquid instruments as follows: making continuous, two-sided quotes and holding oneself out as willing to buy or sell on a continuous basis; a pattern of trading that includes purchases and sales in roughly equal amounts to provide liquidity; by making continuous quotations that are at or near the market on both sides and providing widely accessible and broadly disseminated quotes); see the same issue of the Federal Register (stating that for less liquid instruments the test is holding oneself out as willing and available to provide liquidity by providing quotes on a regular but not mercenarily continuous basis; with respect to securities, regularly purchasing covered financial positions from or selling the positions to clients, customers or counter-parties in the secondary market and transactions whose volume and risk are proportionate to historical customer liquidity and investment needs).

76. *See id.* at 8355-58.

77. *Id.*

78. *Id.*

79. *See* Comment Letter on the Volcker Rule's Notice Of Proposed Rule Making On The Volcker Rule from Securities Industry and Financial Markets Assoc. et al. at A-38 (on file with author) (retrieved by going to CFTC.gov and then going to the Laws and Regulation Tab and then clicking the Federal Register on the dropdown box and then clicking Proposed Rules and then selecting the year 2012 and then clicking the Volcker NPR and choosing the second SIMFA comment letter available).

80. Wyman *supra* note 71, at 28.

81. Bryan Settele, *The Volcker Rule's Market Making Exemption*, 31 Rev. Banking & Fin. L. 556, at 564–65 (2012).

82. *Id.*

83. *See* Prohibitions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 77 Fed. Reg. 8332, at 8356 (codified at 17 C.F.R. pt. 75).

84. *Id.*

85. *See* Landreth Timber Co. v. Landreth, 471 U.S. 681, at 686 (1985) (describing the attributes of stock).

86. *See* Prohibitions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 77 Fed. Reg. at 8356.

87. Financial Stability Oversight Council, Study and Recommendations on Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds, at 13 (2011).

88. Jeffrey Snider, *The Unclear Hedging Boundary: Should Banks Trade Their Own Money?*, Real Clear Markets (October 4, 2013), http://www.realclearmarkets.com/articles/2013/10/04/the_unclear_hedging_boundary_should_banks_trade_their_own_money_100647.html (providing the following example: Assume a banking entity has a mix of credit assets totaling $10 billion. The bank would not hedge the entire carrying cost of that inventory. Such an approach would not be cost-effective. Instead, the banking entity would use its risk calculation models to evaluate the expected risks that are most likely to occur and then hedge accordingly. If the combined risk calculation projects that the anticipated potential change with the underlying is $500 million, then the banking entity would at most hedge for $500 million. However, it could also over-hedge up to $750 million and not only reduce losses but profit to a great degree.

89. *See* Prohibitions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 77 Fed. Reg. at 8360–62.

90. *Id.*

91. CFTC, Comment Letter of JP Morgan Chase by Barry L. Zubrow at 24-25 (as available on bloomberglaw.com in response to Volcker Rule NPR).

92. Board of Governors of the Federal Reserve System, http://www.federalreserve.gov/newsevents/pressbcreg/20111122a.htm.

93. *See supra* note 89, at 8361 (stating that if a banking entity was highly likely to become exposed to a particular risk and there was a sound risk management rationale for hedging the risk slightly in advance of actual exposure, then such a procedure would be consistent with the hedging exemption).

94. *See supra* note 91, at 24–25.

95. *See Definition of Fat Tails*, Financial Times Lexicon, http://lexicon.ft.com/term?term=fat-tails (defining "fat tail risk").

96. *See Black Swan*, Investopedia, http://www.investopedia.com/terms/b/blackswan.asp (defining "black swan events" as an event or occurrence that deviates beyond what is normally expected of a situation and that would be extremely difficult to predict. This term was popularized by Nassim Nicholas Taleb, a finance professor and former Wall Street trader) (also note what happened when the previously successful hedge fund Long Term Capital Management (LTCM) was driven into the ground as a result of the ripple effect caused by the Russian government's debt default. The Russian government's default represented a black swan event because none of LTCM's computer models could have predicted this event and its subsequent effects.

97. *See* Prohibitions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 77 Fed. Reg. at 8361.

98. Spencer Winters, *The Volcker Rule's Hedging Exemption*, 111 Mich. L. Rev. First Impressions 90, at 95 (2012).

99. *See supra note* 96, at 8361.

100. Winters, *supra* note 43, at 95.

101. *Id.*

102. Financial Stability Oversight Council, *supra* note 60, at 13.

103. *Id.*

104. *Id.*

105. 513 U.S. 251 (1995). Under 12 U.S.C.A. § 24 para. 7 there is no explicit authority for the banks to use derivatives as hedging devices. However, the *North Carolina v. Variable Life Insurance Co.* case, in its infamous footnote 2, stated the following: "We expressly hold that the business of banking is not limited to the enumerated powers in 24 Seventh and that the Comptroller therefore has discretion to authorize activities beyond those expressly enumerated so long as his interpretation is reasonable." 513 U.S. at 258 n.2.

106. *See* O.C.C. Interp. Ltr. 684 (Aug. 4, 1995) (stating that it is legally permissible for a national bank to hedge the financial exposure arising from otherwise permissible banking activities that involve physical delivery of commodities in connection with such hedging activities subject to approval by the O.C.C. due to the safety and soundness concerns posed by derivatives).

107. *See* 15 U.S.C.A. § 8305(d)(2).

108. *See* Long, *supra* note 14, at 9-28 (Chapter 9: Derivatives Reform). *See also* 15 U.S.C. § 8305(d)(3) (notice how the statute states this limitation applies only to (d)(2) without mentioning its application to (d)(1)).

109. *See* O.C.C. Interp. Ltr. (Aug. 4, 1995) (stating that it is legally permissible for a national bank to hedge the financial exposure arising from otherwise permissible banking activities that involve physical delivery of commodities in connection with such hedging activities subject to approval by the O.C.C. due to the safety and soundness concerns posed by derivatives).

110. Kristin N. Johnson, *Governing Financial Markets: Regulating Conflicts*, 88 Wash. L. Rev. 185, 216–17 (2013) (describing the advantages and disadvantages of centralized clearing).

111. *Id.*

112. *See* 15 U.S.C. § 8305(b)(2)(B).

113. Swap dealer exceptions would include the de mimimis exception, found in 7 U.S.C.A. § 1a 49(C) and a situation where a person enters into swaps for such person's own account, either individually or in a fiduciary capacity, but not as part of a regular course of business found in 7 U.S.C.A. § 1a (43). Security-based swap dealers face similar exceptions.

114. Settele, *supra* note 81, at 565.

115. Wyman, *supra* note 71, at 14.

116. *See* Prohibitions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 77 Fed. Reg. 8332, 8361 (proposed Feb. 14, 2012).

117. Financial Stability Oversight Council, *supra* note 60, at 15.

118. *See* Prohibitions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 77 Fed. Reg. at 8408.

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"Positively 4th Street"[1]: Lawyers and the "Scripting" of Witnesses

By C. Evan Stewart

George W. Bush once famously said: "Fool me once,…shame on…shame on you. Fool me—you can't get fooled again."[2] Well, if a very prominent attorney is correct, shame on me, and I did get fooled again. I have always thought it was unethical to give a witness a written script with "answers" on it; and I have always thought that such a document, once given to a witness, was a document to which my adversary was fairly entitled. Am I wrong on both counts?

Back to the Future

Recently, I wrote about the wide divergences in witness preparation practices between American lawyers and our English "cousins."[3] But I had thought our practices in America had been pretty well settled for quite some time. Let's start first with the waiver issue, because that is close to my heart.

I had been a lawyer less than three months when I was summoned to an all-firm meeting at the top of 30 Rockefeller Plaza. There, for the first time, I saw Sam Murphy, Donovan Leisure Newton & Irvine's most famous litigator,[4] explain to a stunned group of lawyers (i) that a senior partner at the firm had lied about destroying documents sent to (and reviewed by) a client's expert witness, and (ii) what the possible effects this inexplicable act might/would have on the client (then concluding the country's most significant antitrust trial, *Berkey Photo v. Eastman Kodak*) and the firm.[5] The inexplicable act had come on the heels of the trial judge putting counsel on notice that any materials shown to testifying experts would have to be produced to the other side pursuant to Federal Rules of Evidence 612 ("Writing Used to Refresh a Witness's Memory").[6]

Rule 612 reads, in whole, as follows:

> (a) **Scope**. This rule gives an adverse party certain options when a witness uses a writing to refresh memory:
>
> > (1) while testifying; or
> >
> > (2) *before testifying, if the court decides that justice requires the party to have those options.*
>
> (b) **Adverse Party's Options; Deleting Unrelated Matter.** Unless 18 U.S.C. § 3500 provides otherwise in a criminal case, an adverse party is entitled to have the writing produced at the hearing, to inspect it, to cross-examine the witness about it, and to introduce in evidence any portion that relates to the witness's testimony. If the producing party claims that the writing includes unrelated matter, the court must examine the writing in camera, delete any unrelated portion, and order that the rest be delivered to the adverse party. Any portion deleted over objection must be preserved for the record.
>
> (c) **Failure to Produce or Deliver the Writing**. If a writing is not produced or is not delivered as ordered, the court may issue any appropriate order. But if the prosecution does not comply in a criminal case, the court must strike the witness's testimony or—if justice so requires—declare a mistrial.[7]

Thus, the key provision at issue here is (a)(2) ("before testifying"), which gives the court discretion to order production when "justice requires" it.

In the wake of the *Berkey Photo* decision[8] and the searing impact of what happened during that litigation and trial,[9] many, many courts have reflexively ruled that any written materials used to refresh a witness's memory (including work product) are fair game under Rule 612.[10] A number of other courts—influenced both by the concerns of the U.S. Supreme Court's ruling in *Hickman v. Taylor* vis-à-vis the attorney-work product doctrine,[11] as well as by Judge Jack Weinstein's learned treatises on evidence[12]—have ruled that the court's discretion should take into account several factors, including (i) the extent to which the witness was influenced by and/or actually relied on documents to refresh his or her recollection, and (ii) the extent to which privileged or "core" work product material would be revealed as a result of disclosure.[13]

The leading case applying this "balancing" test—and *not* ordering disclosure—is *Sporck v. Peil*, decided by the Third Circuit in 1985.[14] That case involved several hundred thousand documents, a select number of which counsel picked out, compiled, and presented to a witness prior to a deposition. When this preparatory process was revealed at the deposition, opposing counsel moved for the documents' production. The trial court granted that motion. The Third Circuit reversed, however, and did so principally on two grounds: (i) the attorney's selection of the materials reflected his core work product; and (ii) there was no evidence that the witness relied on the documents or that they had influenced his testimony.

Whether or not a subset of already produced materials shown to a witness before testimony should or should not be subject to production,[15] that type of witness preparation is light years from a "script" of questions *and answers* counsel has prepared and shown to a witness in advance of testimony. Such a "script" would surely be a significant crutch on which a witness would be heavily relying, and it also would clearly constitute the sort of coaching that has caused courts employing the "balancing" test to order production.[16]

Furthermore, even Judge Weinstein (who is a major proponent of the "balancing" approach) urges that my prominent colleague at the bar desist:

> In the present state of uncertainty [i.e., the policy conflict between *Hickman v. Taylor* and Rule 612], attorneys should **not** refresh prospective deponents or witnesses with material containing counsel's theories or thought processes. Not only may such documents ultimately fall into opposing counsel's hands if Rule 612 is satisfied, but there are too many risks of unethical suggestions to witnesses when they see such material.[17]

Is It Ethical?

So if such a "script" is going to fall into the hands of opposing counsel 99.99 out of 100 times, left is the question of whether the practice of "scripting" is ethical.

First, the good news: assuming that the "answers" are not suggesting (or more) that the witnesses present false testimony, such a "script" will likely skate past suborning perjury.[18] Now, the bad news: there is a New York Court of Appeals decision directly on point. In *In re Eldridge*, a lawyer was suspended for writing out answers for witnesses; the court declared that a lawyer's duty is "to extract the facts from the witness, not to pour them into him; to learn what the witness does know, not to teach him what he ought to know."[19]

While *Eldridge* is from the Gilded Age, it would appear to still be good law,[20] although most *reported* decisions of disciplinary cases of late involve subornation of perjury or similar lawyer misconduct seeking to promote false testimony.[21] That said, a plaintiffs' law firm in heated asbestos litigation in the 1990s was "excoriated" by one trial judge for conduct that included scripting witnesses.[22] There, the law firm used a document to prepare clients for depositions in personal injury suits against asbestos manufacturers, and the document included these directives:

- "It is important to emphasize that you had NO IDEA ASBESTOS WAS DANGEROUS when you were working around it."
- "It is important to maintain that you NEVER saw any labels on asbestos products that said WARNING or DANGER."
- "DO NOT say you saw more of one brand than another, or that one brand was more commonly used than another…. Be CONFIDENT that you saw just as much of one brand as all the others."
- "Unless your…attorney tells you otherwise, testify ONLY about INSTALLATION of new asbestos material, NOT tear-out of the OLD stuff."
- "If there is a MISTAKE on your Work History Sheets, explain that the "girl from [the law firm]" must have misunderstood what you told her when she wrote it down."

The foregoing—excerpts from the 20-page document—would appear to be skating up to (or over) the line of "counsel[ing] or assist[ing] a witness to testify falsely" (a violation of Rule 3.4(b)). Nonetheless, and for all the hubbub about sanctions and a possible criminal referral, the law firm got very lucky and ultimately escaped without any official penalty.[23] Even so, the publicity about what had happened brought enormous scrutiny down upon the law firm, caused it to take a huge reputational hit, and earned it general scorn from legal academic ethics experts.[24]

So the take-away on "scripting" is what? Maybe if I do it I won't get caught? But even if I do, maybe I will get lucky (like the asbestos lawyers) and not be sanctioned? That is not the professional advice I would be giving to those who want to lead a long, happy, and prosperous career at the bar. But, à chacun son goût.

Conclusion

A number of years ago, my law school dean wrote of the legal profession's "terribly insecure" world, in which lawyers "are caught in a rat race that makes money and status the only shared goals."[25] One area which he specifically identified as a place to stem the tide and make lawyers "more accountable for their conduct" was to "police the extent to which witness coaching has the effect of creating a coordinated or fabricated story."[26] That does not seem to be too much to ask.

Endnotes

1. Bob Dylan's classic song was recorded on July 29, 1965, and released by Columbia Records on September 7, 1965 (a single only, it reached #7 on the U.S. Billboard Hot 100). The invocation of this song was "inspired" by the attorney referenced herein.
2. President George W. Bush, Nashville, Tenn. (Sept. 17, 2002). Of course, he also once posed the rhetorical question: "Rarely is the question asked: is our children learning?" Florence, S.C. (Jan. 11, 2000). Dubya's quote in the text should not be confused with The Who's most famous lyric: "Meet the new boss, same as the old boss…. We won't get fooled again." "Won't Get Fooled Again" (Who's Next, MCA 1971).

3. *See* C.E. Stewart, *Mad Dogs and Englishmen*, NY Bus. L. J. (Summer 2013).

4. *See* C.E. Stewart, *Jumping on a Hand Grenade for a Client*, Fed. Bar Council Quarterly (November 2009).

5. *See* J. Stewart, The Partners (Simon & Schuster 1983); S. Brill, *When a Lawyer Lies*, Esquire (Dec. 19, 1979); S.M. Edwards, *There But For Fortune*…, Federal Bar Council News (Feb. 2005).

6. Berkey Photo, Inc. v. Eastman Kodak Co., 74 F.R.D. 613, 617 (S.D.N.Y. 1977).

7. Fed. R. Evid. 612 (emphasis added). Rule 612 was adopted January 2, 1975 (effective July 1, 1975) and amended December 1, 2011. *Id.*

8. Berkey Photo, Inc. v. Eastman Kodak Co., 74 F.R.D. 613 (S.D.N.Y. 1977).

9. The Donovan Leisure partner ultimately went to jail. Kodak lost at trial, but the Second Circuit reversed that determination on the ground that the measure of damages was improper. *See* Berkey Photo, Inc. v. Eastman Kodak Co., 603 F.2d 263 (2d Cir. 1979). Ultimately, Kodak settled the matter by paying Berkey a few million dollars.

10. *See, e.g.*, Wheeling-Pittsburgh Steel Corp. v. Underwriters Laboratories Inc., 81 F.R.D. 8 (N.D. Ill. 1978); James Julian, Inc. v. Ratheon Co., 93 F.R.D. 138 (D. Del. 1982); U.S. v. 22.80 Acres of Land, 107 F.R.D. 20 (N.D. Cal. 1985); Leybold-Heracus Technologies Inc. v. Midwest Investment Co., 118 F.R.D. 607 (D. Wis. 1987); In re Joint Eastern and Southern District Asbestos Litigation, 119 F.R.D. 4 (E.D.N.Y. & S.D.N.Y. 1988); Redvanly v. NYNEX Corp., 152 F.R.D. 460 (S.D.N.Y. 1993); Audiotext Communications Network v. US Telecom, 164 F.R.D. 250 (D. Kan. 1996).

11. 329 U.S. 495 (1947). *See* C.E. Stewart, "Good Golly Miss Molly!: The Attorney Work Product Takes Another Hit," NY Bus. L. J. (Winter 2012). Perhaps because most judges have been trial lawyers, many seem to bend over backwards to protect "core" work product, even when lawyers improperly put such materials at issue. *See, e.g.*, In re Kidder Peabody Securities Litigation, 168 F.R.D. 459 (S.D.N.Y. 1986).

12. *See*, *e.g.*, J. Weinstein & M. Berger, "Weinstein's Evidence Manual" (LexisNexis 2013).

13. *See*, *e.g.*, Sporck v. Peil, 759 F.2d 312 (3d Cir. 1985); A1-Rowarshan Establishment Universal Trading & Agencies, Ltd. v. Beatrice Foods Co., 92 F.R.D. 779 (S.D.N.Y. 1982); In re Comair Air Disaster Litigation, 100 F.R.D. 350 (E.D. Ky. 1983); Boring v. Keller, 97 F.R.D. 404 (D. Colo. 1983); Levacadia, Inc. v. Reliance Inc. Co., 101 F.R.D. 674 (S.D.N.Y. 1983); Nutramax Lab., Inc. v. Twin Lab, Inc., 183 F.R.D. 458 (D. Md. 1998); In re Riv. Astigmine Patent Litigation, 2007 WL 1029671 (S.D.N.Y. April 6, 2007).

14. *See Sporck*, 759 F.2d 312; *Al-Rowarshan Establishment Universal Trading & Agencies, Ltd.*, 92 F.R.D. 779; *In re Comair Air Disaster Litig.*, 100 F.R.D. 350; *Boring*, 97 F.R.D. 404; *Levacadia, Inc.*, 101 F.R.D. 674; *Nutramax Lab., Inc.*, 183 F.R.D. 458; *In re Riv. Astigmine Patent Litig.*, 2007 WL 1029671.

15. *Compare Sporck,* 759 F.2d 312, *with Nutramax Lab., Inc.,* 183 F.R.D. 458.

16. *See*, *e.g.*, Parry v. Highlight Indus., Inc., 125 F.R.D. 449 (W.D. Mich. 1989); *In re Comair Air Disaster Litig.*, 100 F.R.D. 350; *In re* Joint E. & S. Dist. Asbestos Litig., 119 F.R.D. 4 (E. & S.D.N.Y. 1988).

17. *See* Weinstein & Berger, *supra* note 12, at §10.05 (3), 10-30 (emphasis added).

18. 18 U.S.C. §1622. Another federal statute to keep in mind is 18 U.S.C. § 1512 (witness tampering). In the classic movie Anatomy of a Murder (Columbia Pictures 1959), my cousin Jimmy Stewart, in preparing his client, explains a legal defense to murder that prompts his client to "recall" facts consistent with such a defense. *See* Richard H. Underwood, *Perjury! The Charges and the Defenses*, 36 Duq. L. Rev. 715, 781–82 (1998). There seems to be a broad consensus that such conduct is more than one bridge too far. *See* Charles W. Wolfram, Modern Legal Ethics § 12.43 (1986); Peter A. Joy & Kevin C. McMunigal, *Witness Preparation: When Does It Cross the Line?* 17 Crim. Just. 48, 49 (2002).

19. 82 N.Y. 161, 171 (1880).

20. *See* State v. McCormick, 259 S.E.2d 880, 882 (N.C. 1979) (explaining that proper witness preparation is "preparing the witness to give the *witness'* [sic] testimony at trial and not the testimony that the attorney has placed in the witness' [sic] mouth.").

21. *See, e.g.*, In re Attorney Discipline Matter, 98 F.3d 1082 (8th Cir. 1996*);* Goodsell v. The Mississippi Bar, 667 So. 2d 7 (Miss. 1996); In re Oberhellmann, 873 S.W.2d 851 (Mo. 1994); In re Edson, 530 A.2d 1246 (N.J. 1987). *See also* Joseph D. Piorkowski, *Professional Conduct and the Preparation of Witnesses for Trial: Defining the Acceptable Limitations of "Coaching,"* 1 Geo. J. Legal Ethics 389 (1987).

22. *See* J. Rogers, Ethics of Witness Preparation, ABA/BNA Lawyer's Manual on Professional Conduct (1998); *see also* Abner v. Elliot, 706 N.E.2d 765 (Ohio 1999); N. LeGrande & K. Mierau, *Witness Preparation and the Trial Preparation Industry*, 17 Geo. J. Legal Ethics 947 (2004).

23. *See supra* note 22. This is likely due to the facts that (i) a paralegal created the document, and (ii) no lawyer at the firm saw it or pre-approved its use. *See* R. Parloff, *The $200 Billion Miscarriage of Justice*, Fortune (March 4, 2002).

24. *See, e.g.*, L. Brickman & R. Rotunda, *When Witnesses Are Told What to Say*, Washington Post, Jan. 13, 1998, at A-15; C. Silver, *Preliminary Thoughts on the Economics of Witness Preparation*, 30 Texas Tech L. Rev. 1383 (1999); R. Cramton, *Lawyer Ethics on the Lunar Landscape of Asbestos Litigation*, 31 Pepperdine L. Rev. 175 (2004) (the law firm was also heavily criticized for, *inter alia*, being ethically challenged vis-à-vis client solicitation and presenting false expert testimony).

25. *See* R. Cramton, *Furthering Justice by Improving the Adversary System and Making Lawyers More Accountable*, 70 Fordham L. Rev. 1599, 1603 (2002).

26. *Id.* at 1610. The profession's race to the bottom has also caught the attention of the U.S. Securities and Exchange Commission. *See* R. Morvillo, *Ethics and Preparing Witnesses for SEC Testimony*, N.Y.L.J. (April 3, 2004) ("scripts should be avoided").

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Report of the Section Chair

The Business Law Section is pleased to report a victory in its long-sought revisions to New York's Not-For-Profit Corporation Law. In December 2013, Governor Cuomo signed the Nonprofit Revitalization Act of 2013, which aims to "streamline the incorporation process for non-profit organizations in New York, modernize the oversight and corporate governance laws to prevent conflict of interest problems and fraud, enhance public trust in the non-profit sector, provide guidance to non-profit organizations' boards of directors, and reduce burdens on non-profit organizations." A subcommittee of the Business Law Section's Corporations Law Committee has worked for many years to bring about this change. The law took effect July 1, 2014. In this regard, I am pleased to announce that at its spring meeting, and after consultation with the NYSBA executive officers, the Section Executive Committee voted unanimously to establish a new standing committee, the Not-for-Profit Corporations Committee, and to appoint Frederick Attea, Esq., of Phillips Lytle in Buffalo, as the inaugural Chair of the Committee. Mr. Attea was instrumental in the effort to secure passage of the new law. Section members who are interested in not-for-profit corporations law are welcome to join the Committee—simply send an email to BusinessLaw@NYSBA.org. Membership in this and all other Section Committees is free of charge to all Section members.

The Section continues to set its sights on reform of New York's franchise law to conform more closely to the Federal Trade Commission's franchise rule in order to facilitate the offering and sale of franchises in New York. The Section also was on the front lines in reacting to the SEC's proposed rules under the JOBS Act to permit the sale of securities through crowdfunding. In December, the Section presented an educational program, both live in New York City and via webcast, detailing the implications of the proposed rules. Participants from 6 foreign countries, 24 states and the District of Columbia tuned in. An archive of the program is available to Section members at www.nysba.org/CrowdfundingWebcast. If you don't already have them, get your free NYSBA web site log-in credentials to see the program.

The Section continues to boast a strong and growing membership, with over 4,000 members as of this writing—the second largest Section in the Association. In the past year, the Section's outreach to new NYSBA members inviting them to join for a free introductory year of membership has met with a good response. Active Business Law Section committees support the needs of the diverse practices represented among the membership.

In order to recognize the importance of the many hours of volunteer service provided to the Section and its Committees by its members, the Section has established the David S. Caplan Award for Meritorious Service. Named in remembrance of the former Chair of the Technology and Venture Law Committee, the first award was presented to David L. Glass at the 2014 Annual Meeting. Mr. Glass, at various times, has held every executive officer position in the Section; he was the Chair of its Banking Law Committee; and he is currently Editor-in-Chief of the Section's *NY Business Law Journal*. All the members of the Section are invited to submit nominees for the award. Submissions should be sent to the Chair of the Business Law Section c/o NYSBA, One Elk Street, Albany, NY 12207.

The Section's Annual Meeting program, held in cooperation with the Corporate Counsel Section, focused on business lawyers and corporate counsel "Competing Ethically in a Global Marketplace." The Business Law Section Fall Meeting at the Cranwell Resort in Lenox, MA dealt with (among other topics) cyber security and liability, and implementing a successful social media strategy in unregulated industries. The Business Law Section Spring Meeting in May included four CLE programs presented by its Banking Law, Bankruptcy Law, Private Investment Funds and Technology and Venture Law Committees. The Section also hosted networking and diversity events in conjunction with the Westchester Black Bar Association and the Metropolitan Black Bar Association in 2013.

The Section's Legislative Affairs Committee is also actively working on developing a legislative program to present in future legislative sessions. Proposals should be sent to the Legislative Affairs Committee, Business Law Section, c/o NYSBA, One Elk Street, Albany, NY 12207.

As my term as Chair of our Section comes to a close, let me take this opportunity to welcome James Everett of Albany as the incoming Chair.

Jay L. Hack, Outgoing Chair, Business Law Section

Banking Law Committee

A meeting of the Banking Law Committee was held during Annual Meeting week on January 29, 2014. The theme for the meeting was community banking issues, and senior officers from the New York offices of the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency and from the Federal Reserve Bank of New York discussed several areas of particular concern to community banks, including capital requirements, banking trends and the Volcker Rule applicability to community banks. The members were not shy about asking questions, and even after the formal part of the meeting was over, the speakers were kind enough to stay around and speak with members who had additional questions.

A meeting also was held in conjunction with the Section's May meeting in New York City, featuring a panel discussion by key regulators and industry representatives before a packed house. The speakers were Jonathan Rushdoony, Regional Counsel of the Office of the Comptroller of the Currency, which regulates national banks (OCC); Ashby Hilsman, Regional Counsel of the FDIC; Greg Rozansky, an attorney with the New York Clearing House Association; and Roberta Kotkin, General Counsel of the New York Bankers Association. Key topics included cybersecurity; the OCC's "heightened expectations" program, whereby large banks will be expected to enhance their risk management framework, including the adoption of the "three lines of defense" model (front line management, compliance, and internal audit) as well as more vigorous Board oversight; and more pro-consumer initiatives at the State and City level.

Our next meeting is scheduled for September at the Section's annual Fall Meeting, to be held this year at the Equinox in Manchester, Vermont.

Kathleen A. Scott, Chair

Bankruptcy Law Committee

The Bankruptcy Law Committee met at the Fall and Annual Meetings. At the fall meeting, Scott Bernstein, Bruce Mael and Kevin Newman spoke regarding Attorneys' Fees for Creditors in Bankruptcy Cases. At the Annual Meeting, Bankruptcy Judge Cecilia Morris, Matthew Spero and Robert Raicht presented at an informative and interactive meeting regarding Sellers' Rights in Bankruptcy.

Kevin Newman, Chair

Corporations Law Committee

At the Annual Meeting in New York City on January 30, 2014, the Corporations Law Committee and the Securities Regulation Committee held a joint meeting, which attracted over 20 participants from the two committees. David N. Feldman and Peter W. LaVigne, Chair of the Securities Regulation Committee, presented on "Regulation A+ Proposal: Making the Grade?" and "Offering Exemptions under the Securities Act of 1933: a Comparison," respectively. Jeffrey Bagner of the Corporations Law Committee gave a presentation on Recent Developments in Delaware Law. The presentation highlighted recent Chancery Court decisions addressing (i) fiduciary duties of constituent directors, (ii) application of the "entire fairness" standard of review, (iii) enforceability of letters of intent, (iv) the validity of forum selection bylaws and (v) attorney-client privilege in the context of a merger.

Richard De Rose, Chair

Derivatives and Structured Products Law Committee

No report submitted.

Franchise, Distribution and Licensing Law Committee

Since our last report the Franchise, Distribution and Licensing Law Committee has had two significant occurrences. On January 29th, 2014, the Committee held a meeting in conjunction with the Annual Meeting of the Business Law Section. An (unusually) robust group of 23 franchise attorneys, ranging from those with long time experience in the field to younger folks seeking to learn about this area of law, attended the meeting, which was held at the New York Midtown Hilton. The meeting featured a presentation by Michael H. Seid, founder and Managing Director of MSA Worldwide (together with your Chairman), regarding the means, methods and criteria utilized in evaluating whether a business is suitable for formulating a franchise program. The presentation, which included a variety of forms of agreements and other franchise related documents, was designed to qualify for CLE credit, which was likely a factor in the increased attendance at the meeting. Mr. Seid, one of the foremost franchise consultants in the industry, provided a variety of anecdotal examples and general information, which proved to be of great interest to those in attendance.

On March 13th, your Chairman, together with Tom Pitegoff and David Oppenheim, former Chairs of the Committee, and Kevin Kerwin, Associate Director of Governmental Relations at the New York State Bar Association, met with representatives of the New York State Attorney General's Office to discuss the status of proposed modifications to the New York Franchise Sales Act that had been previously drafted by a subcommittee of the Franchise, Distribution and Licensing Law Section. The purpose of the meeting was to discuss the proposed modifications to the current statute, with a goal of reaching a consensus with the Attorney General's Office with the hope, if possible, of presenting a "united front" to the New York State Legislature in seeking to formulate a bill amending the present statute. Our Committee is seeking to make the New York law more "friendly" to the franchise industry, generally, and to make it consistent with the Federal Trade Commission Rule, the federal statute which regulates franchise offerings. The meeting, which was held at 120 Broadway, in Manhattan, was productive and will, hopefully, set the stage for further discussions with the Attorney General's Office with respect to this proposed legislation, which is now on the Bar Association's "list of priorities." For further information regarding the Committee and its activities or with respect to the next Committee meeting, please contact Committee Chair Richard L. Rosen (rlr@rosenlawpllc.com or at 212-644-6644).

Richard L. Rosen, Chair

Insurance Law Committee

The Insurance Law Committee met on January 29, 2014 in conjunction with the Annual Meeting of the Business Law Section and received a presentation on current federal and international developments in insurance regulation, including designations of non-bank systemically important financial institutions by the federal Financial Stability Oversight Council and recent activities of the Federal Insurance Office and the International Association of Insurance Supervisors.

Thomas M. Kelly, Chair

Legislative Affairs Committee

The Legislative Affairs Committee is proud to make two announcements. First, the Business Law Section's years of work on modernizing New York's Not-for-Profit Corporation Law has finally paid off, resulting last December in the enactment of the Nonprofit Revitalization Act of 2013.

The last meeting of the Legislative Affairs Committee took place on January 29, 2014, in conjunction with the NYSBA's Annual Meeting. Frederick Attea (Partner, Phillips Lytle LLP) participated by conference call and gave a lively description of his years of work on the nonprofit law project for the NYSBA and the Business Law Section.

Second, in November 2013, the NYSBA announced that the Business Law Section's proposed revision of the New York Franchise Act had been selected as one of the Association's 2014 legislative priorities.

Like the Not-for-Profit Corporation Law, the New York Franchise Act (NYFA) is enforced by the New York State Attorney General's Office. Mr. Attea's discussion at the last Committee meeting of his work on the nonprofit law change was especially instructive for the Committee's pending effort to modernize the state's franchise law.

Representatives of the Business Law Section met March 13, 2014, with key staff in the New York Attorney General's Office to discuss the NYSBA's proposed changes to the NYFA. I attended that meeting along with Richard Rosen and David Oppenheim. The three of us were among the five subcommittee members who drafted the franchise report for the Business Law Section in November 2009. Kevin Kerwin, Associate Director of Governmental Relations at NYSBA, organized and attended the meeting. The meeting was productive, but only the first step in a long process. We plan to follow up with the Attorney General's Office and then to meet with state legislators.

Thomas Pitegoff, Chair

Not-for-Profit Corporations Committee

After a struggle lasting more than ten years, members of the Business Law Section of the New York State Bar Association, working with other members of NYSBA and the NYSBA staff, were able to secure passage of the Non-profit Revitalization Act last year, upgrading the New York Not-for-Profit Corporation Law. Our members who were active in the effort noted that there was no single "home" within NYSBA for attorneys working for, or providing legal services to, not-for-profit corporations. After consultations with NYSBA executive officers and to meet that perceived need, our Executive Committee has established a new standing committee to focus on the legal needs and interests of not-for profit corporations. The inaugural Chair of the committee is Frederick Attea, Esq., of Phillips Lytle in Buffalo, who was instrumental in the effort to secure passage of the statute last year. If you work for or provide services to not-for-profit corporations, or if you are otherwise interested in the legal affairs of such corporations, we invite you to join the committee. If you want to join the committee, send an e-mail to BusinessLaw@NYSBA.org. Membership in this and all other Business Law Section committees is free to all members of the Section.

Jay L. Hack, Outgoing Section Chair

Public Utility Law Committee

No report submitted.

Securities Regulation Committee

See report of the Corporations Law Committee, above.

Peter W. LaVigne, Chair

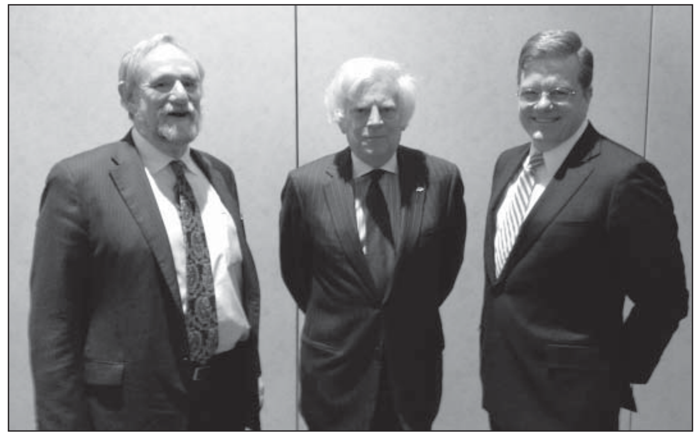
Technology and Venture Law Committee

At the Spring Meeting, the Technology and Venture Law Committee presented a discussion of Recent Developments in Intellectual Property Law and Early-Stage Financings. Yuval Marcus, a partner at Leason Ellis, spoke about patent, trademark and copyright issues and cases, including *Alice Corp. v. CLS Bank* (whether claims to computer-implemented inventions are eligible subject matter for patent purposes, a matter recently decided in the negative by the U.S. Supreme Court) and *Petroliam Nasional Berhad v. GoDaddy.com, Inc.* (whether the Anti-cybersquatting Consumer Protection Act provides for a cause of action for contributory cybersquatting; cert. petition pending before the U.S. Supreme Court). Shalom Leaf, the Chair of the Committee, spoke about current developments in angel and venture financings.

The Committee plans to present panel discussions of transactional issues in the upcoming months.

Shalom Leaf, Chair

ABA Business Leaders Conference



James R. Silkenat (in the middle), President, American Bar Association, 2013-2014, a partner in the New York office of the national law firm of Sullivan & Worcester and a member of its Corporate Department, along with Jay L. Hack (on the left), outgoing Chair of the Business Law Section of the New York State Bar Association, and James Everett (on the right), incoming Chair of the Business Law Section.

The ABA Business Leaders Conference provided an opportunity to state and local bar leaders to share ideas on membership recruitment, involvement, and outreach. Jay Hack described New York's efforts.

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