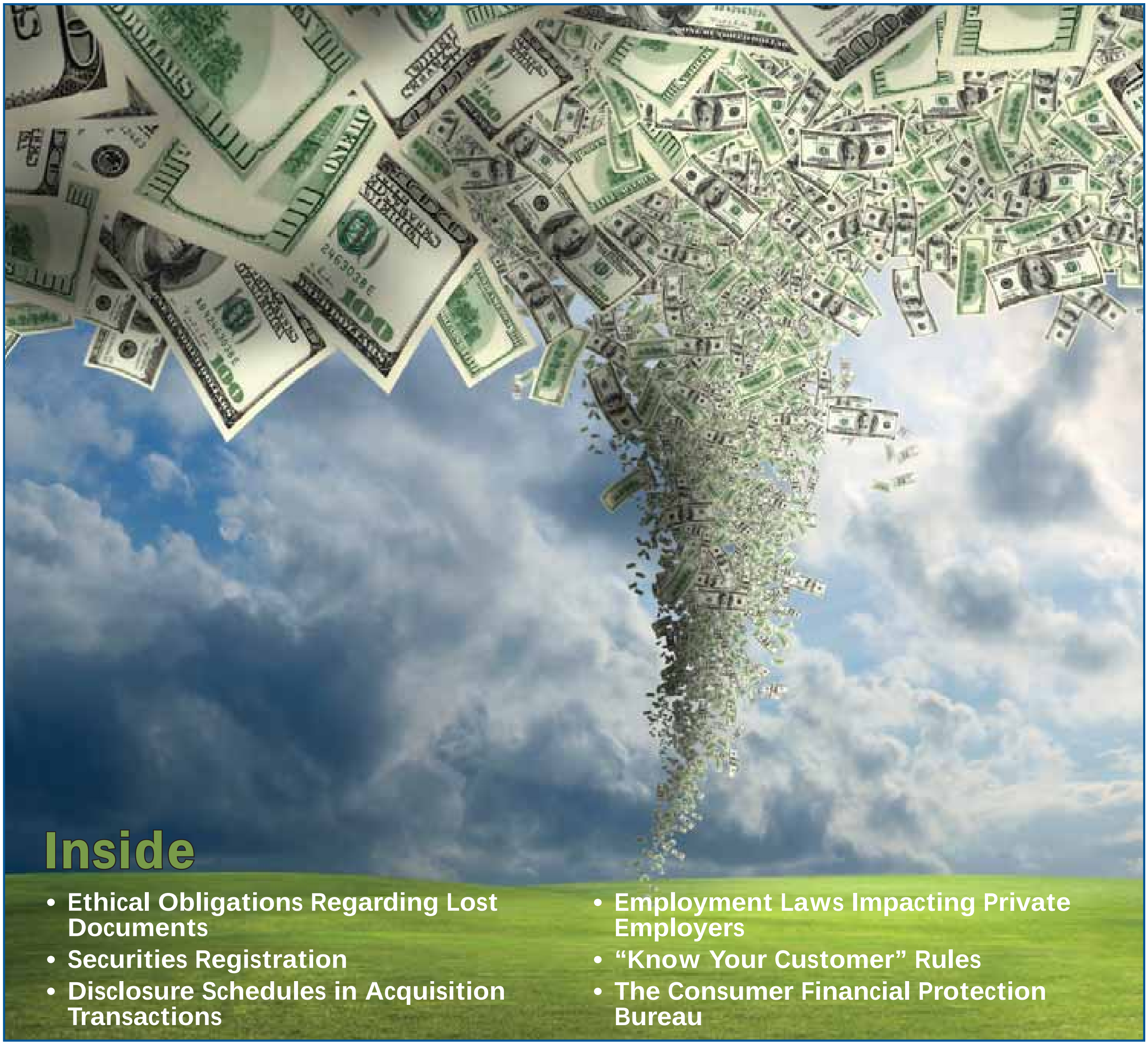
NYSBA

SUMMER 2016 | VOL. 20 | NO. 1

NY Business Law Journal

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

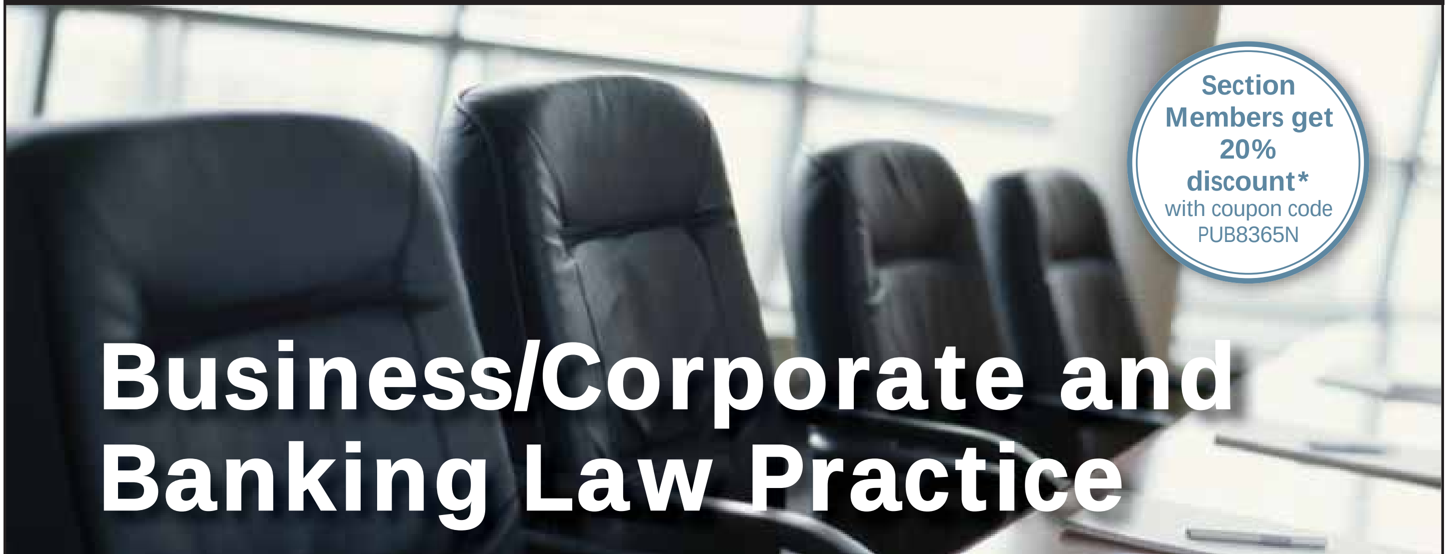


Inside

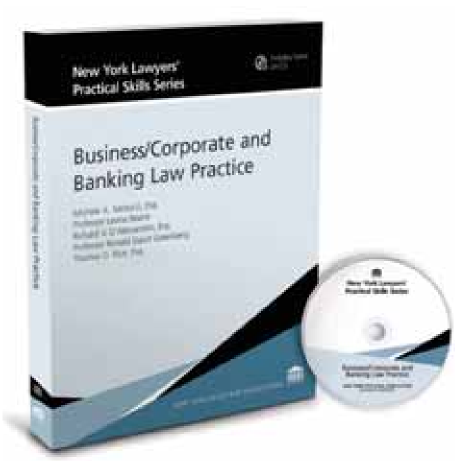
- Ethical Obligations Regarding Lost Documents
- Securities Registration
- Disclosure Schedules in Acquisition Transactions
- Employment Laws Impacting Private Employers
- “Know Your Customer” Rules
- The Consumer Financial Protection Bureau

NYSBA

From the NYSBA Book Store



Business/Corporate and Banking Law Practice



Authors

Michele A. Santucci, Esq.
Attorney at Law, Niskayuna, NY

Professor Leona Beane
Professor Emeritus at Baruch College and Attorney at Law, New York, NY

Richard V. D'Alessandro, Esq.
Richard V. D'Alessandro Professional Corporation, Albany, NY

Professor Ronald David Greenberg
Larchmont, NY

Thomas O. Rice, Esq.
Attorney at Law, Garden City, NY

PRODUCT INFO AND PRICES*

2015-2016 / 886 pp., softbound
PN: 405196

NYSBA Members	**$125**
Non-members	$165

Order multiple titles to take advantage of our low flat rate shipping charge of $5.95 per order, regardless of the number of items shipped. $5.95 shipping and handling offer applies to orders shipped within the continental U.S. Shipping and handling charges for orders shipped outside the continental U.S. will be based on destination and added to your total.

***Discount good until September 30, 2016.**

This practice guide covers corporate and partnership law, buying and selling a small business, the tax implications of forming a corporation and banking law practice. It covers many issues including the best form of business entity for clients and complicated tax implications of various business entities.

Updated case and statutory references and numerous forms following each section, along with the practice guides and table of authorities, make this edition of *Business/Corporate and Banking Law Practice* a must-have introductory reference.

The 2015–2016 release is current through the 2015 New York legislative session and is even more valuable with the inclusion of **Forms on CD**.

Get the Information Edge

NEW YORK STATE BAR ASSOCIATION

1.800.582.2452 www.nysba.org/pubs

Mention Code: PUB8365N

NYSBA

NY BUSINESS LAW JOURNAL

Summer 2016

Vol. 20, No. 1

THE BUSINESS LAW SECTION
NEW YORK STATE BAR ASSOCIATION

in cooperation with

ALBANY LAW SCHOOL

ISSN 1521-7183 (print) ISSN 1933-8562 (online)

Business Law Section Officers

Chair .... Sarah E. Gold
Gold Law Firm
1843 Central Avenue #187
Albany, NY 12205
sg@goldlawny.com

First Vice-Chair .... Kathleen A. Scott
Norton Rose Fulbright US LLP
666 Fifth Avenue
New York, NY 10103
Kathleen.scott@nortonrosefulbright.com

Second Vice-Chair.. Peter W. LaVigne
Goodwin Procter LLP
620 Eighth Avenue
The New York Times Building
New York, NY 10018
plavigne@goodwinprocter.com

Secretary... Drew Jaglom
Tannenbaum Helpern Syracuse & Hirschtritt LLP
900 Third Avenue, 12th Floor
New York, NY 10022-4728
jaglom@thsh.com

Business Law Section Committees

Chair

Banking Law .... Tanweer Sheikh Ansari
First National Bank of Long Island
10 Glen Head Road
PO Box 67
Glen Head, NY 11545
tanweer.ansari@fnbli.com

Bankruptcy Law .... Scott H. Bernstein
Stradley Ronon Stevens & Young, LLP
100 Park Avenue, Suite #3210
New York, New York 10017
sbernstein@stradley.com

Corporations Law .... Dr. Richard De Rose
Houlihan Lokey
245 Park Avenue
New York, NY 10167-0002
rderose@hl.com

Derivatives and Structured Products Law	Rhona H. Ramsay MUFG Americas Legal Department 1251 Avenue of the Americas, 15th Floor New York, NY 10020-1104 rramsay@us.mufg.jp
Franchise, Distribution and Licensing Law	Justin Michael Klein Marks & Klein, LLP 63 Riverside Avenue Red Bank, NJ 07701-1007 justin@marksklein.com rlr@rosenlawpllc.com
Insurance Law	Marilyn Assicurato Lion Debevoise & Plimpton LLP 919 Third Avenue New York, NY 10022-3902 malion@debevoise.com
Legislative Affairs	Michael A. de Freitas William C. Moran & Associates, PC 6500 Main Street, Suite 5 Williamsville, NY 14221 mdefreitas@moranlawyers.com Tom.Pitegoff@leclairryan.com
Membership	Carol Spawn Desmond 95 Corona Avenue Pelham, NY 10803-2028 carolspawndesmond@gmail.com
Not-For-Profit Corporations Law	Frederick G. Attea Phillips Lytle LLP One Canalside 125 Main Street Buffalo, NY 14203-2887 fattea@phillipslytle.com
Public Utility Law	Mary L. Krayeske Consolidated Edison Company of NY, Inc 4 Irving Place New York, NY 10003 krayeskem@coned.com Kevin Lang Couch White LLP 540 Broadway Albany, NY 12201 klang@couchwhite.com
Securities Regulation	Anastasia T. Rockas Skadden, Arps, Slate, Meagher & Flom LLP 4 Times Square New York, NY 10036-6518 anastasia.rockas@skadden.com
Technology and Venture Law	Peter W. Rothberg Reitler Kailas & Rosenblatt LLC 885 Third Avenue New York, NY 10022 prothberg@reiterlaw.com

Table of Contents

HeadNotes

With great pleasure the editors announce that New York City financial services attorney C. Evan Stewart has been honored with the 2016 Sanford D. Levy Award by the New York State Bar Association's Committee on Professional Ethics. For more than ten years, Mr. Stewart's timely, insightful and witty articles on issues of legal ethics have graced the pages of the *Journal*, and we are particularly pleased that Committee Chair Marjorie Gross cited these articles as key factor in Mr. Stewart's selection. Mr. Stewart is a senior partner in the New York City office of Cohen & Gresser LLP, focusing on business and commercial litigation, and also has taught as an adjunct law professor at Fordham Law School and as a visiting professor at Cornell University.

Named for Sanford D. Levy, a former member of the Committee on Professional Ethics, the award was presented March 16 in Manhattan. Since 1982, it has been presented to an individual or institution that, in the opinion of the Committee, has contributed most to understanding and advancement in the field of professional ethics. Previous recipients of this prestigious award include the late former New York State Chief Judge Judith S. Kaye; Professor Stephen Gillers (New York University School of Law); Professor Thomas D. Morgan (George Washington School of Law); Roger C. Cramton of Ithaca (Cornell University Law School); and, in 2015, author and distinguished Professor Roy D. Simon.

And while we're on the subject of awards, the editors congratulate Frederick G. Attea as the 2016 recipient of the Business Law Section's David S. Caplan Award for Meritorious Service. Mr. Attea, a corporate lawyer at Phillips Lytle LLP, Buffalo, concentrates his practice on mergers and acquisitions, securities law, corporate governance and legal compliance programs. He has been a member of the NYSBA since 1965 and has served as a member of the House of Delegates, Chair of the Business Law Section, and Chair of the Corporations Law Committee, and is currently Chair of the recently organized Not-For-Profit Corporations Law Committee.

The Section established the Award in 2014 in order to recognize the importance and value of the many hours of volunteer service provided to the Section and its Committees by its members. The award is named in honor of Mr. Caplan, former Chair of the Technology and Venture Law Committee, who, despite his personal physical challenges, was always willing to volunteer his time, his effort, and his ideas for the benefit of the Section. Prior recipients of the Award are Samuel F. Abernethy (2015) and David L. Glass (2014).

The Caplan Award is presented annually at the Annual Meeting of the Business Law Section held in conjunction with the Annual Meeting of the New York State Bar Association. The recipient of the award is selected by a committee consisting of the three most immediate past chairs of the Section, and members of the Section's Executive Committee will also be invited to submit nominees. Members of the Section are invited to submit nominations to the committee; elsewhere in this issue there is an announcement of the Award with information on how to do so.

And finally, the editors are pleased to announce the winners of the Section's annual Student Writing Competition for 2015. First and second prizes are shared equally by Mr. Matthew Mobilia and Ms. Amanda Godkin, both of whom received the JD degree from Albany Law School in 2015, for their co-authored article "Emerging Equities in Paying for Municipal Services —The Problem with the Real Property Tax," which appeared in the Summer 2015 issue of the *Journal*. In an eye-opening analysis, the authors provide considerable insight into why New York has one of the highest tax burdens in the country, and how the burden might be more equitably shared by the many tax-exempt institutions that benefit from the municipal services funded by those taxes. Third prize is awarded to Ms. Amanda Evans, a candidate for the JD degree at Richmond Law School, for her article "Successfully Advocating for Gender Parity on Corporate Boards," which also appeared in the Summer 2015 *Journal*. Elsewhere in this issue is information on how to submit articles for the Competition. Any article written by a student enrolled in a degree program at an accredited law school at the time the article was written is eligible.

Honoring Mr. Stewart as recipient of the Levy Award, we lead off this issue with his latest contribution. In "Finders Keepers, Losers Weepers?" Mr. Stewart poses the question: what are lawyers supposed to do when they inadvertently come into possession of material mistakenly delivered by an opposing party? The question is, of course, not rhetorical. An ABA Model Rule adopted in 2002, and later in New York, seems clear: the attorney's duty is simply to notify the sender. Seemingly, the Rule is a model of clarity, and earlier interpretations requiring the attorney to do more were withdrawn by the ABA. But as always, there's a catch—or more than one. For one thing, numerous jurisdictions still follow the earlier rules. For another, the Rule itself is subject to numerous interpretive comments. In his usual clear and witty fashion, Mr. Stewart leads us through the thicket.

An ongoing area of controversy in franchise law is the degree to which the franchisor can control the franchisee. In the case of automobile dealers in New York, the State's

Franchised Motor Vehicle Dealer Act generally prohibits unfair practices by franchisors. In a case recently decided by the State's highest court, a dealer sued the manufacturer, arguing that the Act was violated by the manufacturer's system for assigning performance ratings and allocating territory. In "Case Note: *Beck Chevrolet v. GM*," Stuart Newman and Tyler Silvey explain the significance of the ruling, which sheds considerable light on the requirements of the Act. Mr. Newman is Chair and Advisor Emeritus of the *Journal*'s Editorial Advisory Board; he and Mr. Silvey are attorneys with the firm Salon Marrow Dyckman Newman & Brody LLP.

Our next two articles explore different aspects of the issues under both securities and corporate law involved in business combinations. In "Avoiding Securities Act Registration in Share-for-Share Business Combinations between Non-U.S. Companies," Guy P. Lander deals with the situation where, even though both companies in the business combination are outside the United States, the target company may have sufficient U.S. shareholders to implicate the registration requirements under the U.S. securities laws. Since registration is generally a costly, burdensome and lengthy process, avoiding the need to register can be highly advantageous. Mr. Lander, a partner in the firm Carter Ledyard & Milburn and a past Chair of the Business Law Section, is a recognized expert in the area of securities registration law. His clear and practical article explains the types of business combinations that might be considered; how to determine whether registration is required; the criteria a company needs to satisfy to be considered a "foreign private issuer," and whether there are any applicable exemptions to registration.

Another factor that can add to the complexity and affect the timeliness of a business combination is the content and timing of certain disclosures required to be made between the parties and to third parties. In "Disclosure Schedules in Acquisition Transactions," attorneys Joseph Cuomo and Allison Rosenzweig provide a thorough and practical guide to the process of preparing a disclosure schedule, with particular focus on the representations and warranties made by the seller in the transaction. Noting that the seller normally is responsible for preparing the schedules, they weigh the pros and cons of delegating this task to counsel or to the seller's accountants. They also discuss the pros and cons of "overdisclosing" —while it can protect the seller from liability, it may also raise unnecessary concerns on the part of the buyer. Mr. Cuomo is Co-Chair of the Corporate and Commercial Law Department and Ms. Rosenzweig is an associate in the Long Island-based firm Forchelli, Curto, Deegan, Schwartz, Mineo & Terrana LLP.

As any businessperson knows, employment law continues to be an area where change is continuous and dynamic—especially in New York, which has always been in the forefront of protecting and expanding workers' rights. So our readers are fortunate to have the benefit of "Recent Employment Laws Impacting Private Employers in New York," an ongoing series authored by Sharon Parella, founder of the Parella Law Firm LLC and a recognized expert in employment law. The current issue is no exception, as Ms. Parella highlights two significant new laws —one State, one City—as well as guidance issued by the New York City Commission on Human Rights (NYCCHR) and the federal Equal Employment Opportunity Commission (EEOC). The State has enacted a new law governing paid family leave that provides substantial benefits for covered employees. Meanwhile, the City Council has amended the City Human Rights Law to prohibit discrimination against caregivers, while the NYCCHR has released comprehensive guidance on issues related to gender identity and gender expression, matters much in the news as different states and localities react in different ways. Finally, the EEOC has issued key guidance on employer-provided leave as a reasonable accommodation under the Americans with Disabilities Act. Ms. Parella's clear and concise discussion of these new initiatives are required reading for all attorneys advising New York businesses.

Especially since the terrorist attacks of 9/11 and the enactment of the USA PATRIOT Act, measures to detect and prevent money laundering through banks and other financial institutions have been a prime focus of the financial regulators. In particular, financial institutions are required to establish a customer identification program (CIP) at the outset of the relationship, and have an ongoing "know-your-customer" (KYC) mandate. For borrowers and other bank customers, this has meant a burdensome and often confusing process whereby information must be provided to the bank at the outset of the relationship and updated regularly thereafter. In "'Know Your Customer' and Credit Providers," Kathleen Scott outlines the requirements in this increasingly complex area. She explains that banks, like other financial institutions, must have a risk-based anti-money laundering program, and highlights areas where a bank must be especially careful—for example, in determining "who is the customer," the lender increasingly must consider parent and subsidiary relationships as well as the named borrower. Ms. Scott, an attorney with Fulbright & Jaworski in New York, is currently First Vice Chair of the Business Law Section and past Chair of the NYSBA Banking Law Committee.

An issue that is, or should be, on the mind of every business lawyer is the ever-increasing threat of attacks on a company's systems and critical data, including private information belonging to the company's customers. In "Emerging Trends in Privacy and Cybersecurity," Stuart D. Levi outlines the key themes that have emerged in 2015 and into 2016 as the legal system seeks to respond—from initiatives by U.S. regulators including the Securities & Exchange Commission (SEC) and Federal Trade Commission (FTC), to the European Union's (EU) new directive affecting all companies with European customers, to the proliferation of class action lawsuits where customer privacy has been compromised. The good news, as Mr. Levi notes, is that these various initiatives reflect an emerging consensus on what constitutes “best practices” in cybersecurity and privacy protection. Mr. Levi is co-head of the Intellectual Property and Technology Group at Skadden, Arps, Slate, Meagher & Flom LLP, and coordinates the Firm’s outsourcing and privacy practices.

Since its establishment under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the Consumer Financial Protection Bureau (CFPB) has quickly become a force to be reckoned with for all companies offering financial services of any type to consumers. In “CFPB Pursues Aggressive Enforcement Agenda and Arbitration Restrictions,” a group of attorneys at the Skadden Arps law firm highlight the agency’s current major initiatives. In 2015 the CFPB pursued some 50 enforcement actions, primarily concentrated in unfair and deceptive acts and practices, resulting in some $1.6 billion in settlements. Fair lending has been another area of aggressive enforcement. Recently, the CFPB has caused a major stir by proposing an outright ban on arbitration clauses in consumer financial product agreements, if the effect would be to prohibit class action lawsuits. The CFPB has been receiving comments in the early part of this year, including from a panel focused on protecting small businesses. But as the authors note, if the regulations are finalized as expected, many companies will need to significantly change their business practices, with increased compliance costs and burdens. The effect on financial products such as credit cards, checking accounts, prepaid cards, some auto loans, and many others, will be dramatic. This timely update is required reading for every attorney who advises a business that offers consumer financial products of any type.

The development of virtual currencies, of which Bitcoin is the best known, continues to confound the regulators. It is intangible and completely outside the existing financial system, thus posing unique problems in relation to issues such as money laundering as well as more mundane matters related to payments and valuation. In the prior issue of the *Journal* we featured several articles related to efforts of the Commodity Futures Trading Commission (CFTC) to get a handle on Bitcoin. In this issue we feature “*In re Coinflip, Inc.*” by Caitlin Dance, in which the CFTC charged Coinflip with a violation of the Commodity Exchange Act (CEA) because it operated a platform for trading Bitcoin futures and options and did not register with the CFTC. But the article goes much deeper than just the Coinflip case; Ms. Dance, a candidate for the JD degree from New York Law School and a Notes & Comments Editor of the *New York Law School Law Review*, provides a thorough and exhaustively researched discussion of the background of Bitcoin and the attempts to date to regulate it. As such, her article is an excellent introduction to the complexities of Bitcoin for practitioners seeking to gain an understanding of this mysterious but game-changing development in the world of finance.

No issue of the *Journal* would be complete without “Inside the Courts,” a comprehensive survey by the attorneys of Skadden Arps LLP of current litigation pertaining to securities and corporate matters in the federal courts that has proven invaluable to practitioners and is a favorite of our readers. The current issue contains the usual clear and concise summaries of a wide range of current matters, ranging from shareholder derivative suits, to fiduciary duties, to current developments in Madoff-related litigation. We remain indebted to the attorneys of Skadden for continuing to generously share this exceptionally valuable summary with the readers of the *Journal*.

One of the consequences of the financial crisis of 2008-9 was to expose the inherent flaws in the process whereby private credit rating agencies known as NRSROs (nationally recognized statistical rating organizations), of which Standard & Poor’s and Moody’s are the two largest and best known, assign ratings to securities offered to the public. In particular, both agencies assigned their highest ratings to securities backed by pools of mortgages, which then defaulted at an alarming rate, causing massive losses to investors. Congress responded in the Dodd-Frank reform legislation by prohibiting the bank regulatory authorities from relying on NRSRO ratings and gave authority to the Securities & Exchange Commission (SEC) to impose rules on the NRSROs and how their ratings are used. In “…[E]xcept For All the Others”: A Compromise Proposal for Correcting the Incentives of Credit Rating Agencies in the Wake of the Dodd-Frank Act,” Lawrence Crane-Moscowitz, a candidate for the JD degree at Vanderbilt University School of Law, argues that the efforts to date do not go far enough in addressing the perverse incentives in the NRSRO structure, in particular the inherent conflict of interest that results from the rated party paying for its rating. His thoughtful and well-researched article, in addition to articulating several specific reform proposals, provides a wealth of background information on the NRSROs and their role in the financial system. It is well worth the attention of any attorney involved in advising financial institutions or securities issuers.

Concluding this issue is a review by Samuel F. Abernethy, a partner in the New York firm Menaker & Herrmann LLP, of the Fourth Edition of *Commercial Litigation in New York State Courts.* Mr. Abernethy, a past Chair of the Business Law Section and current Chair of the NYSBA’s Electronic Communications Committee, reviewed the Third Edition of the book in 2010 in this *Journal*. As Mr. Abernethy explains the book, for which Robert L. Haig of the firm of Kelley Drye & Warren LLP serves as Editor in Chief, is far more than a procedural handbook; its eight volumes contain extensive case citations and analysis of substantive areas of law such as banking, derivatives, and mergers and acquisitions. As such, the book may be well worth the attention of New York business practitioners who are involved to any extent in commercial litigation.

David L. Glass

Finders Keepers, Losers Weepers?

By C. Evan Stewart

On May 26, 1963, Elvis went into RCA Victor's Studio B in Nashville and recorded Dory Jones and Ollie Jones's "Finders Keepers, Losers Weepers":

> The loser has to pay the score
> He lost you and I found you
> And I'm keeping you for ever more.[1]

That idea might apply to love, Elvis-style ("a hunk, a hunk of burning love"),[2] but does it also apply to lost documents and lawyers' ethical obligations in that context?

If You Just Look at the Rule…

ABA Model Rule 4.4(b) addresses what lawyers are supposed to do, as a matter of ethics, when they come into possession of materials mistakenly delivered by an opposing party: "A lawyer who receives a document or electronically stored information relating to the representation of the lawyer's client and knows or reasonably should know that the document was inadvertently sent shall promptly notify the sender." Before 4.4(b) was adopted by the ABA in 2002,[3] there was no Model Rule governing inadvertent disclosure. Notwithstanding, in 1992, the ABA issued Formal Opinion 92-368, which declared that a lawyer receiving attorney-client privileged materials or other confidential information had three ethical duties: (i) refrain from reading the document; (ii) notify the sender of the document; and (iii) obey the direction(s) of the sender as to next steps (e.g., return, destroy, etc.). That guidance was reinforced two years later in ABA Formal Opinion 94-382.

Three years after Model Rule 4.4(b) was issued, the ABA expressly withdrew Formal Opinion 92-368 (*see* ABA Formal Opinion 05-437), and the next year, it expressly withdrew ABA Formal Opinion 94-382 (*see* ABA Formal Opinion 06-440). While both earlier (and now withdrawn) opinions had been concerned with, *inter alia*, "protection of confidentiality, the inviolability of the attorney-client privilege,…and general considerations of common sense, reciprocity, and professional courtesy," the ABA (in withdrawing the earlier opinions) stated that while such "considerations" "may guide a lawyer's conduct," "[t]hey are not…an appropriate basis for a formal opinion [by the ABA], for which we look to the Rules themselves." And since Model Rule 4.4(b) only requires notification, and nothing more, that was (and is) that. Formal Opinion 06-440 also made clear that, besides the notification-only requirement, the receiving lawyer was free to (i) review the document, and (ii) not abide by any instructions from the sender.

When New York State adopted its most recent iteration of attorney ethical rules in 2009, it adopted the language and substance of ABA Model Rule 4.4(b).[4] Thereafter, the Association of the Bar of the City of New York's Committee on Professional Ethics issued Formal Opinion 2012-1. That opinion mirrored ABA Formal Opinion 06-440, permitting an attorney to review the document and disregard the instructions of the sender; furthermore, it also expressly withdrew a prior opinion (Formal Opinion 2003-04), which required additional obligations beyond those that are set forth in Rule 4.4(b).

According to a leading legal academic who played a key role in drafting the New York State rules, Rule 4.4(b) is a "model of clarity";[5] compliance with it, therefore, should be quite straight forward. But wait, there is a catch; indeed, there is more than one.

The Multi-Jurisdictional Issue

First off is the fact that numerous jurisdictions do not follow the ABA's (and New York's) lead on this ethical standard. For example, a number of states require exactly what the ABA suggested in 1992: (i) stop reading the document; (ii) notify the sender; and (iii) abide by the sender's instructions.[6] Other states require something a little less than those three steps.[7] And while some states do in fact follow the ABA and New York,[8] still other states have no Rule 4.4(b) at all.[9] This disparate kettle of fish tees up an ethical quandary for any lawyer who has clients beyond just the four corners of the state in which she is licensed: how does she comply with these very different ethical obligations vis-à-vis inadvertent disclosure?[10]

And Then There Are the Comments

Beyond Rule 4.4(b) itself, all of the New York Rules have Comments. As a general matter, these Comments "are intended as guides for interpretation" *only*; the "text of each Rule is authoritative."[11] With respect to Rule 4.4(b), two key Comments have hidden in them two huge *red flags*.[12] In the fourth sentence of Comment 2, for example, the Rule drafters wrote the following:

> Although this Rule does not require that the lawyer refrain from reading or continuing to read the document, a lawyer who reads or continues to read a document that contains privileged or confidential information may be subject to **court-imposed sanctions, including disqualification and evidence-preclusion.**

And in the third sentence of Comment 3, the Rule drafters wrote the following:

> **[S]ubstantive law** or **procedural rules** may require a lawyer to refrain from reading an inadvertently sent document, or

to return the document to the sender, or both.

Thus, if all one reads is the "authoritative" Rule, but not the *red flagged* Comments, the unsuspecting (but Rule-compliant) lawyer might be "ethical," but she could be facing some pretty unhappy consequences for blithely following the Rule.[13]

What If the Materials Are Privileged?

A few years ago the legal powers that be (with the assistance of Congress) made some changes to protect lawyers who are imperfect in dealing with the production of documents and emails.[14] First, the Federal Rules Advising Committee adopted Fed. R. Civ. P. 26 (b)(5) (and analogs to it in Rules 16, 33, 34, and 37); and Congress thereafter adopted Rule 502(b) of the Federal Rules of Evidence. The rules codify that an "inadvertent disclosure" of privileged material does not operate as a waiver so long as (i) the privilege holder took "reasonable steps to prevent disclosure;" and (ii) the privilege holder took "reasonable steps to rectify the error." Whether this "reasonableness" approach has led to the promised land is unclear.[15]

As part of these "reforms," Fed. R. Civ. P. 26 (b)(5) put specific obligations onto the receiving lawyer once she is made aware of the production of privileged information: (i) she "must promptly return, sequester, or destroy" the material(s); (ii) she "must not use or disclose the information until the claim is resolved"; and (iii) she "must take reasonable steps to retrieve the information if the [receiving] party disclosed it before being notified." About half of the states have imposed similar obligations on litigating lawyers in their jurisdictions;[16] importantly, for readers of this distinguished *Journal*, New York State does *not* have the same or similar obligations in the Civil Practice Law and Rules.[17] So New York litigators in New York federal courts would seem to have *very* different responsibilities with regard to inadvertent production than they would in New York State courts.[18]

In addition, the above-mentioned federal protocols have left some open issues for all lawyers governed thereby. [19] For example, does the receiving lawyer have an affirmative obligation to notify the sender or may she wait until she is "notified" of the inadvertent disclosure? And can the receiving attorney read the inadvertent privileged material and / or share it with her client?[20] Finally, what about privileged or confidential information that is overheard? (None of these rules seem to cover that scenario.)

How Have the Courts and Bar Authorities Dealt with This Evolving Situation?

Perhaps not surprisingly, the jurisprudence enforcing these protocols differs depending upon time and jurisdiction. Let us first look at New York.

- New York and "Finders Keepers":
  - *Matter of Weinberg,* 517 N.Y.S. 2d 474 (1st Dept. 1987). Court approved the sanction of disqualification where an attorney acquired privileged information through the improper use of discovery devices.
  - *Lipin v. Bender,* 597 N.Y.S. 2d 340 (1st Dept. 1993). Court approved the sanction of disqualification where an attorney used documents containing an adversary's work product that had been improperly obtained.
  - *American Express v. Accu-Weather, Inc. 1*991 WL 346388 (S.D.N.Y. June 25, 1996). Court sanctioned attorneys who ignored sending counsel's instructions to return a not-yet-opened package of documents which contained a privileged communication. [*Note*: The court relied upon ABA Opinion 92-368.]
  - *United States v. Rigas, 2*81 F. Supp. 2d 733 (S.D.N.Y. 2003). Defense counsel application for an order authorizing them to retain and use the government's work product inadvertently produced in discovery was denied. [*Note*: The court relied on ABA Opinion 92-368 in rejecting defense counsel argument that they were being punished for promptly notifying the government lawyers and not reviewing the materials: "The Court finds this argument wholly unpersuasive. Attorneys, of course, bear responsibility for acting in accordance with ethical norms of the legal profession."].[21]
  - *People v. Terry,* 1 Misc. 3d 475 (County Ct., Monroe Co. 2003). The court precluded a prosecutor from using documents inadvertently sent by defense counsel.
  - *Galison v. Greenberg,* 2004 NY Slip Op. 51538 (Sup. Ct. N.Y. Co. 2004). Citing, *inter alia*, the New York City Bar's Formal Opinion 2003-04, the court cautioned that any attorney who receives information the attorney knows or should reasonably know contains privileged information must be aware of her ethical obligations and promptly adhere to them "in order to avoid sanctions."
  - *MNT Sales, LLC v. Acme Television Holdings, LLC,* Index No. 602156 / 2009, NYLJ, p. 42, col. 5 (Sup. Ct. N.Y. Co. April 29, 2010). The court held that the "spirit" of the New York City Bar's Formal Opinion 2003-04 had been violated by the plaintiff's lawyer, who had been asked to destroy an inadvertent email and had then refused to do so. As a sanction to "remediate the egregious conduct," the court denied the plaintiff's motion to be allowed to use the email.
- Other Jurisdictions and "Finders Keepers":
  - *In re Richard E. Lee*, 06-DB-22 (Louisiana Attorney Disciplinary Board, April 2, 2007). Discipline was

not ordered because the inadvertently disclosed document did not appear (on its face) to be privileged or confidential.

– *Rico v. Mitsubishi Motors Corp.*, 171 P.3d 1092 (Cal. 2007).[22] The court held than an attorney may read only as much as necessary to determine if documents are privileged; once it is so determined, the attorney must notify opposing counsel immediately and attempt to resolve the situation promptly, either by agreement or by seeking judicial intervention. In this case, where one of the plaintiffs' attorneys used his opponent's work product and also shared it with his expert and co-counsel, the court disqualified the plaintiffs' attorneys and their experts.[23]

– *Burt Hill Inc. v. Hassan*, 2010 BL 19879 (W.D. Pa. Jan. 29, 2010). The court questioned the ethics advice a law firm had received—that it could keep and use its opponent's confidential documents that had been received from an anonymous source.

– *Merits Incentive LLC v. Eighth Judicial District Court*, 262 P.3 720 (Nev. 2011). The court denied a motion to disqualify a law firm that received confidential information about an opponent from an anonymous source. The court noted that the firm had followed the notification requirement of Rule 4.4(b), even though the rule deals with inadvertent disclosure and *not* intentional but unauthorized disclosure.

– *Lund v. Meyers*, No. CV-12-0349-PR (Arizona Sup. Ct. July 16, 2013). Attorneys moved to disqualify opposing counsel because they had "read, kept, and distributed" privileged documents inadvertently produced. The litigated issue to the Supreme Court was the interplay between Rule 4.4(b) and Arizona's Rule of Civil Practice 26.1(f)(2): the procedure for providing documents to the trial court, their status during that process, and when any in camera review for privilege should take place.

– *Jablow v. Wagner*, 2015 BL 103103 (N.J. Super. Ct. App. Div. April 18, 2015). The plaintiff's lawyer, who kept and used for several months his opponent's privileged documents—which he had received from an anonymous source—was properly disqualified for breaching his duties under Rule 4.4(b).

– *Foss Mar. Co. v. Brandewiede*, 2015 BL 297104 (Wash. Ct. App. Div. 1, Sept. 17, 2015). Washington trial courts must apply a four-factor test in determining whether to disqualify an attorney who receives her opponent's privileged information: (i) prejudice to the sender; (ii) sender counsel's fault (or lack thereof); (iii) receiving counsel's knowledge that the materials are in fact privileged; and (iv) whether lesser sanctions are appropriate. The lower court's disqualification of the receiving lawyer was remanded expressly to apply the four factors before entering any disqualification order.

So What Is Next?

Many who have looked at this indisputably confused state of affairs have argued that the ethics gurus should go back and re-articulate, at a minimum, the standards articulated pre-Rule 4.4(b) in Formal Opinions 92-368 and 94-382.[24] And in July of 2011, New York's Committee on Attorney Professionalism proposed something along these lines to the State Bar's Committee on Attorney Standards and Conduct. But there was significant pushback to going that route—on the ground that such a step "would be a step backwards"; according to one commentator, "[a] profoundly important argument for limiting the scope of lawyers' ethical obligations in these situations is the unfairness of making the 'innocent' lawyers who receive such communications potentially subject to professional discipline in situations" not of their making.[25] Thus, according to the pushback argument, "vagueness is preferable to…any broader rule."[26]

For me, I am not sure who is right in the aforementioned debate (which, as things currently stand, is unresolved). What I do know is that this is one mighty big and tricky area. Hopefully, readers of this distinguished *Journal* will now be forewarned of the dangers that lurk if they ever get air-dropped into one of these unfortunate situations.

Endnotes

1. *See* "Elvis for Everyone" (RCA Victor August 1965) (reached number 10 on the Top Pop Albums chart). While completing this article I discovered that fourteen years ago a law student at Temple had used this same title (albeit without involving Elvis) for a student note on the same subject: *See* David Stanoch, " 'Finders Keepers, Losers Weepers?': Clarifying a Pennsylvania Lawyer's Obligations to Return Inadvertent Disclosures, Even After a New ABA Rule 4.4(b)," 75 *Temple L. Rev*. 657 (2002). Professor Emeritus Joseph J. Simeone of the Saint Louis University School of Law has also used this title, albeit on a different topic: " 'Finders Keepers, Losers Weepers': The Law of Finding 'Lost' Property in Missouri," 54 *Saint Louis Univ. L.J.* 167 (2009) (again, however, with no reference to the King of Rock and Roll).
2. "Burning Love" (written by Dennis Linde) (RCA Studios August 1972). Elvis's cover of this song (originally sung by Arthur Alexander) was his last #1 hit (Cashbox's Top 40 Charts).
3. In 2012, the ABA amended the rule to specifically reference "electronically stored information."
4. To date, New York State has not amended the rule to specifically reference "electronically stored information."
5. *See* R. Simon, *Simon on New Rules: Rules 4.1 through Rule 8.6* (December 2009).
6. E.g., District of Columbia, Iowa, Kentucky, Louisiana, New Hampshire, New Jersey, Maine.

7. E.g., Alabama, Arizona, Colorado, Maryland.

8. E.g., Florida, Indiana, Kansas, Minnesota, Nevada, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, Washington, Wisconsin.

9. E.g., California, Georgia, Hawaii, Illinois, Massachusetts, Michigan, Missouri, South Dakota, Texas, Vermont, Virginia, West Virginia, Wyoming.

10. *See* C.E. Stewart, "Lawyers and the Border Patrol: The Challenge of Multi-Jurisdictional Practice," *NY Business Law Journal* (Summer 2011). Just how idiosyncratic the disparate jurisdictions can be was recently highlighted by Opinion 1871, issued on July 24, 2013 by the Virginia State Bar Standing Committee on Legal Ethics. In that opinion, the Virginia bar authorities wrote that an attorney who receives privileged materials inadvertently is *not* ethically obligated to return the materials to the sender if "the confidential information [was] received in the discovery phase of litigation" rather than "[o]utside of the discovery process."

11. *See* N.Y. Rules of Professional Conduct Preamble, 13.

12. "Huge," of course, is one of Donald Trump's favorite words. *See* Jimmy Fallon and Donald Trump —Huge Huge Huge —YouTube (September 18, 2015).

13. This calls to mind the searing lesson taught to all students of the incomparable Cornell Law Professor Rudolph Schlesinger on the third day of Civil Procedure in September of 1974, when he rebuked a classmate who was unable to proceed in a Socratic dialogue because of an unfortunate confession to not having read the footnotes in the case at hand. With his finger pointing at the offending student (it shook, due to his advanced age), Professor Schlesinger ominously intoned: "Lawyers who do not read footnotes…[dramatic pause], their children will *starve*!"

14. *See* C.E. Stewart, "Thus Spake Zarathustra (and Other Cautionary Tales for Lawyers)," *NY Business Law Journal* (Winter 2010).

15. "Reasonableness" appears to be in the eye of the judicial beholder. *Compare Rhodes Industries, Inc. v. Building Materials Corp. of America*, 254 F.R.D. 216 (E.D. Pa. 2008) *with Sitterson v. Evergreen School District No. 114*, 196 P.3d 735 (Wash. Ct. App. 2008), *with Mt. Hanley Ins. Co. v. Felman Prod. Inc.*, 2010 WL 1990555 (S.D. W. Va. May 18, 2010), *with Edelen v. Campbell Soup Co.*, 265 F.R.D. 676 (N.D. Ga. 2010). Interestingly, the claw-back safe haven provided by F.R.E. 502(d) has not appeared to have had much effect in obviating the risks of the "reasonableness" standard. *See Spicker v. Quest Cherokee*, 2009 WL 2168892 (D. Kan. 2009). *See also* John Rosans, "6 Years In, Why Haven't FRE 502(d) Orders Caught On?," *Law360* (July 24, 2014).

16. E.g., Alabama, Arizona, Arkansas, California, Idaho, Indiana, Iowa, Kansas, Maryland, Minnesota, Montana, New Mexico, North Dakota, Ohio, Tennessee, Texas, Utah, Vermont, Virginia, Washington, Wyoming.

17. *See* CPLR §§3101 & 4503. With respect to the "reasonableness" standards adopted by F.R.E. 502(b), New York courts have traditionally followed those standards. *See, e.g., New York Times v. Lehrer McGovern Bovis*, 752 N.Y.S. 2d 642 (1st Dept. 2002); *Manufacturers & Traders Trust Co. v. Servotronics, Inc.*, 522 N.Y.S. 2d 128 (4th Dept. 1987).

18. Presumably, to attempt to enforce such obligations, where none are specifically set forth, one would have to proceed under CPLR §3103(c) (protective orders: suppression of information improperly obtained).

19. Beyond the Federal Rules themselves, lawyers also need to be on the lookout for the local rules of specific federal courts. *See, e.g.,* U.S. District Court of Western District of Pennsylvania, Local Rules of Court 16.1(D).

20. As set forth above, there are a number of states that require a lawyer to stop reading the inadvertent document as soon as she realizes it is privileged or confidential. *See supra* notes 6 & 7 and accompanying text. Of course, "[o]nce [the receiving lawyer] ha[s] acquired the information…, he cannot purge it from his mind." *Aerojet-General Corp. v. Transport Indemnity Inc.*, 18 Cal. App. 4th 996, 1006 (Cal. App. 1st Dist. 1993).

21. For other cases where courts have not been quite as nice to the government in this situation, *see United States v. Gangi*, 1 F. Supp. 2d 256 (S.D.N.Y. 1998); *SEC v. Cassano*, 189 F.R.D. 83 (S.D.N.Y. 1999).

22. When it has no ethical rule to govern a situation (*see supra* note 9), California looks to the ABA Model Rules. *See* W.L. Patrick, "Inadvertent disclosure and the attorney-client privilege," *California Bar Journal* (August 2011).

23. Presumably, *State Comp. Ins. Fund v. WPS. Inc.,* 82 Cal. Rptr. 2d 799 (Cal. Ct. App. 1999), is no longer good law in California. There, the receiving lawyer (i) failed to notify the sender lawyers of the inadvertent production of privileged materials, and (ii) immediately sent the materials on to his expert (who then sent them on to another law firm that had also retained him). On appeal, the appellate court lifted the trial court's sanction on the receiving lawyer, on the ground that California's ethics rules were not clear. *See also Clark v. Superior Court,* 125 Cal. Rptr. 3d 361 (Cal. Ct. App. 2011) (court disqualified receiving lawyers who reviewed privileged materials and then used them to advance their client's case).

24. Practitioner James Altman has been particularly "vocal" in this regard. *See* "Model Rule Should be Amended," *Professional Lawyer* Vol. 21, No. 1 (2011); "Inadvertent Disclosure and Rule 4.4(b)'s Erosion of Attorney Professionalism," *NYSBA Journal* (Nov / Dec 2010). Indeed, Mr. Altman has prepared a revised Model Rule 4.4(b):

> A lawyer who receives a document in connection with the representation of a client and has reasonable cause to believe that the document may contain confidential information that may have been inadvertently disclosed,
>
> (1) shall not read or examine the document or, if the lawyer already has begun to do so, shall stop reading or examining the document;
>
> (2) shall notify the author or sender of the document of its receipt;
>
> (3) shall promptly return, sequester or, to the extent appropriate and reasonably practicable, destroy the document and any copies of it;
>
> (4) shall not use or disclose the confidential information contained in the document until permitted by a court order; and
>
> (5) shall take reasonable steps to retrieve any copies of the document that the lawyer disclosed before having reasonable cause to believe that the document contained confidential information.

25. *See* Anthony Davis, "Inadvertent Disclosures —Regrettable Confusion," *New York Law Journal* (November 7, 2011).

26. *Id.*

C. Evan Stewart is a senior partner in the New York City office of Cohen & Gresser LLP, focusing on business and commercial litigation. He is an adjunct professor at Fordham Law School and a visiting professor at Cornell University. Mr. Stewart has published over 200 articles on various legal topics and is a frequent contributor to the *New York Law Journal* and this publication.
Mr. Stewart would like to acknowledge the significant contributions of his former law student, Robert Bolcome III (Fordham Law School '15), to this article.

Case Note: *Beck Chevrolet v. GM* (New York Franchised Motor Vehicle Dealer Act)

By Stuart B. Newman and Tyler Silvey

On May 3, 2016, the highest court in New York rendered a decision that affects automotive dealerships. In *Beck Chevrolet v. GM*, *No. 48*, a franchised Chevrolet dealer in Yonkers, NY ("Beck Chevrolet"), sued General Motors ("GM"), arguing that GM violated two sections of New York's Franchised Motor Vehicle Dealer Act ("Dealer Act"), which prohibits unfair business practices by franchisors in the vehicle franchise business. First, Beck Chevrolet argued that GM's dealer performance standards (RSI Rating System) are "unreasonable, arbitrary or unfair" under the Dealer Act because they do not take into account the impact of local customer brand preference. Second, Beck Chevrolet argued that when GM unilaterally altered the dealership's assigned territory, it constituted a prohibited "modification" of the franchise agreement under the Dealer Act.

The court ruled that GM's performance standard was, in fact, in violation of the Dealer Act because "[i]t is unlawful to measure a dealer's sales performance by a standard that fails to consider the desirability of the Chevrolet brand itself as a measure of a dealer's effort and sales ability." The Dealer Act's prohibition of performance standards that are "unreasonable, arbitrary or unfair" depends on case-specific facts, but, as the court stated, "[a]t a minimum [the Dealer Act] forbids the use of standards not based in fact or responsive to market forces because performance benchmarks that reflect a market different from the dealer's sales area cannot be reasonable or fair." GM's standard measures a dealer's sales performance by comparison to a statewide class of dealers, adjusted to reflect certain local market peculiarities with respect to local consumer purchasing preferences for certain vehicle *types.* However, GM specifically chose to exclude from its measure the impact of customer preference with respect to vehicle *brand* in determining the dealer's RSI. Therefore, "those dealers, like Beck, who service an assigned area in which Chevrolet is less popular are disadvantaged when measured against dealers in other parts of the state in which the Chevrolet brand is stronger and facilitates dealer sales performance." As a result, "GM's exclusion of local brand popularity or import bias rendered the standard unreasonable and unfair because these preference factors constitute market challenges that impact a dealer's sales performance differently across the state…[m]easuring the dealer's performance against a market the dealer never faces is not reasonable or fair within the meaning of [the Dealer Act]."

As to the alteration of Beck Chevrolet's assigned territory, however, the court found that the Dealer Act is only concerned with "modifications" that thus result in negative consequences for a dealer. In Beck Chevrolet's case, the change in territory could very well positively impact the dealer over time, and Beck could not show that the alteration was made in bad faith. Thus GM's revision of the franchise agreement as to territory was indeed lawful.

Stuart B. Newman is Chair and Advisor Emeritus of the *Journal*'s Editorial Advisory Board; he and Tyler Silvey are attorneys with the firm Salon Marrow Dyckman Newman & Brody LLP.

Securities Registration

By Guy P. Lander

Avoiding Securities Act Registration in Share-for-Share Business Combinations Between Non-U.S. Companies

If a non-U.S. target company has a shareholder basis that includes a significant percentage of U.S. shareholders, a non-U.S. acquiror must consider the application of the U.S. securities laws. There are, however, ways for the foreign company to avoid registering securities under the Securities Act of 1933.

When one non-U.S. company seeks to acquire another non-U.S. company, it may choose to structure the transaction as a share-for-share business combination. However, if the target company's shareholder base includes a significant percentage of U.S. holders, a share-for-share transaction could trigger various U.S. securities law issues, including a requirement to register the offered shares with the SEC.[1] For example, if a Canadian company seeks to acquire an Argentinian company and the target Argentinian company has U.S. shareholders, the U.S. securities laws could be implicated.

There are several reasons a non-U.S. acquiror may want to avoid registration under the U.S. Securities Act of 1933 (Securities Act): (1) the cost and delay of registration; (2) liability under Sections 11 and 12(a)(2) of the Securities Act for the acquiror's directors, officers, underwriters and others; (3) publicity restrictions under the Securities Act; and (4) the acquiror becoming an SEC reporting company. This article addresses how foreign private issuer (FPI) acquirors might avoid SEC registration for the issuance of the acquiror's securities in share-for-share business combinations (including acquisitions that are essentially mergers) between FPIs that are not registered with the SEC and are not reporting in the United States.

Common Structures Using Shares as Consideration

A non-U.S. (FPI) acquiror may use its shares as consideration in a business combination and structure the transaction in a variety of ways. The most common structures are:

- *Exchange offer*. The acquiring company directly invites stockholders of the target company to exchange securities of the target company for those of the acquiror. Exchange offers are tender offers where the consideration is stock. (This article will not be covering tender offers.)
- *Plan or scheme of arrangement*. The business combination and issuance of acquiror shares is conducted under statutes where a court supervises and approves the fairness of the transaction.
- *Merger of two entities by operation of law*. Where the stockholders of the target company (disappearing company) receive shares of the acquiring company (surviving company) by operation of law.
- *Amalgamation, consolidation or similar transaction*. Typically, a newly formed holding company issues its securities to the stockholders of the constituent companies, which companies then merge into, or are otherwise acquired by, the new holding company.[2]

Each of these transaction structures requires an analysis of how U.S. federal securities laws (among other laws) apply to the transaction. As discussed above, the U.S. securities laws could affect the process and timing of the transaction as well as post-closing obligations of the company.

Determining Whether SEC Registration Is Required

The Registration Requirement

The acquiror's issuance of its securities in exchange for those of the target could trigger a requirement to register the offered shares with the SEC, particularly if the target's shareholder base includes a significant percentage of U.S. stockholders.[3] When non-U.S. companies that are not reporting companies in the U.S. (even those with no U.S. trading market for their securities) engage in share-for-share mergers (or other binding share exchanges), if the transaction is approved by a shareholder vote of the target's shareholders, then the target shareholders will receive consideration consisting of the securities of the acquiring company.

Section 5 of the Securities Act applies broadly to require the registration with the SEC of every offer or sale of securities in the United States, including securities issued in business combinations, unless an exemption is available. Rule 145(a) under the Securities Act extends the terms "offer" and "sale" to include mergers and other business combinations involving the exchange of securities after a shareholder vote. Transactions outside the United States, even if solely between non-U.S. companies, are subject to Section 5 registration if U.S. jurisdictional means are used, which is interpreted very broadly. Consequently, the issuance by the acquiror of its shares to the U.S. target shareholders in exchange for their shares in the target (i.e., acquired in a merger adopted by stockholder vote) would be deemed an offer and sale of the acquiror's securities within the meaning of Rule 145(a) under the Securities Act. So, the registration requirement of the Securities Act would apply to the securities issued by the surviving entity to U.S. stockholders of the target. Accordingly, the issuance of shares by the surviving company would have to be registered under Section 5 of the Securities Act or be exempt from registration.

What Is a "Foreign Private Issuer?"

The SEC's rules make important accommodations in this area for FPIs. An FPI is an issuer other than a foreign government and its political subdivisions formed or organized outside of the U.S. that either:

(1) has 50 percent or less of its outstanding voting securities held of record by U.S. residents or

(2) has more than 50 percent of its outstanding voting securities held of record by U.S. residents but does not have any one of the following:

- (a) a majority of its executive officers or directors are U.S. citizens or residents, or
- (b) more than 50 percent of its assets are located in the U.S. or
- (c) its business is principally administered in the U.S.[4]

Exemptions from Registration

There are numerous exemptions that typically apply in cross-border share-for-share business combinations, which include mergers.

Issuances to Non-U.S. Security Holders of Target Outside the U.S.

The issuance of securities by the FPI acquiror to the non-U.S. shareholders of the FPI target outside the United States may not be subject to registration under the Securities Act by virtue of Regulation S. Generally, Regulation S limits the requirement to register securities with the SEC to the territory of the U.S.[5] Under Regulation S, offers and sales of securities outside the United States do not trigger registration under the Securities Act. Regulation S also sets forth a non-exclusive safe harbor for offers and sales outside the United States (i.e., "Offshore Transactions" as defined in Regulation S) with no publicity or other activity undertaken to condition the market in the United States for the relevant securities (i.e., no "Directed Selling Efforts" in the United States as defined in Regulation S). Other offering restrictions may be required to be implemented, including certain transfer restrictions, depending on the circumstances.[6]

If the acquiror is an FPI with substantial U.S. market interest in its securities, the non-U.S. security holders of the target who receive the acquiror's securities outside the United States under Regulation S may receive those securities with restrictions on their ability to resell the securities in the United States.

Issuances to U.S. Security Holders Inside the U. S.

Rule 802. Rule 802 provides an exemption from the registration requirement of the Securities Act for certain cross-border exchange offers and business combinations where U.S. ownership is 10 percent or less of the relevant class of the securities of the target company and the target is an FPI.[7] Accordingly, if the acquiror issues securities in an exchange offer to U.S. shareholders for the securities of a target that is an FPI (or an exchange of securities for the securities of an FPI in a business combination), the issuance will be exempt from registration under Section 5 of the U.S. Securities Act if the U.S. shareholders hold no more than 10 percent of the subject class of securities and certain other conditions are met.[8]

However, availability of Rule 802 is subject to the following conditions, among others:

- *Disclosure*. There is no specific information that must be provided under Rule 802. If any document or other information concerning the exchange offer (or business combination) is provided to offeree security holders of the non-U.S. target, an English version must be provided to the SEC (for notice purposes only) on Form CB. Financial Statements prepared under local GAAP that are submitted under Form CB need not be reconciled to U.S. GAAP. Information must be disseminated to offeree security holders of the non-U.S. target (with certain legends) on at least a comparable basis to that provided to security holders in the home jurisdiction. If the acquiror disseminates information by publication in its home jurisdiction, it must publish the information in the United States in a manner reasonably calculated to inform U.S. holders.[9]
- *SEC Filings: Form CB and Form F-X*. The bidder must submit to (but not file with) the SEC for notice purposes, under cover of Form CB, a copy of any information (and any amendments) in English that it disseminates to security holders in the exchange offer. Form CB must be submitted no later than the first business day after dissemination to security holders. A foreign company must also file with the SEC a Form F-X, appointment of agent for service of process in the United States, with Form CB.[10]
- *Transfer Restrictions*. If the securities subject to the Rule 802 were "unrestricted" under Rule 144, the new securities are also unrestricted. If the securities were "restricted," the new securities issued under Rule 802 will also be restricted.[11]

Private Placement*: *Section 4(a)(2). The issuance of securities by the acquiror in an exchange offer (or other business combination) may qualify for a private placement exemption under the Securities Act. Section 4(a)(2) of the Securities Act exempts private placement transactions from the registration requirement of the Securities Act, and Rule 506 of Regulation D is the safe harbor under Section 4(a)(2).

To determine that the issuance of securities in an exchange offer (or other business combination) does not involve a "public offering" under Rule 506 and is, therefore exempt from registration, the acquiror must either (1) establish the identities of the U.S. security holders of the target (this may be possible where the number of securities holders is small and manageable), or (2) require that all U.S. security holders who tender their securities in connection with the business combination certify that they are accredited investors in order to receive the acquiror's securities (failing which they can only receive cash).

The acquiring company could place restrictions on the types of U.S. stockholders who may receive the acquiror's shares. For example, the acquiring company could restrict the issuance of its shares to U.S. stockholders of the target company to only those that are qualified institutional buyers. However, this approach may not be practicable because of the procedural measures required to implement it and because it may be prohibited under the home-country laws of one or both of the companies involved.[12]

So, if the number of U.S. security holders is small and manageable, the issuance of acquiror shares might be structured as a private placement. Generally, a Section 4(a)(2) and Rule 506 private placement may be used because Rule 506 preempts state securities ("blue sky") laws (except for notice and fees to the states). However, for the acquiror to avoid providing to investors the information otherwise required under Rule 506 (e.g., U.S. GAAP reconciliation), all the U.S. holders of target shares must be accredited.[13]

- *Disclosure*. If all of the security holders of the target are accredited investors, the issuance of securities will not be subject to any disclosure requirements (other than the general anti-fraud provisions).[14] But, if there is at least one non-accredited investor in the target security holder group, the acquiror would be required to provide disclosure meeting the requirements of a full prospectus to the non-accredited investor(s) (and, to avoid selective disclosure or other fraud issues, to all other target security holders).

- *Transfer Restrictions*. The securities issued to target security holders in a private placement under Section 4(a)(2) and Rule 506 of Regulation D will be "restricted securities." Holders of restricted securities may resell their securities only outside the United States in an offshore transaction pursuant to Regulation S, or pursuant to a registration statement covering their securities or inside the United States pursuant to an exemption such as Rule 144.[15]

Rule 904 of Regulation S permits holders of restricted securities to resell their securities to purchasers outside the United States or through certain offshore securities markets without imposing any holding periods subject to any initial Regulation S distribution compliance period.[16] Consequently, holders of restricted securities may be able to resell their securities by executing their trade through an offshore stock exchange so long as the transaction has not been pre-arranged with a purchaser in the United States.[17]

Rule 144 imposes a minimum one-year holding period. Sales by non-affiliates of the acquiror could be effected following a lapse of the one-year holding period. Once the one year has elapsed, sales of restricted securities can be made freely in the United States by non-affiliates under Rule 144.[18]

Issuances to Security Holders of Both a Non-U.S. Target and U.S. Target

Section 3(a)(10) of the Securities Act provides an exemption from registration for the issuance of the acquiror's shares in exchange for the shares of the target if the fairness of the terms of the exchange are approved by a court after a hearing open to all recipients of securities issued in the exchange. The SEC has granted Section 3(a)(10) no-action relief for numerous cross-border transactions, including schemes of arrangement or similar statutory arrangements involving a vote of affected security-holders, a court-convened meeting of those security holders and a subsequent court ruling on the fairness of the transaction. Generally, the Section 3(a)(10) exemption would be available under the laws of various UK commonwealth countries, e.g., Australia, Bermuda, BVI, Canada, Cayman, England, Hong Kong, Ireland and South Africa.[19] However, it has not generally extended similar relief to statutory mergers under the laws of continental Europe, Latin America or other jurisdictions.[20]

The necessary elements for a valid exemption under Section 3(a)(10) are as follows:

(A) The securities must be issued in exchange for securities, claims, or property interests; they cannot be offered for cash.[21]

(B) A court or authorized governmental entity must approve the fairness of the terms and conditions of the exchange.[22]

(C) The reviewing court or authorized governmental entity must:

   (1) find, before approving the transaction, that the terms and conditions of the exchange are fair to those to whom securities will be issued;[23] and

(2) be advised before the hearing that the issuer will rely on the Section 3(a)(10) exemption based on the court's or authorized governmental entity's approval of the transaction.

(D) The court or authorized governmental entity must hold a hearing before approving the fairness of the terms and conditions of the transaction.

(E) The court or governmental entity must be expressly authorized by law to hold the hearing, although it is not necessary that the law require the hearing.

(F) The fairness hearing must be open to all persons to whom securities would be issued in the proposed exchange.

(G) Adequate notice must be given to all those persons.

(H) There cannot be any improper impediments to the appearance by those persons at the hearing.[24]

The key consideration is whether "those to whom securities will be issued," i.e., the target's security holders, are treated fairly.

The acquiror must confirm that the issuance of its common shares in exchange for the target shares will be covered (i.e., exempt or qualified) in each state in which a U.S. holder is located.[25]

Subsequent exercise of convertible securities. If options, warrants or other convertible securities are issued by the acquiror, Section 3(a)(10) does not provide an exemption for their later exercise. The later exercise of the acquiror's options, warrants or other convertible securities by holders in the United States is viewed as a second, separate investment decision and purchase that must be registered or exempt. For this reason, options, warrants and convertible securities issued in transactions intended to qualify under Section 3(a)(10) are often structured so that they may not be exercised for a year or more, relying on the general view that the issuance of such an option, warrant or convertible security does not involve the present or concurrent offering of the underlying security. Another way to handle this is to rely on the Rule 506 private placement exemption to cover the subsequent exercise if the exercising holder is accredited and the exercise otherwise meets the requirements for the exemption. In that case, a standard private placement purchaser letter is typically used to cover the exemption.[26]

Alternative Structures

Avoiding U.S. Jurisdictional Means—Exclusionary Offers

The exchange offer or merger could be structured in a so-called "exclusionary" manner (making an offer not open to U.S. residents, i.e., excluding U.S. shareholders) that would avoid the use of U.S. jurisdictional means, and thereby avoid the application of U.S. securities laws, because the laws and regulations only apply to offers made in the United States.[27] However, this may be impractical or prohibited under the home-country laws of one or both of the companies involved.

If the number of shares owned by U.S. holders is sufficiently small, making acquisitions of the shares held by such persons unnecessary to the successful conclusion of the acquiror's tender offer or exchange offer, the acquiror may elect to avoid the cost and difficulty of compliance with the U.S. securities law in connection with the acquisition by making an offer that is not open to U.S. residents. This is frequently done by non-U.S. bidders. In fact, the SEC has observed that this exclusion of U.S. investors is the non-U.S. bidder's method of choice in situations in which U.S. share holdings are not necessary for the success of the acquisition. The non-U.S. bidder, in this way, is able to avoid (1) the costs of complying with U.S. laws (which outweigh the benefit of U.S. security holder participation), and (2) registering the non-U.S. acquiror's securities with the SEC under the Securities Act and incurring a continuous reporting obligation under the Exchange Act.

Cash Offers

Cashing out target company shareholders avoids making an offer or sale of acquirors' securities. In stock-for-stock transactions, acquiror companies generally wish to minimize the cash consideration paid in the transaction. However, the acquiror may wish to offer cash consideration to the U.S. security holders of the target if the acquiror determines that only a limited number of target security holders are U.S. holders. By extending a cash only offer to the U.S. holders, the acquiror will be able to avoid the cost and difficulty of preparing a registration statement under the Securities Act.

However, the laws of the home jurisdiction of the acquiror or the target may prohibit different treatment of the target's security holders, i.e., with some holders offered the acquiror's securities and other holders (i.e., the U.S. holders) offered cash. Additionally, although the registration requirement of the Securities Act may not apply, the acquiror may have to comply with the tender offer rules of the Exchange Act for a cash tender offer extended to U.S. holders.

Cashing Out U.S. Target Holders

The acquiror may be able to acquire the target securities from U.S. security holders without filing a registration statement by using a "vendor placement." In a vendor placement, the acquiror issues its securities (that would otherwise be issued to the U.S. security holders of the target) to a third-party trustee that is a non-U.S. financial institution. The trustee is instructed by the acquiror to pool the acquiror's securities for all the U.S. security holders of the target and to sell those securities offshore that would have been issued to the U.S. security holders. After the sale, the trustee remits to each U.S. security holder the proceeds from the sale of the acquiror's securities that would have been issued to the U.S. security holder net of all expenses for the sale. A vendor placement requires that the non-U.S. trading market for the acquiror's securities is sufficiently liquid for the sale by the trustee. In effect, the vendor placement converts an exchange offer including the acquiror's securities (which would have required Securities Act registration) into an offer solely for cash (which does not require registration).[28]

If the acquiror concludes that a substantial number of target securities are held by U.S. holders who are not "accredited investors" and that the acquisition of the target securities from those U.S. non-accredited investors is necessary for a successful acquisition, then a vendor placement may be appropriate.[29]

Other Considerations

The above list is not exclusive. An exchange offer may qualify for other exemptions from Securities Act registration. Additionally, a transaction may be structured to rely on several exemptions.[30] However, exemptions from registration are strictly construed and the burden of proof is on the issuer claiming the exemption. As a result, an issuer must take precautions when offering and selling securities under an exemption to ensure, if assessed at a later date, that the facts surrounding the issuance supported such an exemption.[31] Whether a particular exemption will be relied on depends on the facts and circumstances of the proposed transaction, including whether reliance is: (1) permitted under the equal treatment principles (and other provisions) of the corporate and other home country laws and practices of the companies involved; (2) feasible from a technical or mechanical perspective, including in light of the level of the target's U.S. ownership; (3) desirable from a marketing or investor relations perspective; and (4) likely to affect the chances of the proposed transaction being consummated.[32]

Registration

The offered shares could be registered, but registration is time consuming and expensive and will also result in the surviving company becoming a reporting company, with various disclosure, compliance and other obligations. The registration statement for business combinations generally is Form F-4, which is used to both register the shares issued and as a proxy statement. The MJDS is also available to eligible Canadian companies.[33]

No Tender Offer Regulation

Generally, a business combination effected by a merger (or similar binding share exchange) carried out through a statutory transaction involves a shareholder vote under local law. Generally, approval is required by the target company's board and its shareholders. In these kinds of business combinations, the tender offer provisions of the Exchange Act do not apply because no purchase offer is being made directly to individual target shareholders. Consequently, the merger (or similar binding share exchange) would not be subject to U.S. tender offer regulation.[34] However, if a transaction is structured as a tender offer, the tender offer regulations will apply (unless an exemption is available).

Other SEC Regulations

Exemption from U.S. Proxy Regulation

In a share-for-share exchange, the target will not be required to comply with U.S. proxy regulation for its offering circular if, as discussed above, it is an FPI. FPIs are exempt from the proxy rules of Section 14 of the Exchange Act.[35]

Regulation M

Regulation M under the Exchange Act generally prohibits participants (including the issuer and any affiliated purchaser) in a "distribution" from bidding for, purchasing or attempting to induce any person to bid for or purchase, a covered security (i.e., a security subject to a distribution and any reference security) during the applicable restricted period.[36] Generally, Regulation M applies to distributions of securities in connection with mergers, share exchanges and similar business combinations by prohibiting purchases of the offeror's shares (or other similar transactions) by the offeror and related persons during the restricted period.[37] Therefore, in an exchange transaction, such as discussed here, procedures may need to be implemented by the acquiror to ensure compliance with Regulation M. For example, the acquiror may need to terminate or suspend any share buyback or similar program.

The restricted period generally begins when proxy or offering materials are first disseminated and ends at the time of the shareholder vote or the expiration of the offer.[38]

Antifraud Provisions

Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and similar U.S. state laws prohibit manipulation, fraud and misleading statements or omissions in connection with the purchase or sale of any security. These laws apply to business combinations.

Endnotes

1. *See* 1 Edward F. Greene, et al., *U.S. Regulation of the International Securities and Derivatives Markets*, at 9-40 n.125 (10th ed. 2013).

2. Alan P.W. Konevsky, *Share-for-Share Business Combinations Between Non-U.S. Companies: SEC Registration and its Consequences*, Practical Law (Aug. 4, 2011), http://us.practicallaw.com/3-505-8131. Business combinations providing a choice between cash consideration and shares, or consideration consisting of both cash and shares, would likely raise many of the same considerations as share-for-share transactions. *Id.*

3. *See* 1 Greene, *supra* note 1.

4. 17 C.F.R. § 230.405. Generally, the acquirer must "look through" the record ownership of certain securities brokerage firms, banks or other nominees holding securities of the target for the accounts of their customers to determine the percentage of the securities held in nominee accounts that have U.S. addresses. To determine the percentage of outstanding voting securities held by U.S. residents:

   (a) The issuer must use the "look through" method of calculating record ownership in Rule 12g3-2(a) under the Securities Exchange Act of 1934, except that its inquiry as to the amount of voting securities held in accounts of U.S. residents may be limited to voting securities held of record by broker-dealers, banks, and other nominees located in: (i) the United States, (ii) the issuer's jurisdiction of incorporation, and (iii) the primary trading market for the issuer's voting securities, if different than the issuer's jurisdiction of incorporation.

   (b) If, after reasonable inquiry, the issuer cannot obtain information from the nominee about the amount of voting securities represented by accounts of U.S. residents, including where a nominee's charge for supplying this information would be unreasonable, the issuer may presume, for purposes of the definition of foreign private issuer, that the customers are residents of the jurisdiction where the nominee has its principal place of business.

   (c) Nevertheless, the issuer must count shares of voting securities as beneficially owned by U.S. residents as stated in beneficial ownership reports that are provided to the issuer or filed publicly, or based on beneficial ownership information otherwise provided to the issuer.

5. Rule 901.

6. *See* Rules 901-905. Securities may be offered and sold outside the United States at the same time they are offered and sold in the country under an exemption such as Rule 802 or Regulation D.

7. Rule 802(a)(1).

8. However, where a U.S. state or jurisdiction does not provide an exemption comparable to Rule 802, thereby requiring registration or qualification, the bidder may exclude security holders in that state or jurisdiction if a cash-only alternative is not being offered in any other state or jurisdiction (whether inside or outside the United States). However, if a cash-only alternative is being offered anywhere, the bidder must offer the same cash-only alternative to security holders in any U.S. state or jurisdiction that would require registration. Similarly, "loan notes" (used abroad to defer capital gains taxes) need not be offered to U.S. shareholders since the tax benefits they provide are not available in the U.S.

   Under Rule 802, an "exchange offer" is a tender offer where securities are issued as consideration, and a "business combination" is a statutory amalgamation, merger, arrangement, or other reorganization requiring the vote of security holders of one or more of the participating companies. Under Rule 802, the term "business combination" also includes a statutory short form merger that does not require a vote of security holders. For an amalgamation (i.e., a business combination where the securities will be issued by a successor company to all participating companies), all participants in the business combination must be foreign private issuers. Cross-Border Adopting Release, Release No. 34-52054(Oct. 22, 1999).

9. Rule 802(a)(3)(i)–(iii).

10. To summarize, the conditions of Rule 802 are as follows:

    a. Generally, U.S. holders must participate in the exchange offer on terms at least as favorable as those offered to foreign holders. This includes a consideration of procedural, durational, pro rationing, and withdrawal right concerns.

    b. If the bidder disseminates any information concerning the exchange offer to security holders in Canada, it must disseminate copies of that information (and any amendments) to U.S. security holders in English on at least a comparable basis to that provided to the security holders in Canada. If the bidder disseminates the information solely by publication in Canada, it must publish that information in the United States in a manner reasonably calculated to inform U.S. security holders of the offer. Of course, the bidder may always mail the information to U.S. security holders. The bidder must provide the information to U.S. security holders when it provides the information to home jurisdiction security holders.

    c. A legend must be included in any information the bidder disseminates to U.S. security holders stating, among other things, that the exchange offer is being conducted under foreign disclosure requirements, and that those requirements may differ from U.S. disclosure requirements, including financial statement requirements.

11. General Note 8 to Rules 800-802.

12. *See* Konevsky, *supra* note 2.

13. Rule 502(b)(1).

14. *See id.*

15. Rule 502(d).

16. *See* Rules 901 and 904(a).

17. Rule 904(b).

18. Rule 144(d)(ii).

19. *See, e.g.*, Constellation Brands, Inc., SEC No-Action Letter, 2003 WL 215032, at *1 (Jan. 29, 2003) (approving an Australian court's fairness determination); Weatherford Int'l, Ltd., SEC No-Action Letter, 2009 WL 142326, at *1 (Jan. 14, 2009) (approving a Bermuda court's fairness determination); Digicon Inc. Veritas Energy Servs. Inc., SEC No-Action Letter, 1996 WL 475801, at *6 (Aug. 19, 1996) (approving a Canadian court's fairness determination); Transocean Inc., SEC No-Action Letter, 2007 WL 2838963, at *2 (Sept. 26, 2007) (approving a Cayman court's fairness determination); Lucas Industries plc, SEC No-Action Letter, 1991 WL 473389 (Aug. 20, 1991) (the Highest Court of Justice in England); The Hongkong and Shanghai Banking Corp., Ltd., SEC No-Action Letter, 1991 WL 176538, at *1 (Jan. 23, 1991) (approving a Hong Kong court's fairness determination); Galen Holding PLC, SEC No-Action Letter, 2000 WL 1234277 (Aug. 7, 2000) (the High Court of the Republic of Ireland); Buffelsfontein Gold Mining Co. Ltd., SEC No-Action Letter, 1996 WL 167738, at *1 (April 9, 1996) (approving a South African court's fairness determination).

20. There are exceptions to this general posture. *See* SanDisk Corp., SEC No-Action Letter, 2006 WL 2805149, at *1 (Sept. 21, 2006) (approving an Israeli court's fairness determination); AngloGold Ltd., SEC No-Action Letter, 2004 WL 111629, at *1 (Jan. 15, 2003) (approving a Ghanaian court's fairness determination).

21. Section 3(a)(10) also exempts sales of securities that are "partly in such exchange and partly for cash.…" The SEC takes the position that § 3(a)(10) exempts transactions that are predominantly exchanges and that the "partly for cash" language is intended merely to permit flexibility in structuring those exchanges. Because this analysis necessarily would be very fact-specific, if this issue is presented in a transaction, the issuer should request no-action

relief from the SEC for that transaction. SEC Staff Legal Bulletin No. 3A (CF), n.6 (June 18, 2008) http://www.sec.gov/interps/legal/cfslb3a.htm.

22. Authorized governmental entities may include state insurance commissions, state corporation or securities commissions, state banking agencies, etc. SEC Staff Legal Bulletin No. 3A (CF), n.7.

23. In the SEC's view, the reviewing court or authorized governmental entity must find the terms and conditions of the exchange to be fair both procedurally and substantively. SEC Staff Legal Bulletin No. 3A (CF), n.8.

24. *See* Securities Act Section 3(a)(10); SEC Staff Legal Bulletin No. 3A (CF), n.5.

25. The National Securities Markets Improvement Act of 1996 (NSMIA) preempts state law from requiring the registration of "covered securities." Although the scope of the term "covered securities" is expansive, the NSMIA specifically removes securities issued pursuant to § 3(a)(10) from protection from State blue-sky laws, thus necessitating compliance from the issuer.

26. *See* Securities Act Section 3(a)(10); SEC Staff Legal Bulletin No. 3A (CF).

27. *See* Cross-Border Tender and Exchange Offers, Business Combinations and Rights Offerings, Securities Act Release No. 7759, Release No. 34-42054 (Nov. 10, 1999).

28. *See* Commission and Revisions to the Cross-Border Tender Offer, Exchange Offer, Rights Offerings, and Business Combination Rules and Beneficial Ownership Reporting Rules for Certain Foreign Institutions, Release No. 33-8957 (Oct. 9, 2008). Note: In 2008, the SEC published a release reiterating that cash offers under Tier I were available and announcing that it does not intend to issue no-action letters about vendor placement regarding registration requirements in the future. *Id.* at 116.

29. *See id.* at II.G.3; Konevsky, *supra* note 2; 1 Greene, *supra* note 1, at 9-41 n.126.

30. Konevsky, *supra* note 2, at 3.

31. SEC Division of Corporate Finance, Accessing the U.S. Capital Markets–Overview for Foreign Private Issuers, at IV (Feb. 13, 2013), https://www.sec.gov/divisions/corpfin/internatl/foreign-private-issuers-overview.shtml.

32. *See* Konevsky, *supra* note 2, at 3.

33. Multijurisdictional Disclosure and Modifications to the Current Registration and Reporting System for Canadian Issuers, Release No. 33-6902 (June 21, 1991).

34. *See* John M. Basnage, Cross-Border Tender Offers and Other Business Combinations Exemptions, http://us.practicallaw.com/1-500-6746; 1 Greene, *supra* note 1, at 9-44. *But see* SEC Securities Act Rule, 17 C.F.R. § 230.165(f)(1). As defined in Rule 165(f)(1), a "business combination transaction" is: (a) a transaction specified in Rule 145(a) under the Securities Act (which applies to certain mergers, reclassifications, consolidations, and transfers of assets where security holders are asked to vote or consent); or (b) an exchange offer.

35. *See* Rule 3a12-3(b) (exempting foreign private issuers from the SEC's proxy rules).

36. Rule 101(a).

37. Rule 102. For the purposes of purchasing the acquirer's securities pursuant to a merger agreement, the target company is considered an "affiliated purchaser" and is within the scope of Regulation M. However, both the acquirer and the target may purchase the target's securities without being within the regulation (provided the value of the acquirer's securities are not somehow linked to that of the target's securities). *See* SEC Staff Legal Bulletin No. 9 (Sept. 10, 2010).

38. Rule 100.

Guy P. Lander is a partner at Carter Ledyard & Milburn LLP in New York, N.A. Mr. Lander practices corporate and securities law representing international and U.S. companies and financial institutions. His practice emphasizes a wide range of financial transactions, including U.S. and international public and private offerings of debt and equity, Rule 144A placements, Regulation S cross-border offerings, MJDS offerings, listing companies on U.S. exchanges, tender and exchange offers, mergers, and acquisitions. Mr. Lander's practice includes providing corporate governance and other advice to a wide variety of corporations and financial institutions. He also devotes a significant part of his time to regulatory matters for U.S. and international securities brokerage firms, investment advisers and hedge funds advising on their registration, structuring, documentation, compliance, business activities and significant transactions. He has authored four books on securities law. Mr. Lander is the former Chair of the Committee on Securities Regulation of the NYSBA Business Law Section, Chair of the Business Law Section of the NYSBA and Chairman of the Subcommittee on Disclosure and Continuous Reporting of the Committee on Federal Regulation of Securities of the American Bar Association.

Disclosure Schedules in Acquisition Transactions

By Joseph V. Cuomo and Allison W. Rosenzweig

Disclosure schedules play an important role in all acquisition agreements (whether it is an asset purchase agreement, stock purchase agreement or merger agreement). Schedules are generally related to the representations and warranties ("reps and warranties") made by the seller in the acquisition agreement. Reps and warranties are assertions of fact that the seller, and to a lesser extent, the buyer make about themselves and their businesses. Schedules are an extension of the agreement and add caveats and exceptions to the reps and warranties or disclose instances in which the reps and warranties are not true. Compiling the necessary information and preparing the schedules is one of the most time consuming aspects of an acquisition transaction. It is essential that the schedules are carefully prepared and reviewed because any inaccuracies or incomplete information could leave the seller potentially liable for breaches of the acquisition agreement.

This article sets forth general information about disclosure schedules, why these schedules are necessary and how they are prepared, as well as the importance of the schedules to the seller. It is hoped this article can serve as a guide for any individual, including the seller business person or a junior attorney, managing the disclosure schedule process.

1. Why Are Disclosure Schedules Necessary?

The reps and warranties in the acquisition agreement govern how detailed the disclosure schedules need to be. The seller's reps and warranties in the acquisition agreement are almost always significantly more extensive than the buyer's, and, accordingly, the seller almost always has to prepare more schedules than the buyer. This disclosure schedule process allows the buyer to better understand the target company being acquired.

The main reasons disclosure schedules are necessary are that they further the due diligence process and disclose information about the business in all aspects. The buyer is relying on the statements in the schedules to determine the target's condition, including its financial and legal condition. The reps and warranties, and the related schedules, help the buyer identify possible risks affecting the target company. If the disclosures are incomplete, inaccurate or reveal unfavorable information, the buyer may kill the deal or adjust the purchase price accordingly.

Schedules contain disclosures that are fact specific and either list information in accordance with ("as set forth in the schedules") or as an exception to ("except as set forth in the schedules") the reps and warranties in the acquisition agreement. A list schedule gives the buyer the full picture. These schedules may provide details relating to material contracts, intellectual property, leased or owned real property, assets owned, ownership of the company, key customers, legal proceedings and many other categories of company information. An exception schedule limits the scope of the seller's reps and warranties, and, as a result, may limit the seller's potential liability. For example, the agreement may state that "the seller requires no consents, permits or approvals in connection with the execution of this agreement, *except as set forth on Schedule* ___." A schedule would then be prepared detailing all of the consents, permits or approvals needed in order to consummate the acquisition agreement (and if the answer is none, the appropriate schedule should simply state "None").

The lawyer representing the seller may want to negotiate with the buyer's counsel to add qualifiers to the reps and warranties in the acquisition agreement. Qualifiers such as "to the best of seller's knowledge" or "except those that would not have a material adverse effect" narrow the reps and warranties. As discussed below, the more a seller promises is true in the reps and warranties, the more opportunities the buyer has to claim a breach of the agreement and seek damages. Narrowing the reps and warranties limits the seller's potential liability.

2. Process for Preparing Disclosure Schedules

a. Drafting and Negotiation

The reps and warranties section of the acquisition agreement is often the longest. This section also requires the most time-consuming and laborious action since the disclosure schedules need to be prepared in accordance with the reps and warranties. Preparation of the schedules typically occurs concurrently with the negotiation of the acquisition agreement.

The first draft of the schedules will generally be based on the first draft of the acquisition agreement. Typically, the buyer's attorneys will prepare the first draft of the acquisition agreement. Once the agreement has been reviewed by the seller's counsel, the seller's counsel will typically start to prepare the initial schedules—a separate page or pages for each schedule mentioned in the agreement—in correlation with the reps and warranties and the list of required schedules set forth in the agreement, and include instructions to the seller in brackets "[ ]." The instructions will be either a copy-and-paste or reworded description of the related disclosure requirement in the agreement. To make it easier for the seller's review, the instructions are often highlighted.

Once the initial set of schedules with instructions has been prepared and sent to the seller, the seller must gather the information related to each schedule. This information-gathering process may include discussions with the seller's accountant, CFO, or employees in different departments of the company to identify the items that need to be included in the disclosure schedules or excluded from the reps and warranties. Either the seller, the seller's counsel or the seller's accountant compiles the information and places it into the appropriate schedule. Once the schedule has been answered, the highlighted instructions should be removed, leaving only the disclosures. Regardless of who prepares the initial draft of the disclosure schedules, it is essential that the seller review the schedules with care. The seller's business people have a much deeper understanding of the facts and conditions of their company. Prior to sending the schedules to the buyer, the seller's counsel must also review the schedules to ensure that the information appropriately and completely answers the disclosure requirements in the agreement and is displayed professionally. As the seller's counsel sends each draft of the schedules to the buyer's side, the seller's counsel should reserve the right for the seller to update the schedules prior to closing.

As part of the buyer's review of the schedules, the buyer will add comments or questions to the disclosures, asking the seller to add, elaborate or explain certain items. Sometimes the buyer will include a comment to the seller related to information that the buyer learned during the due diligence process. The schedules will then be sent back to the seller for another round of adjusting and eventually for completion.

As the seller and the buyer continue to negotiate the acquisition agreement, the schedules will be adjusted accordingly, going through the back-and-forth review process of the seller's side, then the buyer's side, and then back to the seller for revisions. During the negotiation process, some schedules may be added or removed; some schedules may be expanded or qualified in the agreement; and some schedules may be turned into separate agreements entirely. The disclosure schedules must be adjusted to reflect the changes to the agreement as the agreement progresses to completion.

It is important for the seller and the seller's counsel to constantly review the reps and warranties. Together, they must identify the reps and warranties that are untrue, misleading or inaccurate. If the acquisition agreement includes a rep and warranty with no reference to a schedule, but the seller has something to disclose related to that rep, a new schedule should be added and the appropriate words must be included in the agreement. The misleading reps and warranties must be corrected or qualified with a schedule.

The acquisition agreement may be negotiated to include some qualifiers (i.e., to the best of the seller's knowledge). If the agreement includes these qualifiers, it is important that the disclosure schedules do not contain additional qualifiers. To have the agreement limit disclosure with a qualifier, and then have the seller prepare the disclosure schedules with additional qualifiers would be "double dipping," which likely will be offensive to the buyer and its counsel.

b. Who Prepares the Schedules

The schedules may be prepared by the seller, the seller's counsel or the seller's accountant. There are several things to consider when deciding who will prepare the disclosure schedules.

The seller is the likely choice to prepare the disclosure schedules for several reasons. Nobody knows the business like the owner of the business. The seller is in the best position to know specific facts about its business, and to know the right person who would have the relevant information. If the seller takes the responsibility of preparing the schedules, the lawyer's role is to make sure that his or her client understands all of the representations that they are making. The lawyer should also review the schedules and ensure that all necessary information that the lawyer is aware of is included in the disclosures. It is likely, however, that the seller has never been involved in an acquisition transaction before. As a result, the seller may be unfamiliar with the disclosure schedule process, which may result in unprofessional or incomplete schedules, and may delay the preparation of the schedules and the closing of the deal.

The seller's counsel typically takes the role of overseeing and coordinating the preparation process and reviewing the schedules, but counsel may sometimes be in the best position to prepare the schedules, as well. Junior attorneys typically take the lead in the schedule preparation, and the senior attorney or partner will review the junior attorney's work. The attorneys know what information or documents to look for in the data room; what the agreement is asking for; and the meaning of terms used in the agreement that a business person may not completely understand.

Finally, the seller's accountant is another option to prepare the disclosure schedules. The accountant is an educated member of the seller's team who knows the financial and tax specifics of the company. The accountant may have a long-standing relationship with the seller, and may be in a good position to confirm company information. Accountants, like attorneys, are also skilled at the careful and detail-oriented (and often tedious) work required to move through the schedule process. During certain times of year, such as the accountant's "busy tax season," the accountant may ask that the attorney take the lead role in schedule preparation, if the client cannot.

3. Importance of Disclosure Schedules to the Seller

Since the disclosure schedules directly relate to the reps and warranties in the acquisition agreement, should the buyer incur any losses post-closing due to information the seller failed to disclose or inaccurately disclosed, the buyer may have legal recourse against the seller. For this reason, it is extremely important for the seller to prepare the schedules with precision.

Sellers typically approach schedule preparation in one of two ways: (1) wanting to overdisclose to protect themselves or (2) wanting to keep bad news hidden from the buyer by not including information on the schedules. Overdisclosing in the schedules may alarm the buyer because the sheer volume of information disclosed may lead the buyer to think the target company has a lot of issues. Overdisclosing is helpful to the seller, however, as overdisclosing reduces the seller's risk of liability for breaching its reps and warranties.

It is not encouraged for a seller to keep information hidden from the buyer by excluding it from the disclosure schedules or burying it in tremendous lists. By not disclosing information on the schedules, the seller is leaving itself open to potential liability. Just telling the buyer information, either during due diligence or in passing, does not relieve the seller from the obligation to include such information on the disclosure schedule. The same is true for giving the buyer access to the data room—it is not enough; the information must also be included on the schedules. Further, including bad or surprising information on disclosure schedules without any verbal or prior notice to the buyer may result in a breakdown of trust, and may kill the deal. A good practice is for the seller to have a conversation with the buyer about sensitive matters early on in the transaction process.

Intentional failure to disclose material information can raise fraud concerns and subject the seller's senior executives and, in extreme instances, its counsel to liability and even criminal exposure. Serious ethical issues may result as well. Counsel should encourage clients that this type of conduct must be avoided without exception.

a. Qualifiers

Instead of excluding information from the disclosure schedules, the seller's attorney may negotiate to include qualifiers to the reps and warranties in the acquisition agreement. As mentioned above, narrowing the reps and warranties limits the seller's potential liability. Qualifiers may also reduce the laborious preparation process. Qualifiers change the information that is required to be included in the disclosure schedule. For example, instead of a rep and warranty asking to list all of the contracts entered into by the target company, the lawyers could negotiate to add a qualifier, such as "all contracts that exceed $10,000," in order to make the disclosures list shorter. This is helpful to both the seller and the buyer. Adding qualifiers minimizes the amount of time spent preparing schedules because the preparer no longer has to produce every single applicable thing, and it also makes it easier for the buyer to identify the material items.

b. Indemnification

As mentioned throughout this article, the disclosure schedules play an important role in the seller's potential liability post-closing. A seller's breach of the reps and warranties that creates liability or loss for the buyer post-closing will likely result in the seller's obligation to indemnify the buyer (subject to the terms of the acquisition agreement). If the agreement contains provisions for a holdback amount or earnouts, the seller should be even more aware of the impact of improperly prepared disclosure schedules. If these provisions are included in the acquisition agreement and there are issues related to the seller's reps and warranties, the buyer may be able to exercise "self help" and keep some of the purchase price that was originally due to the seller.

4. Conclusion

The reps and warranties are usually the most voluminous portion of the acquisition agreement. Accordingly, the related disclosure schedules are an integral part of any acquisition. The seller's team must carefully manage the process of preparing and reviewing the schedules due to the high level of specificity and precision needed to complete the disclosures. The schedules may play an important role in the seller's potential liability post-closing.

Joseph V. Cuomo is the Co-Chair of the Corporate and Commercial Law Department of the Long Island-based firm Forchelli, Curto, Deegan, Schwartz, Mineo & Terrana LLP. He concentrates his practice on the representation of private and public companies and emerging businesses with respect to business law and transactional matters. Allison W. Rosenzweig is an associate with the firm.

Recent Employment Laws Impacting Private Employers in New York

By Sharon Parella

1. Introduction

Recently, the New York City Council and the New York State Legislature enacted two new laws that significantly impact private employers and their workplaces. First, the New York City Council's amendment to the New York City Human Rights Law prohibits discrimination against caregivers. Second, the New York State Legislature's new paid family leave law provides substantial benefits for eligible employees. In addition, the New York City Commission on Human Rights has released a comprehensive Legal Enforcement Guidance on issues relating to discrimination based on gender identity and gender expression. Furthermore, the Equal Employment Opportunity Commission has issued an extensive resource document on employer-provided leave as a reasonable accommodation under the federal Americans with Disabilities Act.

A summary of these laws and guidelines is set forth below.

2. New York City Council

a. Prohibition of Discrimination Against Caregivers

Effective May 4, 2016, an amendment to the New York City Human Rights Law[1] prohibits workplace discrimination against employees based on their actual or perceived "caregiver status."[2] Under this new law, a "caregiver" is defined as a person who provides direct and ongoing care for (i) a child under eighteen (18) years of age, or (ii) a "care recipient."[3] In this connection, a "care recipient" is defined as a person who has a disability, relies on the caregiver for medical care or to meet the needs of daily living, and is:

(i) the caregiver's child of any age (including a biological, adopted or foster child, a legal ward or a child of a caregiver standing *in loco parentis*);

(ii) the caregiver's spouse;

(iii) the caregiver's domestic partner;

(iv) the caregiver's parent (including a biological, foster, step- or adoptive parent, legal guardian or a person who stood *in loco parentis* when the caregiver was a minor child);

(v) the caregiver's sibling (including half-siblings, step-siblings and siblings related through adoption);

(vi) the caregiver's grandchild;

(vii) the caregiver's grandparent;

(viii) a child of the caregiver's spouse or domestic partner;

(ix) a parent of the caregiver's spouse or domestic partner;

(x) a person who resides in the caregiver's household; or

(xi) a person in a familial relationship with the caregiver as designated by the rules of the New York City Commission on Human Rights ("NYCCHR").[4]

In its effort to eradicate employers' negative assumptions about a caregiver's commitment or ability as an employee, among the protections for caregivers under the law the NYCCHR has particularly emphasized the issues of flexible scheduling and accommodations. Specifically, while the new law does not require employers to provide either flexible scheduling or accommodations (which may be available to caregivers under the New York City Earned Sick Time Act and / or the federal Family and Medical Leave Act), the NYCCHR has stated that "[e]mployers cannot provide certain benefits, like flexible scheduling, to some employees and refuse to provide the same benefits to employees who request them because of their caregiving responsibilities."[5] With respect to flexible scheduling, the NYCCHR has provided the following example that would likely constitute a violation under the new law:

> An employee works as a medical assistant for a small medical practice. Two months ago, the employee's husband was diagnosed with cancer. For the next six weeks, the employee's husband will be attending twice weekly chemotherapy appointments in the morning before the employee goes to work. The employee asked her office manager if she could arrive up to an hour late on the days when her husband goes to chemotherapy so that she can drive him home before coming to work. The office manager said no, explaining that the practice can't function if everybody doesn't arrive on time. A couple of weeks later, the employee notices another medical assistant arriving late and being greeted by the office manager. When she asked the medical assistant why she was late, the medical assistant explained that the office manager is allowing her to come late a couple of times a week while she trains for an upcoming marathon.[6]

Likewise, the NYCCHR has stated that employers cannot deny accommodations "to employees with caregiving responsibilities if they provide these benefits to other employees."[7]

3. New York City Commission on Human Rights

a. Prohibition of Discrimination Based on Gender Identity and Gender Expression

Recently, the New York City Commission on Human Rights ("NYCCHR") issued a comprehensive Legal Enforcement Guidance regarding discrimination on the basis of gender identity and gender expression (which constitute gender discrimination under the NYCHRL).[8] In this Guidance, the NYCCHR provides several examples of conduct by employers which may constitute violations of the NYSHRL including:

(i) failing to use an employee's preferred name or pronoun. Specifically, the NYCCHR requires employers "to use an individual's preferred name, pronoun and title (*e.g.*, Ms./Mrs.) regardless of the individual's sex assigned at birth, anatomy, gender, medical history, appearance, or the sex indicated on the individual's identification." The Guidance further provides that employees "have the right to use their preferred name[s] regardless of whether they have identification in that name or have obtained a court-ordered name change, except in very limited circumstances where certain federal, state, or local laws require otherwise (*e.g.*, for purposes of employment eligibility verification with the federal government). Asking someone their preferred gender pronoun and preferred name is not a violation of the NYCHRL."

(ii) refusing to allow an employee to utilize single-sex facilities (such as bathrooms and locker rooms) or participate in single-sex programs consistent with the employee's gender, regardless of his or her sex assigned at birth. Pursuant to the Guidance, "the law does not require entities to make existing bathrooms all-gender or construct additional restrooms.… Some people, including, for example, customers…or employees, may object to sharing a facility or participating in a program with a transgender or gender non-conforming person. Such objections are not a lawful reason to deny access to that transgender or gender non-conforming individual."

(iii) engaging in sex stereotyping—namely, discrimination based on any employee's failure to conform to sex stereotypes. For example, an employer may not have a policy which prohibits men from wearing jewelry or make-up at work or "[overlook] a female employee for a promotion because her behavior does not conform to the employer's notion of how a female should behave at work."

(iv) imposing dress codes or uniforms, or apply grooming or appearance standards, that contain different requirements for individuals based on sex or gender.

(v) providing employee benefits that discriminate based on gender. As set forth in the Guidance, to "be non-discriminatory with respect to gender, health benefits plans must cover transgender care [including hormone replacement therapy, voice training and surgery], also known as transition-related care. In no case, however, will an employer that has selected a non-discriminatory plan be liable for the denial of coverage of a particular medical procedure by an insurance company, even when that denial may constitute discrimination on the basis of gender."

(vi) considering gender when evaluating requests for accommodations. According to the Guidance, when an employer "grants leave requests to address medical or health reasons, it shall treat leave requests to address medical or health-care needs related to an individual's gender identity in the same manner as requests for all other medical conditions." Such health-care needs relating to gender transition include "medical leave for medical and counseling appointments, surgery and recovery from gender affirming procedures, surgeries and treatments."

(vii) engaging in discriminatory harassment based on an employee's actual or perceived gender identity or expression, including actual or threatened violence, verbal harassment, defacing or damaging real property and cyber bullying.

(viii) engaging in retaliation against an employee who opposes discrimination or requests a reasonable accommodation for a disability based on gender identity or gender expression.[9]

As set forth in the Guidance, the NYCCHR may impose civil penalties of up to $125,000 for violations, and up to $250,000 for willful violations.

4. New York State Legislature

a. Paid Family Leave

Effective January 1, 2018, the newly enacted New York State Paid Family Leave Law will require employers to provide eligible employees with paid, job-protected leave each year (i) to care for a new child, (ii) to care for a family member with serious medical condition, or (iii) when a family member is called to active military service.[10] This paid leave, which amends the New York State disability law and will be funded through nominal payroll deductions, applies to all full-time and part-time employees who have been working for their employers for at least twenty-six (26) weeks. Such employees may use paid leave to:

(i) bond with a new child (including an adopted or foster child) within the first twelve (12) months after the child's birth (or adoption or placement);

(ii) provide physical or psychological care when the employee's child, spouse, domestic partner, parent (including step-parent or legal guardian), parent-in-law, sibling, grandchild or grandparent is suffering from a serious health condition; or

(iii) address certain exigent needs when the employee's spouse, domestic partner, child or parent is called to active military service.

Beginning on January 1, 2018, an eligible employee may take up to eight (8) weeks of paid leave, and will be paid at the rate of fifty percent (50%) of the employee's average weekly wage (capped at fifty percent (50%) of the statewide average weekly wage). On January 1, 2019, the paid leave period will increase to ten (10) weeks, and the pay rate will increase to fifty-five percent (55%); on January 1, 2020, the pay rate will increase to sixty percent (60%) (both pay rate increases will be capped at the respective statewide average weekly wage). Finally, on January 1, 2021, an eligible employee may take up to twelve (12) weeks of paid leave at the rate of sixty-seven percent (67%) of the employee's average weekly wage (capped at sixty-seven percent (67%) of the statewide average weekly wage).

Under the new law, employees who elect to take family leave are entitled to guaranteed job protection and continued health care benefits during the leave period. Moreover, the law prohibits retaliation against any employee who exercises his or her rights to take paid family leave under the program.

5. Federal Law

a. Employer-Provided Leave and Reasonable Accommodation

On May 9, 2016, the Equal Employment Opportunity Commission ("EEOC") released a new resource document on employer-provided leave as a reasonable accommodation under the Americans with Disabilities Act ("ADA").[11] These new guidelines provide, among other things, as follows:

(1) A reasonable accommodation may include making modifications to existing leave policies (including to extend the amount of available leave time) and also providing leave for a disability even where an employer does not offer leave to other employees (unless such modifications or leave would cause undue hardship). Such leave may be required despite the fact that the employer does not offer leave, the employee is not eligible for leave under the employer's policy or the employee has already exhausted all available leave. The employer need not, however, provide paid leave beyond what the employer normally provides as part of its paid leave policy, if any.

(2) Employees with disabilities must be provided with access to leave on the same basis as all other similarly situated employees. For example, if an employer provides five (5) days of "paid time off" and does not set any conditions on its use, the employer cannot require that an employee who uses paid time off due to a disability must provide a note from his or her health care provider.

(3) An employer who had granted leave with a fixed return date may not ask the employee to provide periodic updates. The employer may, however, contact an employee on an extended leave to check on the employee's progress.

(4) An employee on leave for a disability may request reasonable accommodation in order to return to work. This request may be made by the employee, or in a health care provider's note releasing the employee to return to work with certain restrictions. As set forth in the guidelines, an "employer will violate the ADA if it required an employee with a disability to have no medical restrictions—that is be '100%' healed or recovered—if the employee can perform her job with or without reasonable accommodation unless the employer can show providing the needed accommodations would cause undue hardship."[12]

Endnotes

1. N.Y.C. Admin. Code §§ 8-102 *et seq.*
2. *Id.* at §§ 8-101 & 8-107(a).
3. *Id.* at § 8-102 (30) (a) & (j).
4. *Id.* at § 8-102 (30) (b)—(i).
5. *FAQ's for Caregiver Protections,* NYC Commission on Human Rights, at www.nyc.gov/html/cchr/downloads/pdf/materials/Caregiver_FactSheet-Employer.pdf.
6. *Protections for Workers with Caregiving Responsibilities,* NYC Commission on Human Rights, 26 Apr. 2016 at www.nyc.gov/html/cchr/downloads/pdf/materials/Caregiver_FAQ.pdf.
7. *Id.*
8. *Gender Identity/Gender Expression: Legal Enforcement Guidance,* NYC Commission on Human Rights, 21 Dec. 2015 at www.nyc.gov/html/cchr/html/law/gender-identity-legalguidance.shtml.
9. *Id.*
10. Assemb. 09006, 2016 Leg. Gen. Assemb. (N.Y. 2016).
11. *Employer-Provided Leave and the Americans with Disabilities Act,* Equal Opportunity Employment Commission, at www.eeoc.gov/eeoc/publications/index.cfm.
12. *Id.*

Sharon Parella is the founder of Parella Firm P.C. Her practice focuses on representing employers, including domestic and foreign financial institutions, in all aspects of employment law, as well as representing individuals in various employment matters. She is also the Executive Editor of the Advance@Work blog on workplace innovators (www.advance@work.com).

"Know Your Customer" and Credit Providers

By Kathleen A. Scott

A bank lending money to any customer must obtain information about the customer as part of its loan application due diligence process. This article outlines what borrowers should expect from lenders with respect to "Know Your Customer" rules.

Know your customer rules were designed to try to prevent or inhibit money laundering and other criminal activities conducted through an unsuspecting financial institution. Usually in the due diligence process, a bank may focus on the credit profile of the borrower—but it also must review who the customer *is* as well as how much money the customer actually *has*. Sometimes there may be a new entity that is formed to be the actual borrower, and other times a guarantor may be the actual party in interest. A bank must ensure that it has obtained all of the required information in order to "know its customer" and create a legitimate lending scenario.

The CIP

A bank is required to establish and implement a risk-based customer identification program (CIP) that is appropriate for its size and business and is included in its formal anti-money laundering compliance program.[1] It does not matter which division of the bank is making the loan; as long as the bank itself is making the loan, the CIP is applicable. Other kinds of financial institutions (such as broker dealers) also are required to maintain a functioning CIP.

The U.S. Treasury Department's Financial Crimes Enforcement Network (FinCEN) is a federal agency that polices anti-money laundering within the nation. FinCEN regulations require that a bank develop "risk-based" procedures to verify the identity of each customer so that it can make a reasonable determination that it knows the customer's actual identity.

In developing CIP procedures, the bank must take account of all the risks relevant to its business. This may include an analysis of the risks that may arise from the size and location of the bank, the various types of customers the bank serves, the many products and services offered by the bank, and its methods of opening and maintaining its accounts. As a result, the CIP procedures used in connection with an auto loan to a customer who is an individual, for example, will likely differ from those applicable when the bank is considering a multi-million dollar credit for a corporate entity.

Information Required

Certain routine-specific information must be obtained from the customer, such as: name, street address, date of birth for an individual, and taxpayer identification number (TIN) for a U.S. citizen. For a non-U.S. citizen, one or more of the following are required: taxpayer identification number; passport number and country of issuance; alien identification card number; or number and country of issuance of any other government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard.[2]

Who Is the Customer?

In a lending transaction, the named borrower being granted the loan is usually the customer himself or herself. If a new entity is being established for the transaction, then the information listed above is required to be obtained for that new entity. If a TIN has not yet been acquired for a new entity, then the bank's CIP should address procedures on how to contract with customers that have applied for but not yet received a TIN. The CIP regulations allow the bank to proceed with opening the account but to make sure that the TIN is received within a reasonable period of time after an account is opened. However, a bank's CIP could require that the bank wait for the TIN prior to closing on a loan, and it is permissible for the bank to provide for that in its CIP.

In addition, in many cases with business loans, there are a number of parties involved that constitute "the customer" and that may be involved with the transaction—subsidiaries, parent company, third party guarantor, even potentially an individual owner at the top—the bank will obtain information from all the parties it deems necessary in order to conclude reasonably that it knows its customer. Banks face very serious consequences for violations of these regulations, such as monetary penalties and remedial obligations, not to mention possible reputational damage. Banks will often err on the side of obtaining more information, and business entities may have to provide much more information than otherwise expected in order to obtain a loan.

Verification

In addition to the discussed requirements, banks must take measures to verify the identity of the customer.[3] While it could do so through its own research (such as obtaining a Dun and Bradstreet report or researching other publicly available databases), it also likely will ask for documentation from the proposed borrower (and possibly the conglomerate of which the borrower is merely a part), such as the company's organizational documents, business licenses and certificates of good standing, tax returns and financial statements, and bank references.

In addition to information and documentation on the borrower, there may be instances when the bank may request information on individuals with authority or control over a loan. This includes those with signature authority, if the documentation and verification methods noted above (with respect to the borrower) prove insufficient to allow the bank to meet the regulatory requirements on verification of identity.

If the bank cannot form a reasonable belief that it knows the true identity of a customer, then it may turn down the loan application on this basis. Unlike a loan to an individual, there are no specific requirements that the bank give a reason for rejecting the application with a business loan. However, if the customer believes that there might be a possible discriminatory motive in the rejection of the application, the customer may consider making further inquiries as to the reason for such rejection.

If a business's management believes that the bank is inquiring for an unreasonable amount of additional documentation and information, the management may inquire the bank as to why it is requesting a particular document or piece of information, particularly if the requested information does not exist in the ordinary course of business. A business, however, should not expect that the bank will know each detail of its ordinary course of business, nor should it assume the bank has knowledge of industry customs of the business. In conclusion, the business and the bank must try to work together in gathering the information and documentation that the bank requires without disrupting the business's usual operation.

Recordkeeping and Notifications

Banks will maintain records of the information and documentation received from the customer, as well as information generated by the bank during the verification process. On the other side, the bank generally must retain the information for five years after the date the loan account is closed.[4]

The CIP also must include procedures for providing bank customers with adequate notice that the bank is requesting information to verify their identities.[5] This is why borrowers will usually find the following statement in a given lending document: "To help the government fight the funding of terrorism and money laundering activities, Federal law requires all financial institutions to obtain, verify, and record information that identifies each person who opens an account."

Checking Lists

As part of the verification process, a bank must determine whether the customer appears on any list "of known or suspected terrorists or terrorist organizations issued by any Federal government agency and designated as such by Treasury in consultation with the Federal functional regulators."[6] Currently, there are no such lists; however, as part of due diligence for compliance with economic sanctions laws, a bank will check a potential borrower (and others within the business conglomerate) against the U.S. Department of the Treasury Specially Designated Nationals List. Businesses should keep in mind that compliance with economic sanctions laws is separate and apart from compliance with the CIP regulations.

Reliance

Finally, a bank may specify in its CIP procedures if and when it will rely on another financial institution (including an affiliate of the bank) using the bank's own CIP procedures in evaluating a potential new customer.[7] For example, a business seeking a loan may be referred to a specific bank by another financial institution with which it currently conducts business.

A bank may rely on another financial institution to perform any procedures of the bank's own CIP with respect to a proposed customer provided that:

(i) such reliance is reasonable under the circumstances;

(ii) the other financial institution also is subject to an anti-money laundering compliance program requirement and is regulated by a Federal functional regulator (such as a banking, securities or commodities regulator); and

(iii) the other financial institution agrees by written contract to certify annually to the bank that it has implemented its anti-money laundering compliance program, and that it will perform (or have an agent perform) the specified requirements of the bank's CIP.

Short of such an arrangement, the bank may obtain information about a customer as part of its CIP due diligence process, but it will have to conduct its own verification process to determine whether it can reasonably rely on such information.

Endnotes

1. 31 CFR § 1020.220.
2. 12 CFR § 1020.220(a)(2)(i).
3. 12 CFR § 1020.220(a)(2)(ii).
4. 12 CFR § 1020.220(a)(3).
5. 12 CFR § 1020.220(a)(5).
6. 12 CFR § 1020.220(a)(4).
7. 12 CFR § 1020.220(a)(6).

Kathleen A. Scott is a Senior Counsel at Norton Rose Fulbright, a global legal practice with more than 3,800 lawyers and other legal staff based in more than 50 cities around the world. kathleen.scott@nortonrosefulbright.com, www.regulationtomorrow.com.

Emerging Trends in Privacy and Cybersecurity

By Stuart D. Levi

Entering 2016, the relentless stream of cyberattacks continues unabated, having become a "business as usual" reality to which companies must adapt. All companies, regardless of size or industry, are potential targets, and the pool of attackers is expanding. Below is an overview of the key themes that emerged this year and what we expect to see in 2016.

Best Practices for Cybersecurity Preparedness

In 2015, a number of regulators, including the Securities and Exchange Commission's (SEC) Office of Compliance Inspections and Examinations (OCIE), issued guidance and alerts about cybersecurity preparedness. The good news for companies, whether regulated or not, is that consistent themes are emerging as to what constitutes best practices. They include:

- **Conducting a Risk Assessment.** Cybersecurity preparedness needs to start with assessing the company's risks and designing a plan that addresses those risks.
- **Strong Governance.** A cybersecurity plan must involve the active participation of senior management, and where applicable, the board.
- **Data Access**. Employees should be able to access only the data they require, with appropriate authentication steps.
- **Training.** Many attacks prey on employees who may unknowingly surrender their passwords or click on malware links. Regular employee training on cybersecurity is therefore critical.
- **Vendor Management.** Attacks are often launched through a third-party vendor that has access to the company's system for business purposes. Companies must have robust cybersecurity requirements for vendors.
- **Incident Response Plan.** All companies should have incident response plans to deal with cyberattacks and run tabletop exercises to walk through different scenarios.
- **Cyber Insurance**. Cyber insurance is emerging as an important component of any risk mitigation strategy.
- **Information Sharing.** Companies across multiple industries have begun to appreciate that sharing cyberthreat information and best practices with their competitors is a critical tool to reduce risks. The White House has been encouraging this practice, and in February 2015, President Barack Obama issued an executive order encouraging the development and formation of Information Sharing and Analysis Organizations. We expect these efforts to greatly expand in 2016, and all companies should consider joining an information-sharing group in their industry.

Outlook on Legislation

As in previous years over the past decade, Congress attempted to enact various privacy or cybersecurity legislation. These initiatives were expected to gain more traction following President Obama's release of a number of proposed bills in January 2015, including a federal data breach notification law and information-sharing legislation. However, the only piece of legislation that was enacted was the Cybersecurity Act of 2015, a bill that made it through Congress at the end of the year as part of the 2016 omnibus spending bill. The act creates a voluntary framework for real-time sharing of "cyber threat indicators" and "defensive measures" and provides liability protections and an antitrust exemption for such sharing. We do not anticipate any other meaningful additional privacy or cybersecurity legislation being enacted in 2016. Indeed, state attorneys general responded to widespread calls for a federal data breach notification law by urging Congress to preserve state authority in this area. Such a federal law will probably continue to be discussed but is unlikely to pass in 2016.

The Role of the FTC

The Federal Trade Commission (FTC) has long been the most active regulator in the areas of privacy and cybersecurity. In 2015, the FTC won a significant victory when the U.S. Court of Appeals for the Third Circuit held in the *Wyndham* case that the agency has authority to deem a company's cybersecurity practices unfair under Section 5 of the FTC Act, and that companies had fair notice as to what practices could violate that section. However, as the year drew to a close, the FTC was handed a defeat when its own administrative law judge held in the *LabMD* case that the FTC must show more than the mere "possibility" of harm from a cybersecurity incident in order to sustain a Section 5 case. Despite this setback, we anticipate that the FTC will remain highly active in this area, and that companies should be familiar with the types of cases the FTC is bringing in order to understand the issues on which the agency is focused.

EU Emerges as a Force to Be Reckoned With

Although the European Union has had a robust privacy regime for close to 20 years, the impact on U.S.

companies has been relatively limited. A dramatic shift in this equation occurred last year. In December 2015, the EU announced completion of a new General Data Protection Regulation (GDPR), which will replace and significantly broaden the current EU Data Protection Directive. The GDPR is widely expected to be approved in early 2016 and go into effect two years later. The impact on any company doing business with European residents—even if not situated in Europe—will be significant.

The expanding impact of the EU was also felt two months earlier, when the Court of Justice of the European Union invalidated the U.S.-EU Safe Harbor framework on which thousands of companies had relied to send personal data from the EU to the U.S. The court also empowered local data protection authorities to decide for themselves whether personal information was being protected by international agreements. These developments suggest a far more activist European privacy regime than had been in place— one that could have a significant impact on global commerce in 2016 and beyond.

Class Action Lawsuits Must Remain Part of a Company's Risk Calculus

Most data breaches result in multiple class action lawsuits against the victim company. The gating issue has been whether the plaintiffs' alleged injury is sufficiently concrete and imminent to establish Article III standing, especially since these plaintiffs often have not suffered any monetary loss or other tangible injury. Cases from the past year offered little clarity on this issue. For example, in June 2015, in the Zappos litigation, a Nevada district court held, as have many other courts, that the possibility that a "credible threat may occur at some point in the future" is insufficient to confer standing. However, the U.S. Court of Appeals for the Seventh Circuit adopted a more lenient position, finding standing in the *Neiman Marcus* case because the presumed purpose of the theft of personal information was to make fraudulent charges or engage in identity theft, and plaintiffs should not be required to wait until such harm occurs. The decision by the Seventh Circuit and other courts that have found standing may further incentivize plaintiffs' counsel to bring class action lawsuits. The potential for such suits should therefore be part of the risk calculus of any company that collects or processes personal information.

Stuart D. Levi is a partner and co-head of Skadden's Intellectual Property and Technology Group, and coordinates the firm's outsourcing and privacy practices.

* * *

CFPB Pursues Aggressive Enforcement Agenda and Arbitration Restrictions

By Joseph L. Barloon, Anand S. Raman, Austin K. Brown, Darren M. Welch, Neepa K. Mehta

In 2015, the Consumer Financial Protection Bureau (CFPB) continued to aggressively enforce federal consumer protection laws across a broad spectrum of consumer financial products and services. Additionally, the CFPB took a significant step toward proposing a ban on arbitration clauses that would preclude consumers from being able to file class action lawsuits. Together, these actions demonstrate the increased scrutiny of consumer compliance for providers of consumer financial products and services.

CFPB Enforcement Actions

Last year, the CFPB initiated more than 50 enforcement actions, reaching settlements in most of those cases for a total of over $1.6 billion in compensation to consumers (more than $30 million per settlement, on average) as well as approximately $190 million in civil penalties.

The CFPB's enforcement program has relied most heavily on its authority to enforce the Dodd-Frank Act prohibition on unfair, deceptive, or abusive acts or practices. The CFPB has used this authority to bring actions relating to credit reporting and consumer information, debt collection, ancillary products, payday lending, student lending, mortgage marketing and other areas.

Fair lending is another enforcement hot spot, with the CFPB bringing enforcement actions relating to indirect auto finance and mortgage redlining. In June 2015, the U.S. Supreme Court upheld the disputed "disparate impact" theory of liability under the Fair Housing Act in the case of *Texas Department of Housing & Community Affairs v. Inclusive Communities Project, Inc.* while also articulating limits on application of the disparate impact theory. The Inclusive Communities decision has no doubt emboldened the CFPB and other regulators to aggressively pursue disparate impact cases under the federal fair lending laws, including the Equal Credit Opportunity Act. Accordingly, we expect to see increased fair lending enforcement in 2016.

Arbitration Restrictions Proposed

On October 7, 2015, the CFPB published a long-awaited "potential rulemaking" on predispute arbitration agreements that would effectively ban arbitration clauses in any consumer financial products or services if those clauses would prevent class action cases. The potential rulemaking is the latest and most substantive step in a three-year review that the CFPB has undertaken with respect to arbitration agreements.

The CFPB's announcement of potential rulemaking relating to arbitration agreements is not unexpected in light of its public scrutiny of arbitration agreements over the past few years. In March 2015, the CFPB published a study, required by the Dodd-Frank Act, concluding that arbitration agreements are a substantial barrier to pursuing claims on a class action basis and that consumers benefit far more from class actions than from arbitrations.

The CFPB stopped short of banning arbitration agreements altogether. In particular, the potential rulemaking proposes to accomplish the following:

1. Arbitration agreements that preclude consumers from participating in a class action lawsuit would be prohibited, reflecting the CFPB's view that consumers may benefit from class actions; and
2. Consumer financial companies that use arbitration agreements with consumers would be required to give the CFPB copies of claims filed and awards issued in any arbitration. The CFPB may publish the claims and awards on its website.

The CFPB will gather feedback on its proposal from a small-business review panel process and likely will issue a formal proposed rule in 2016. If the regulations are finalized as expected, many companies will need to make significant changes to their business practices and will encounter increased compliance burdens and costs. The impact of a ban on arbitration would be widespread: The prohibition would apply to many products that the CFPB regulates, including credit cards, checking and deposit accounts, prepaid cards, money transfer services, certain auto loans, auto title loans, small dollar or payday loans, private student loans and installment loans.

We expect that a number of industry and consumer groups will file comments once the rule is formally proposed, and any final CFPB rule restricting arbitration provisions may lead to a showdown at the Supreme Court. In recent years, the Court has issued a number of decisions upholding arbitration provisions, quashing attempts by numerous states and lower courts to limit or prohibit consumer contract arbitration agreements. The Court's most recent decision upholding such arbitration provisions, *DIRECTV, Inc. v. Imburgia* on December 14, 2015, elicited a strong dissent by Justice Ruth Bader Ginsburg, who relied on the CFPB's arbitration study in arguing that "take-it-or-leave-it arbitration agreements mandating arbitration and banning class procedures" have harmed consumers.

Conclusion

In light of the CFPB's recent enforcement activity and anticipated rulemaking restricting arbitration agreements, consumer financial services companies would be well-advised to review consumer complaints as well as their policies and procedures to proactively address practices that may present enhanced risk of enforcement or consumer litigation.

Joseph L. Barloon is a partner and the co-leader of Skadden's Consumer Financial Services practice; Anand S. Raman is a partner and the co-leader of Skadden's Consumer Financial Services practice; Austin K. Brown is a counsel; Darren Welch is a counsel; Neepa K. Mehta is an associate.

In re Coinflip, Inc.

By Caitlin Dance

"[Bitcoin] is a techno tour de force."[1] Bill Gates uttered these words back in 2013, perhaps foreshadowing the historic legal changes in the industry in 2014 and 2015 and the significant growth of the industry in general. A "tour de force" is a perfect way to describe the mysterious phenomenon known as Bitcoin that cannot be seen, touched, or otherwise put into a tangible medium. Oxford Dictionary defines it as "a type of digital currency in which encryption techniques are used to regulate the generation of units of currency and verify the transfer of funds, operating independently of a central bank."[2] Released to the public in 2009,[3] it eliminated the need for banks and transaction fees, provided a means to purchase anonymously, and enabled international transactions to occur more easily and at a lower cost.[4] Due to the anonymity of Bitcoin transactions, it became a popular choice for money laundering, online drug dealers, and other criminal activities,[5] and it has presented a unique legal problem for these same reasons.[6] Disputes arose regarding how to define and regulate Bitcoin, and since it is an ideal choice for investors, a need for regulation quickly emerged.[7] This article examines (1) the invention of Bitcoin, (2) the emergence of a legal standard for virtual currency and Bitcoin, (3) the legal concept of "commodity," (4) the landmark CFTC case *In re Coinflip*, and (4) how these legal and regulatory changes will impact the industry.

First of all, the invention of Bitcoin remains in part inexplicable due to a mystery surrounding its creator.[8] Someone under the name Satoshi Nakamoto published a paper on Bitcoin in 2008 and then released its software in 2009.[9] Some speculated that it was another person altogether, while others claimed it was a group of three people working together.[10] *Newsweek* claimed it found the real Satoshi Nakamoto, a man named Dorian S. Nakamoto, who promptly denied knowing anything at all about Bitcoin.[11] While Nakamoto's true identity may never be discovered, the process of invention remains clear. Bitcoins originate from computer programs that solve math problems, and once generated, they are stored in a digital wallet.[12] Transactions are anonymous because only users' wallet-IDs are publicly recorded, with no link to the owner.[13]

Not only is Bitcoin virtual currency, but it is also crypto-currency because it relies on encryption.[14] The problem that Bitcoin solved from previous and not as successful virtual currency was the risk that people would "double-spend" Bitcoin.[15] Absent some type of central clearinghouse, an individual could potentially use the same piece of virtual currency to buy two different things (double-spending).[16] Bitcoin "eliminated the need for a third-party clearinghouse by turning over the authority to maintain a ledger of transactions to the users of the currency themselves."[17] Users have a pair of cryptographic keys, one public key to submit payment and one private key to accept payment.[18] There is a public, encrypted log of all transactions on a ledger known as the "block chain."[19]

Bitcoin may be considered virtual currency, but that still does not explain its worth or value, which fluctuates daily, even changing by the minute.[20] Google "what is a Bitcoin worth?" and the current market rate appears.[21] On the date this article was submitted, one Bitcoin equaled $361.11.[22] The cost of Bitcoin not only vacillates on an ongoing basis, but it can be best described as volatile, and on more than one occasion, it fell by 50% in a 24-hour period.[23] Using Bitcoin to purchase something does not always equate that thing's cost in dollars. For example, the first Bitcoin transaction was for the delivery of two Papa John's pizzas for 10,000 Bitcoins, or approximately $5.9 million![24] While it may not be an ideal choice to pay for pizza, the price instability makes it an ideal choice for investors in both securities and derivatives.[25] This article focuses on the latter.

Second, Bitcoin's use as an investment necessitates a legal standard; however, its legal standing has been somewhat murky because of its relatively young existence and its intangible quality. In the past year, both the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) issued rulings that spoke directly to this issue. But prior to this, the only guidance existed through other avenues. For example, the United States Government Accountability Office (GAO) and the Financial Crimes Enforcement Network (FinCEN) provided some context for reference. GAO submitted a report to the U.S. Senate Committee on Finance and noted that some virtual-currency transactions were capable of producing taxable income,[26] while FinCEN required administrators of virtual currency to register as a money service business (MSB).[27] However, FinCEN differentiated between users of virtual currency and administrators of virtual currency and did not require users to register.[28]

Courts struggled to police misuse of Bitcoin within this existing framework. For example, in mid-year 2014, the Southern District of New York held that use of Bitcoin constituted a "financial transaction" in the infamous "Silk Road" case.[29] The defendant in *United States v. Ulbricht* operated the Silk Road website as an online marketplace for narcotics and computer hacking, and he used Bitcoins to launder the profits.[30] In that case, Ulbricht appealed a Grand Jury indictment of narcotics trafficking conspiracy, continuing criminal enterprise, computer hacking conspiracy, and money laundering conspiracy.[31] He argued that Bitcoin was not legal tender and thus its use was not a "financial transaction," and that therefore, he did not commit money laundering.[32] The Southern District ultimately held that Bitcoins "act as a medium of exchange" and "carry value," both marks of a "financial transaction."[33] Later in 2014, following the *Ulbricht* decision, the SEC issued more specific guidelines on Bitcoin in what would ultimately be the start of further and more specific legal standards.[34] The defendant in *Shavers* misappropriated an investor's Bitcoins, and the court held that the investments met the definition of an investment contract and, as such, constituted securities.[35] For the first time, the SEC defined Bitcoin as an investment that should be governed by the SEC.[36]

Finally, in 2015, a state regulatory agency spoke directly to the issue for the first time.[37] The New York State Department of Financial Services ("NYDFS") issued a regulation of virtual currency that stated: "no person shall, without a license obtained from the superintendent as provided in this Part, engage in any Virtual Currency Business Activity."[38] The NYDFS defined virtual currency as any digital unit used to exchange digitally stored value and broadly construed it to "include digital units of exchange" that were both centralized and decentralized, as well as those that could be created or obtained through computing or manufacturing.[39] It further required Bitcoin companies to apply for a BitLicense.[40] Additionally, moving forward, this will not only regulate the application process and set capital requirements but also will mandate reporting and financial disclosures; anti-money laundering programs and cyber security programs; and consumer protection disclosures in order to begin and maintain relationships with customers.[41]

Third, the NYDFS' regulations meant a big step forward in the quest for a definitive legal standard, but there was still a lack of clear guidance from the CFTC, particularly concerning whether Bitcoin could be properly defined as a commodity. The CFTC set forth a definition of commodity as follows:

> The term "commodity" means wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles, except onions as provided in Public Law 85–839 (7 U.S.C. 13–1), and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in.[42]

At its inception, the Commodity Exchange Act (CEA) applied to agricultural commodities and prohibited commodity option transactions.[43] The CFTCA amended this definition to include "all other goods and articles, except onions," transforming the act from regulating agricultural commodities to "literally anything other than onions."[44] Thus, the CFTC could regulate anything if its futures were traded on an exchange,[45] which led to a battle between the SEC and the CFTC in a case where the investment could validly be called a commodity *and* a security.[46] The Seventh Circuit, in *Board of Trade of City of Chicago v. SEC*, broadly interpreted the definition of commodity to include Government National Mortgage Association mortgage-backed pass-through certificates ("GNMAs").[47] The issue in that case was whether the SEC could regulate option trading on GNMA certificates, since GNMAs were both securities and commodities, and ultimately, the court held that the SEC could not regulate GNMAs on its own, "pending further CFTC action." The Seventh Circuit elaborated, explaining that the amended definition[48] was intended to regulate these previously unregulated commodities as well as to "encompass futures markets that were expected to be expanded."[49] In anticipation of new futures markets, the definition thus encompassed "non-traditional goods and services."[50]

Following this decision, the Second Circuit held that the terms in the CEA applied to any commodity transaction in a case involving options in spot and cash markets.[51] The defendants in *Commodity Futures Trading Comm'n v. American Bd. of Trade* provided a marketplace for commodity option transactions.[52] They argued that the CEA only applied to options on futures contracts and that their conduct did not fall within the CEA's regulation since they only dealt with options on the *underlying* commodities.[53] The court saw "no merit in defendants' argument that the Act and the regulations did not reach their activities [just] because defendants bought and sold options in the spot and cash markets."[54]

Spot markets remained a point of legal controversy because in order to fall within "the purview of the CEA, defendants must have transacted in contracts for future delivery."[55] The defendants in *Int't Foreign Currency* tried to argue that it was a spot contract and therefore did not fall within the purview of the CFTC.[56] But the Eastern District did not entertain this, stating that a spot contract called for settlement within two days.[57] The court further stated "the fact that Defendants' contracts failed to have a specified future delivery date is not determinative."[58] The court said that while the date is often specified, it does not have to be.[59] The court pointed out that in order to fall under the guidelines of the CEA, the contracts need to be both futures contracts AND classified as a commodity.[60] Defendants in that case argued that foreign currency is not a commodity since it is not agriculture, as titled by the Code in Title 7.[61] The court followed other case law in determining that foreign currency was indeed a commodity.[62] Defendants claimed that under the Treasury Amendment, foreign currency transactions were exempt unless they are conducted on a board of trade.[63] Even assuming this interpretation is correct, the *Int't Foreign Currency* defendants conducted the transactions on a board of trade.[64] A subsequent case elaborated on this issue, stating that the Treasury Amendment was intended "to exempt only interbank transactions that were already regulated by banking regulatory agencies."[65] The court found that here the transactions were not interbank transactions, and that they were conducted on a board of trade, and indeed did fall under the CEA.[66] Given that these cases point to regulation expansion and broad interpretation, the CFTC's ultimate ruling on Bitcoin derivatives seems to fall in line with this trend.

Fourth, the CFTC issued a groundbreaking order last fall regarding Bitcoin regulation.[67] It finally declared Bitcoin a commodity and imposed sanctions on *Coinflip* for violating Sections 4c(n) and 5h(a)(1) of the Commodity Exchange Act ("CEA").[68] *Coinflip*, a Delaware corporation, operated Derivabit, a trading platform to buy and sell Bitcoin options and future contracts.[69] Coinflip never registered with the CFTC.[70] In this order, the commission defined Bitcoin and virtual currencies as commodities, based on Section 1a(9) of the CEA and relevant case law.[71] In the Act, the term "commodity" includes "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in."[72] The commission held that this encompassed Bitcoin because the definition of commodity is broad.[73] *Coinflip* violated the CEA first for operating a swap trading facility without registering with the CFTC and second for conducting activity "contrary to Commission Regulations."[74] While this case may provide the stability that the Bitcoin derivatives market needs, some argue that placing Bitcoin into already existing frameworks only serves to exacerbate the legal problems.[75]

Fifth, these legal and regulatory changes potentially impact the industry in many ways. Inherent problems exist within Bitcoin, and the new parameters do not necessarily fix them or address the overall policy goals of commodity regulation. Virtual currency "may operate like legal tender in some circumstances but lacks the status of legal tender because no person is legally obligated to accept a virtual currency."[76] The G20 countries do not recognize Bitcoin as currency because it is essentially hypothetical, having no tangible value and volatile price stability.[77] However, because it can be used in any country through the web-based marketplaces, Bitcoin presents "unique jurisdictional issues" that make it difficult to regulate.[78] Money-laundering regulations, cybercrime statutes, and consumer protection laws exist to provide some legal recourse; however, its anonymity and ability to move quickly make it much easier to facilitate crime with Bitcoin.[79] An investigation of one particular transnational crime network involved 17 nations that coordinated their law enforcement efforts.[80] Up to the *Coinflip* case, little legal recourse has been available outside of the regulation of money transmission.[81] For example, money-laundering regulations, cybercrime statutes, and consumer protection laws exist.[82] The absence of a central administrative source, like a bank, can make it difficult to find evidence of crime and provide any type of dispute resolution procedure.[83] Bitcoin lacks a dispute resolution procedure like credit cards and banks, meaning that if a consumer suffers financial loss there is no recourse.[84] Further, the lack of a centralized entity means there is no unit or entity that can ensure that anti-money laundering laws are complied with or or that suspicious activity is reported.[85] "There is no Bitcoin company to subpoena, no headquarters to raid, not even a server to shut down."[86] Although the state can track the user's identity and mete out punishment, there is no way to prevent illegal activity from occurring.[87]

Because of all these issues, "regulation that is tailored to traditional financial services or investment methods may fail to account for the unique attributes of Bitcoin."[88] A recent law review article by Kevin Tu and Michael Meredith stated the following:

> Regulation in the US has been narrowly focused on establishing how virtual currencies will be treated under existing law…this "patch-work" approach may result in: "(1) a lack of inter-agency communication such that the resulting regulatory framework may be fragmented and lack cohesion, (2) difficulty in developing regulation tailored to the unique characteristics and risks of virtual currency; and (3) a failure to give sufficient consideration to the full breadth of the regulatory issues raised by decentralized virtual currency such that the resulting regulatory framework may suffer from an unintended oversight in scope.[89]

Tu and Meredith explained how the reaction to Silk Road by administrators wrongly focused on the risk posed by Silk Road instead of looking holistically at virtual currency.[90] The Bank Secrecy Act was enacted for the purpose of preventing criminal activity and serves as a reminder of why Bitcoin regulation is an important policy concern.[91]

The case for Bitcoin regulation is supported by the policy and purpose of financial regulations currently in place. In general, the goal of money regulation includes protecting consumers "from suffering financial loss due to dealing with a money transmitter" and preventing fraud.[92] There is an overall policy concern to prevent misuse of financial systems; however, just because virtual currency can be misused does not justify its elimination.[93] Moreover, the purpose of the CEA is to protect investors from being deceived, and this is achieved through anti-fraud provisions.[94] Courts generally consider fraud "especially serious and deserving of monetary penalties."[95] The CFTC states explicitly that its mission is to "foster open, transparent, competitive, and financially sound markets, to avoid systemic risk, and to protect the market users and their funds, consumers, and the public from fraud, manipulation, and abusive practices…"[96] Further, the purpose of the Commodity Exchange Act is to provide a system for the self-regulation of trading facilities in order "to ensure the financial integrity of all transactions subject to this chapter and the avoidance of systemic risk."[97]

Arguably one of the most important reasons for implementing regulation stems from the fact that "Bitcoin is a decentralized scheme lacking a single authority," and thus, no framework exists to set price points, rules on redemption, and administrative guidelines.[98] Despite the compelling reasons in favor of increased Bitcoin regulation, opponents like the United States Homeland Security and Governmental Affairs Committee have expressed reservations over concern that such regulation may suppress the evolution of digital assets.[99] Since other countries have lower regulation, U.S. laws could push Bitcoin exchanges to these other countries, where consumers would no longer be protected.[100] As with any regulation, transaction costs may rise, but opponents of Bitcoin regulation argue that these costs "outweigh the benefits because there are potentially millions of users to regulate."[101] Ultimately, investor confidence from such regulations cuts in favor of determining that the benefits outweigh the costs.[102]

In conclusion, this article examined (1) the invention of Bitcoin, (2) the emergence of a legal standard for virtual currency and Bitcoin, (3) the legal concept of "commodity," (4) the landmark CFTC case, *In re Coinflip*, and (4) how these legal and regulatory changes will impact the industry. The field of Bitcoin derivatives has the potential to transform investment. These types of new inventions and technologies should be encouraged, not eliminated, and by increasing transparency in this market, investors can participate with confidence.

Endnotes

1. *Munger/Buffet Disagree on Corporate Tax Rates*, FOX BUSINESS (May 6, 2013), http://video.foxbusiness.com/v/2359385547001/mungerbuffett-disagree-on-corporate-tax-rates/?#sp=show-clips.
2. OXFORD DICTIONARIES, at http://www.oxforddictionaries.com/definition/english/bitcoin (last visited Nov. 29, 2015).
3. *Who is Satoshi Nakamoto?*, COINDESK (May 20, 2015), http://www.coindesk.com/information/who-is-satoshi-nakamoto/. Great controversy surrounds the identity of Bitcoin's inventor, but whoever he or she is, likely has earned about $1 billion from his or her creation. *Id.*
4. Tal Yellin, Dominic Aratari & Jose Pagliery, *What is Bitcoin?*, CNN MONEY, http://money.cnn.com/infographic/technology/what-is-bitcoin/ (last visited Nov. 29, 2015).
5. Yellin, Aratari, & Pagliery, *supra* note 4.
6. *See generally* Lawrence Trautman, *Virtual Currencies Bitcoin & What Now After Liberty Reserve, Silk Road, and Mt. Gox?*, 20 RICH. J.L. & TECH. 13, P6 (2014).
7. Kevin Tu & Michael Meredith, *Rethinking Virtual Currency Regulation in the Bitcoin Age*, 90 WASH. L. REV. 271, 293 (2015).
8. *Who is Satoshi Nakamoto?*, COINDESK (May 20, 2015), http://www.coindesk.com/information/who-is-satoshi-nakamoto/.
9. *Id.*
10. *Id.*
11. *Id.*
12. Yellin, Aratari & Pagliery, *supra* note 4. These digital wallets include the following: web-based wallets, like Blockchain and Coinbase, store private keys online; paper wallets do not store private keys digitally; hardware wallets, which are rare, store private keys on a dedicated device; ledger USB wallets store private keys on a USB device using smartcard security; desktop wallets store private keys on software that runs on the individual's private computer; and mobile wallets store private keys on mobile devices through downloadable apps. *How to Store Your Bitcoins*, COINDESK (Oct. 19, 2015), http://www.coindesk.com/information/how-to-store-your-bitcoins/. Bitcoin is entirely anonymous, on the one hand, and entirely traceable, on the other hand. *Id.* Individuals wishing to create a digital wallet on a site like Blockchain can do so on the website itself by merely inputting an email address and password. BLOCKCHAIN, https://www.blockchain.com/ (last visited Nov. 29, 2015). There is no way to recover a wallet should someone forget the password, but the Blockchain site does provide a long wallet recovery key (a complex, nonsensical list of 15 plus words) at the time of account creation. *Id.*
13. Yellin, Aratari & Pagliery, *supra* note 4.
14. Tu & Meredith, *supra* note 7 at 278-79.
15. *Id.*at 281-83.
16. *Id.*
17. *Id.* at 281.
18. *Id.*
19. *Id.*
20. Jared Newman, *How Much is a Bitcoin Worth?*, TIME MAGAZINE (July 16, 2014), http://time.com/2993226/google-bitcoin/.
21. *Id.*
22. GOOGLE, https://www.google.com/?gws_rd=ssl#q=how+much+is+a+bitcoin+worth+today (last visited Dec. 1, 2015). Google also shows a fluctuation chart from 2011 through 2015, where the highest value of Bitcoin occurred in 2014, and in 2015, the Bitcoin appeared to be rising again. *Id.*
23. Tu & Meredith, *supra* note 7 at 289.
24. *Id.* at 285.
25. *Id.* at 293.
26. U.S. GOV'T ACCOUTABILITY OFFICE, GAO13-516, VIRTUAL ECONOMIES AND CURRENCIES: ADDITIONAL IRS GUIDANCE COULD REDUCE TAX COMPLIANCE RISKS 10 (2013).
27. Sarah Jane Hughes & Stephen T. Middlebrook, *Advancing a Framework for Regulating Cryptocurrency Payments Intermediaries*, 32 Yale J. on Reg. 495 (2015). FinCEN offered the first federal regulatory guidance on virtual currency. *Id.* at 507. FinCEN is a bureau within the Treasury Department and "serves as the Financial Intelligence Unit of the United States." 31 U.S.C. § 310. Treasury Order 180-01 defined FinCEN's responsibilities as follows: "to implement, administer, and enforce compliance with the authorities contained in what is commonly known as the 'Bank Secrecy Act.'" Treas. Reg. § 180-01 (2002). The Bank Secrecy Act requires U.S. financial institutions to assist U.S. government agencies to detect and prevent money laundering. Specifically, the act requires financial institutions to keep records of cash purchases of negotiable instruments, file reports of cash transactions exceeding $10,000 (daily aggregate amount), and to report suspicious activity that might signify money laundering, tax evasion, or other criminal activities. It was passed by the Congress of the United States in 1970. The BSA is sometimes referred to as

an "anti-money laundering" law ("AML") or jointly as "BSA/AML." *Id.* Several AML acts, including provisions in Title III of the USA PATRIOT Act of 2001, have been enacted up to the present to amend the BSA. (*See* 31 USC 5311-5330 and 31 CFR Chapter [formerly 31 CFR Part 103]). *Bank Secrecy Act,* FINCEN, https://www.fincen.gov/statutes_regs/bsa/ (last visited Nov. 29, 2015).

28. Hughes & Middlebrook, *supra* note 27, at 522-23 (stating that "a user of virtual currency is **not** an MSB under FinCEN's regulations and therefore is not subject to MSB registration, reporting, and recordkeeping regulations").

29. *United States v. Ulbricht*, 31 F. Supp. 3d 540, 548 (S.D.N.Y. 2014).

30. *Id.* at 546-47.

31. *Ulbricht,* 31 F. Supp. 3d 540.

32. *Id.*

33. *Id.* While the use of Bitcoins does not per se result in a claim of money laundering, here the defendant was using the virtual currency to conceal identities and locations of the persons transferring funds. *Id.* at 569. The court in that case used a plain reading interpretation of the money laundering statute to broadly define "financial transaction." *Id.* at 570.

34. SEC v. Shavers, No. 13-cv-416, 2014 U.S. Dist. LEXIS 130781 (E.D. Tex. Sep. 18, 2014).

35. *Shavers,* U.S. Dist. LEXIS 130781, at *22.

36. *See generally Shavers,* U.S. Dist. LEXIS 130781.

37. Karen Freifeld & Gertrude Chavez-Dreyfuss, *New York Regulator Issues Final Virtual Currency Rules,* REUTERS (June 3, 2015, 4:04 PM), http://www.reuters.com/article/2015/06/03/us-bitcoin-regulation-new-york-idUSKBN0OJ23X20150603#O8yws3mbu26jwqZf.97. After giving notice, the NYDFS held public hearings in January 2014 and issued final rules in June 2015. *NYDFS Virtual Currency Hearing,* N.Y. STATE DEP'T OF FIN. SERVS., http://www.dfs.ny.gov/about/hearings/vc_01282014_indx.htm (last visited Nov. 29, 2015). The NYSDF gave notice of inquiry on virtual currency in August 2013 and notice of intent to hold hearings on virtual currency in November 2013. The public hearings occurred on January 28, 2014, and January 29, 2014. *Id.* Superintendent of the NYSDF Benjamin Lawsky stated later in 2014: "Virtual currencies are at the crossroads of a lightly regulated technology sector and a heavily regulated traditional banking sector, which makes striking the right balance that much more challenging." LW Client Alert News Flash, October 22, 2014, No. 1759.

38. N.Y. COMP. CODES R. & REGS. tit. 23, § 200.3 (2014).

39. *Id.*

40. Freifeld & Chavez-Dreyfuss, *supra* note 37. *See also Hughes* & Middlebrook, *supra* note 27. "On July 17, 2014, the New York State Department of Financial Services jolted the virtual currency community by proposing a comprehensive regulation that would require virtual currency participants to obtain what the state called a 'BitLicense.'" *Id.* at 501.

41. *See generally* tit. 23, § 200.2.

42. 17 C.F.R. § 1a(4) (2015). Commodities are the "building blocks" of derivative contracts. Each derivative instrument has an underlying cash commodity, which may be an agricultural product, like wheat, or a financial instrument, such as the value of a stock index. The derivative contract derives its price and value from that underlying cash commodity. Historically, commodity futures contracts were traded on agricultural products, but today, they usually involve some type of financial instrument. *Id.* The CEA specifically states that its purpose includes the "prevention and removal of obstructions and burdens upon interstate commerce in grain." § 1.

43. *See* Board of Trade of City of Chicago v. SEC, 677 F. 2d 1137, 1142-43 (7th Cir. 1982), *vacated as moot*, 459 U.S. 1026, 74 L. Ed. 2d 594, 103 S. Ct. 434 (1982).

44. *Board of Trade of City of Chicago,* 677 F. 2d at 1142-43.

45. *Id.*

46. *See generally Bd. of Trade of City of Chicago*, 677 F. 2d 1137.

47. *Id.* GNMAs are generally issued by mortgage bankers as a way to generate private sources of funds for residential loans. Buyers of GNMAs receive a portion of the interest generated as mortgagors repay their loans. Ultimately, the court held that the SEC could not regulate GNMAs on its own, "pending further CFTC action." The salient point in *Board of Trade* involved the broad definition of commodity. *Id.*

48. *Board of Trade of City of Chicago,* 677 F. 2d at 1142-43 (where commodity means all other goods and articles, except onions).

49. *Id.*

50. *Id.*

51. Commodity Futures Trading Comm'n v. American Bd. of Trade, 803 F.2d 1242 (2d Cir. 1986). The Second Circuit specifically referenced *Bd. of Trade of City of Chicago*: "as one of our sister Circuits has stated, 'by [the 1974] amendment, literally anything other than onions could become a 'commodity'…simply by its futures being traded on some exchange.'" *Id.* (citing *Bd. of Trade of City of Chicago,* 677 F.2d at 1142). *See also* Salomon Forex, Inc., 795 F. Supp. 768 (E.D. Va. 1992) (holding that foreign currency is a commodity).

52. *Am. Bd. of Trade,* 803 F.2d at 1244.

53. *Id.* at 1244-45.

54. *Id.* at 1248. The court said that the language of the CEA "did not, as defendants would have it, suggest that only options on futures contracts are regulated." *Id.*

55. CFTC v. Int'l Foreign Currency, Inc., 334 F. Supp. 2d 305, 310 (E.D.N.Y. 2004) (noting that futures contracts are bought and sold at a specific price and fixed quantity for future delivery).

56. *Id.* at 311.

57. *Id.* at 312.

58. *Id.*

59. *Int't Foreign Currency*, 334 F. Supp. 2d 305 at 312 (citing *Standard Forex*, 1996 U.S. Dist. LEXIS 14778, at *32).

60. *Id.*

61. *Int't Foreign Currency*, 334 F. Supp. 2d 305 at 312.

62. *Id.*

63. *Id.*

64. *Id.* at 312-13.

65. *Id.* at 313.

66. *Id.*

67. In re Coinflip, Inc., No. 15-29, 2015 CFTC LEXIS 20, at *1 (Sep. 17, 2015).

68. *Id.* at *2.

69. *Id.*

70. *Id.*

71. *Id.* at *3.

72. *Coinflip,* 2015 CFTC LEXIS 20, at *3 (citing 7 U.S.C. § 1a(9)).

73. *Id.* at *3 (citing Board of Trade of City of Chicago v. SEC, 677 F. 2d 1137, 1142 (7th Cir. 1982)). *See also* Hughes & Middlebrook, *supra* note 27. "Trading cryptocurrencies as futures contracts will trigger the Commodities Exchange Act of 1936 (CEA), as amended.… impose[ing] both obligations to have facilities and clearing systems cover market participants, and obligations to have market professionals under the oversight of the CFTC." *Id.* at 218-220. *Cf.* Nicole Swartz, *Bursting the Bitcoin Bubble: The Case To Regulate Digital Currency as a Security or Commodity*, 17 Tul. J. Tech. & Intell. Prop. 319, 333 (2014) (noting that "ordinary bitcoin transactions are not subject to the authority of the CFTC because they are traded instantly").

74. *Coinflip,* 2015 CFTC LEXIS 20, at *2-3.

75. Tu & Meredith, *supra* note 7 at 276.

76. *Id.* at 278.

77. Trautman, *supra* note 6 at P6 (quoting from hearing before NY financial department). A G-20 country means one of the top 20 most important economies. Matt Rosenberg, *What is the G-20?*, ABOUT EDUCATION, http://geography.about.com/od/politicalgeography/a/What-Is-The-G-20.htm (last visited Dec. 1, 2015).

78. Trautman, *supra* note 6 at P44.

79. *See generally*, Trautman, *supra* note 6.

80. Trautman, *supra* note 6 at P45-47 (discussing the Liberty Reserve case). *See generally* United States v. Budovsky, No.13—CR—368, 2015 LEXIS 127717 (S.D.N.Y. Sep. 23, 2015). In *Budovsky* (the Liberty Reserve case), the defendant was charged with operating an unlicensed money operating business. Defendants used a virtual currency known as Liberty Reserve, or LR, to send and receive payment internationally. The business was "designed to help criminals conduct illegal transactions and launder the proceeds of their crimes." *Id.* at *2. Not only did defendants facilitate crime and money laundering, but they failed to register as a Money Transmitting Business. *Id.* at *3.

81. Trautman, *supra* note 6.

82. Trautman, *supra* note 6 at P44.

83. *Id.* at P48.

84. Tu & Meredith, *supra* note 7 at 333.

85. *Id.* at 296-97.

86. *Id.* at 297.

87. *Id.*

88. *Id.* at 274-75.

89. *Id.* at 276.

90. *Id.* at 327.

91. *Id.* at 330.

92. *See generally* Tu & Meredith, *supra* note 7.

93. Tu & Meredith, *supra* note 7 at 326-27.

94. CFTC v. Heffernan, 245 F. Supp. 2d 1276 (S.D. Ga. 2003) (citing CFTC v. R.J. Fitzgerald & Co., Inc., 310 F. 3d 1321, 1329 (11th Cir. 2002) and CFTC v. Field, 249 F.3d 592, 593 (7th Cir. 2001)).

95. United States CFTC v. Am. Bullion Exch. Abex Corp., No. SACV-10-01876, 2014 U.S. Dist. LEXIS 110057 (C.D. Cal. Aug, 7, 2014), (finding that an intentional misrepresentation or omission of information to investors caused significant harm).

96. *Mission & Responsibilities*, U.S. COMMODITY FUTURES TRADING COMMISSION, http://www.cftc.gov/About/MissionResponsibilities/index.htm (last visited Dec. 1, 2015).

97. 7 U.S.C § 5 (2015). *See* CFTC v. Baragosh, 278 F.3d 319 (4th Cir. 2002). The Fourth Circuit in *Baragosh* examined the history and purpose of the CEA and pointed out that the CEA was intended to protect both investors and the market itself from fraud. *Id. See also* Dunn v. CFTC, 519 U.S. 465 (1997) ("The Commodity Futures Trading Commission (CFTC) was created by Congress as part of the 1974 amendments to the Commodity Exchange Act (CEA) (7 U.S.C.S. §§ 1 et seq.). Pursuant to the CEA as amended, the CFTC generally was authorized to regulate the market in futures contracts in fungible commodities."). *See generally* Hughes & Middlebrook, *supra* note 6 (listing the reasons for commodity regulation as market-efficiency, transparency, and accountability). Further, the CFTC enforces these regulations to "ensure financial integrity of all transactions." *Id.*

98. Hughes & Middlebrook, *supra* note 6.

99. Swartz, *supra* note 73 at 75.

100. *Id.* at 75-76.

101. *Id.* at 77.

102. *Id.* 73.

Caitlin Dance is a Notes & Comments Editor of the 2015-2016 *New York Law School Law Review*, J.D., 2016.

Inside the Courts

An Update by the Attorneys at Skadden, Arps, Slate, Meagher & Flom LLP

Class Certification

Colorado District Court Certifies Class of Investors in Municipal Bond Fund Case

In re Oppenheimer Rochester Funds Grp. Sec. Litig., No. 09-md-02063-JLK-KMT (D. Colo. Oct. 16, 2015)

Judge John L. Kane reaffirmed a prior ruling certifying a class of investors in the Oppenheimer California Municipal Bond Fund who alleged claims under Sections 11 and 12(a)(2) of the Securities Act, after reconsidering the order in light of *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, 135 S. Ct. 1318 (2015). While the defendants conceded that certain alleged misstatements were appropriate for class treatment, they argued that the allegation that the fund failed to adhere to its investment objective was too individualized to be dealt with on a classwide basis. After an evidentiary hearing, the court found that the commonality element was satisfied because of the presence of "numerous common questions in [the] case, including whether the Fund's offering documents contain[ed] misstatements or omissions, whether those misstatements and omissions were material, and whether Class members sustained monetary losses." With regard to the typicality requirement, the court rejected the defendants' argument that the putative class representative's sophistication as an investor rendered him atypical and subject to unique defenses concerning his actual knowledge of the fund's poor performance. The court reasoned that the lead plaintiff's knowledge of the fund's performance was not unique to him but was available to the rest of the market, and that "its significance to a reasonable investor [would be] subject to common proof." The court similarly held that the plaintiff's sophistication did not render him an inadequate class representative and rejected attacks on the plaintiff's credibility. Finally, the court determined that the requirements of Rule 23(b)(3) had been satisfied because common issues predominated and were not defeated by individual investor knowledge. The court determined that, under *Omnicare*, "whether a statement is misleading' depends on the perspective of a reasonable investor," and proof of the misleading nature and materiality of the statements and omissions in the fund's offering documents, measured against a "reasonable investor" standard, would be common to all class members, as would be the calculation of damages. The defendants' affirmative defenses of negative loss causation and due diligence similarly did not defeat a finding of predominance because they relied on "generalized proof." The court also found that the superiority prong of Rule 23(b)(3) was met, given that the class format is the "favored method" in the Tenth Circuit for litigating securities actions. The court noted that case management tools are available if the need to address any individualized issues arises.

Dodd-Frank Act

Cost-Benefit Analysis Required in Financial Stability Oversight Council's SIFI Designations, DC District Court Holds

MetLife, Inc. v. Fin. Stability Oversight Council, No. CV 15-0045 (RMC) (D.D.C. Mar. 30, 2016)

Judge Rosemary M. Collyer rescinded MetLife's designation as a systemically important financial institution (SIFI) subject to enhanced supervision under the Dodd-Frank Act. The court ruled that in imposing the designation, the Financial Stability Oversight Council ignored its own guidance and failed to conduct a required cost-benefit analysis.

In designating MetLife as a SIFI, the council determined that any "material financial distress" at MetLife "could pose a threat to the financial stability of the United States." MetLife challenged its SIFI designation on the grounds that the council failed to assess MetLife's vulnerability to financial distress and the magnitude of that distress on the broader economy. The council argued that its guidance require only an evaluation of whether, and how, MetLife's vulnerabilities could impact the broader economy—not an assessment of the probability or likelihood of material financial distress. The council also argued that its guidance permits it to describe the magnitude of the potential harm in broad terms and that it was therefore unnecessary to estimate actual dollar figures. The court disagreed, ruling that the council's "straightforward" guidance required the council to evaluate the risk of financial distress and assess the magnitude of that risk based on reasoned predictions and quantified analysis.

MetLife also challenged its SIFI designation on the ground that the council ignored the costs the designation imposed on the company. MetLife argued that the designation imposed billions of dollars of regulatory compliance costs on the company, thereby increasing its financial vulnerability. The council countered that Dodd-Frank does not require a cost-benefit analysis because the statute requires only that the regulation be "appropriate." The court disagreed. Citing the U.S. Supreme Court's opinion in *Michigan v. EPA*, 135 S. Ct. 2699 (2015), the court ruled that "cost must be balanced against benefit because [n]o regulation is "appropriate" if it does significantly more harm than good.'"

Fiduciary Duties

Books and Records

Delaware Court of Chancery Orders Production of Books and Records Subject to 'Incorporation Condition'

Amalgamated Bank v. Yahoo! Inc., C.A. No. 10774-VCL (Del. Ch. Feb. 2, 2016)

Vice Chancellor J. Travis Laster issued an opinion ordering production of certain books and records to a plaintiff stockholder of Yahoo! Inc. under Section 220 of the Delaware General Corporation Law (DGCL). Post-trial, the court determined that the plaintiff had demonstrated a "credible basis" to suspect wrongdoing, including possible breaches of fiduciary duty by Yahoo's directors and corporate waste, in connection with the firing of Yahoo's chief operating officer, which triggered a nearly $60 million severance payment. As a result, the court found that certain of the documents the plaintiff sought were necessary for a meaningful investigation into such potential claims.

In addition, in what it described as an "issue of first impression," the court granted Yahoo's request that the court "condition any further production on [the plaintiff] incorporating by reference into any derivative action complaint that it files the full scope of the documents that Yahoo has produced or will produce in response to the Demand." The court reasoned that this incorporation condition "protects the legitimate interests of both Yahoo and the judiciary by ensuring that any complaint that [the plaintiff] files will not be based on cherry-picked documents." The court explained that the condition does not change the pleading standard that governs a motion to dismiss, under which a plaintiff is entitled to all reasonable inferences and must be credited with all well-pleaded factual allegations. Thus, the court concluded, "[t]he only effect of the Incorporation Condition will be to ensure that the plaintiff cannot seize on a document, take it out of context, and insist on an unreasonable inference that the court could not draw if it considered related documents." The parties have filed notices of appeal and cross-appeal to the Delaware Supreme Court, which has stayed the case below pending resolution of the appeals.

Derivative Litigation

Delaware Court of Chancery Finds Demand Is Not Excused With Respect to Challenges to Secondary Offering

Sandys v. PInCus, et al., C.A. No. 9512-CB (Del. Ch. Feb. 29, 2016)

Chancellor Andre G. Bouchard dismissed a derivative claim brought by a stockholder of Zynga, Inc., finding the plaintiff did not adequately allege that demand on the board of directors would have been futile. The plaintiff brought a derivative action to recover damages allegedly suffered by Zynga, claiming the board approved certain transactions, namely exceptions to lock-up agreements and trading restrictions, that allowed directors and officers to sell shares in a secondary offering—shortly after which the company's stock price fell dramatically. By the time the plaintiff filed his action, two of the directors who sold in the secondary offering had been replaced by outside directors with no involvement in the underlying events.

The court granted the defendants' motion to dismiss pursuant to Rule 23.1, finding that presuit demand was not excused because the board at the time the complaint was filed consisted of a majority of disinterested and independent directors. The court held that demand was not excused with respect to the insider trading claim governed by *Brophy v. Cities Serv. Co.* against the secondary offering participants based on their alleged misuse of Zynga confidential information to sell shares at the time of the secondary offering. Applying the test for demand futility set forth in *Rales v. Blasband*, the court found that only two of the current board members participated in the secondary offering and were therefore likely to face a substantial likelihood of liability, and that the other seven directors were disinterested and independent. The court found that the fact that directors had "interlocking business relationships" and sat on the board of other companies together was insufficient to raise a reasonable doubt as to their independence.

The court also held that demand was not excused with respect to the plaintiff's claim that the board breached its fiduciary duties by approving the secondary offering and modifications to the lock-up agreements. The court again applied a *Rales* analysis to that claim, finding that while a majority of the members of the board in place at the time of the secondary offering were interested, and even though a majority of those board members had not been replaced, "enough of the *interested* members of that board were replaced (and an additional director was added) so that the [board existing at the time the suit was filed] had a majority of directors (seven of nine) who derived no personal financial benefit from the challenged transaction" (emphasis in original). Thus, the court found that "it makes no sense under these circumstances to focus any aspect of the demand futility inquiry on the board that approved the underlying transaction," and that "demand here should not be excused if a majority of the Demand Board can impartially consider a demand, even when less than a majority of them were replaced." The court also found that even if entire fairness applied to the board's decision to approve the secondary offering, the plaintiff had not stated any nonexculpated claims against a majority of the board in connection with the secondary offering, because the plaintiff did not make particularized allegations that the disinterested directors "knowingly failed to inform themselves about the Secondary Offering or otherwise consciously disregarded their directorial duties, as is required to allege a non-exculpated claim against them." The court also found that demand was not excused with respect to the plaintiff's *Caremark* claim that the defendants failed to ensure that Zynga maintained adequate controls regarding its public disclosures and failed to disclose material information. The court found that two of the directors were disinterested and independent because they joined the board after the alleged *Caremark* violations occurred, and that the three other independent directors did not face a substantial likelihood of liability for the *Caremark* violations because the plaintiff did not plead particularized facts linking the alleged "red flags" to the outside directors' knowledge or actions.

Delaware Court of Chancery Declines to Dismiss Claim Alleging Controlling Stockholder "Extract[ed] a Non-Ratable Benefit" Through Consulting Agreement

In re EZCORP Inc. Consulting Agreement Derivative Litig., C.A. No. 9962-VCL, slip op. (Del. Ch. Jan. 25, 2016)

Vice Chancellor J. Travis Laster issued a memorandum opinion granting in part and denying in part the defendants' motions to dismiss derivative claims for breach of fiduciary duty challenging certain consulting agreements entered into between EZCORP and an advisory firm, Madison Park, which was affiliated with EZCORP's controlling stockholder. After determining that a demand on the EZCORP board of directors would have been futile because it was not sufficiently independent and disinterested, the court found that the complaint stated a claim for breach of fiduciary duty related to the challenged transactions that would be governed by the entire fairness standard of review. The court explained that Delaware courts have historically applied the entire fairness framework broadly, not just in the squeeze-out merger context but to any transaction in which a controller allegedly "extracts a non-ratable benefit," including "compensation arrangements, consulting agreements, services agreements, and similar transactions between a controller or its affiliate and the controlled entity."

Mergers and Acquisitions

Delaware Court of Chancery Declines to Approve Disclosure-Based Settlement

In re Trulia, Inc. Stockholder Litig., C.A. No. 10020-CB (Del. Ch. Jan. 22, 2016)

Chancellor Andre G. Bouchard declined to approve a disclosure-based settlement of deal litigation arising from Zillow's $3.5 billion acquisition of Trulia. Shortly after the proposed merger was announced, stockholder plaintiffs filed suit, engaged in expedited discovery and ultimately settled the claims in exchange for additional disclosures in a supplemental proxy statement. The court found that the additional disclosures were not "material" or even "helpful" to stockholders. In addition, the court explained that the settlement's release, which had been narrowed following the settlement hearing, was overbroad because it released all claims relating "in any conceivable way" to the merger.

In refusing to approve the settlement, Chancellor Bouchard stated that "the Court's historical predisposition toward approving disclosure settlements needs to be reexamined" but stopped short of saying that future disclosure-based settlements will be automatically rejected. Instead, Chancellor Bouchard explained that disclosure-based settlements will be met with "continued disfavor… unless the supplemental disclosures address a plainly material misrepresentation or omission, and the subject matter of the proposed release is narrowly circumscribed to encompass nothing more than disclosure claims and fiduciary duty claims concerning the sale process, if the record shows that such claims have been investigated sufficiently." Chancellor Bouchard elaborated that in "using the term 'plainly material,'" he meant "that it should not be a close call that the supplemental information is material as that term is defined under Delaware law." The court also left open the possibility that if the information was not plainly material, it may be appropriate to appoint an *amicus curiae* to "assist the Court in its evaluation of the alleged benefits of the supplemental disclosures, given the challenges posed by the non-adversarial nature of the typical disclosure settlement hearing."

Insider Trading Claims

SDNY Denies Motion for Summary Judgment on Insider Trading Claims

SEC v. Payton, 14 Civ. 4644 (S.D.N.Y. Dec. 28, 2015)

Judge Jed S. Rakoff denied a defense motion for summary judgment filed on claims by the Securities and Exchange Commission (SEC) that certain individuals violated Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder by trading on inside information they had obtained downstream from a lawyer who worked on an acquisition. Specifically, the court noted that under Rule 10b5-2, there is a duty of trust and confidence where "the person communicating…material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences." The court recounted the history of sharing confidences between the lawyer who worked on the transaction and the lawyer's friend with whom the lawyer shared the allegedly inside information, and between and among the lawyer's friend and certain other friends and colleagues several degrees removed from the original source of the allegedly inside information, including the defendants. The court noted that, for the defendants to be liable, the SEC would have to demonstrate that (1) the lawyer's friend owed a duty of trust to the lawyer, (2) the lawyer's friend breached that duty by disclosing it to others receiving a personal benefit thereby, and (3) the defendants understood the information was confidential and the lawyer's friend obtained a personal benefit by breaching a confidence. Regarding the first element, the court concluded that it was a genuinely disputed material fact whether a duty of trust existed between the lawyer and his friend because there was competing evidence on either side of the issue. Regarding the second element, the court likewise noted that, based on competing evidence, "a reasonable jury could find that" the lawyer's friend provided the tip for a personal benefit under the "quid pro quo" standard set forth by *United States v. Newman*, 773 F. 3d 438 (2d Cir. 2014) because the lawyer's friend and the tippee to whom he disclosed the allegedly inside information had a history of mutual favors. Regarding the third element, the court concluded that the remote tippees, *i.e.*, the defendants, had reason to know that the allegedly inside information was obtained by breaching a confidence because, among other reasons, they were sophisticated and had been in the securities industry for several years.

Interpreting *Omnicare*

Second Circuit Affirms Pre-*Omnicare* Dismissal of Securities Act Claims Based on a Pharmaceutical Company's Opinions

Tongue v. Sanofi, Nos. 15-588-cv, 15-623-cv (2d Cir. Mar. 4, 2016)

The Second Circuit affirmed the dismissal of claims that Sanofi violated Sections 11 and 12(a)(2) of the Securities Act by concealing information about the company's clinical trials of a multiple sclerosis drug. The plaintiffs alleged that the Food and Drug Administration (FDA) repeatedly expressed concerns about the company's use of a single-blind study rather than a double-blind study, but that the company concealed those concerns from investors, and the FDA subsequently denied the drug application. The district court had dismissed the claims because the alleged misstatements were statements of opinion and the plaintiffs failed to sufficiently allege that the defendants did not genuinely believe the statements when made. The Second Circuit affirmed the district court's determination that the plaintiffs had failed to plead misstatement claims, but—in light of the Supreme Court's opinion in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, 135 S. Ct. 1318 (2015)—also reviewed whether the plaintiffs had sufficiently alleged that the company failed to disclose information in connection with the opinions.

Under *Omnicare*, the plaintiffs failed to state a claim: The court determined that the company had not improperly concealed information about the FDA's interim feedback because the company had a legitimate basis to expect approval based on the positive results of the trials, and sophisticated investors should be aware that a drug application will necessarily entail some dialogue between the company and the FDA. In addition, the offering documents included "numerous caveats," including one that addressed the reliability of the company's projections of the drug's success. Further, the FDA had publicly disclosed its general preference for double-blind clinic tests. The court reiterated that investors were "not entitled to so much information as might have been desired to make their own determination about the likelihood of FDA approval by a particular date," and the company need not have disclosed additional information "merely because it tended to cut against their projections." *Omnicare* requires only that the opinion "fairly align[]" with the information in the issuer's possession at the time.

Jury Trial

Eleventh Circuit Affirms Jury Instruction in Civil Securities Fraud Trial, Holds That Rule 10b-5(b) Does Not Impose Duty to Disclose All Material Information

FrIed v. StIefel Labs., Inc., No. 14-14790 (11th Cir. Mar. 1, 2016)

The Eleventh Circuit affirmed a jury instruction given in a rare civil securities fraud trial, holding that Rule 10b-5(b) promulgated under Section 10(b) of the Securities Exchange Act "does not prohibit a mere failure to disclose material information."

The plaintiff, a former executive at the defendant company, brought suit against the defendant and its president after the defendant announced that it had been acquired at a sizable per-share premium by a large pharmaceutical manufacturer. The plaintiff claimed that the defendants committed securities fraud because, among other things, the president failed to notify the plaintiff of the pending sale during a conversation in which the officer advised the plaintiff to cash out his stock options in the defendant. Before trial, the district court refused to issue the plaintiff's proposed jury instruction that the defendants had a "duty to disclose all material information" to the plaintiff. The jury returned a verdict in favor the defendants.

In affirming the district court, the Eleventh Circuit held that the plaintiff's proposed jury instruction misstated the law. Rule 10b-5(b) imposes a duty only "to update prior statements if the statements were true when made, but misleading or deceptive if left unrevised." It does not require individuals to disclose material facts if the individual never made affirmative statements that would be misleading if left uncorrected. The plaintiff's jury instruction thus misstated the law, because the defendant's only duty was to disclose information necessary to prevent prior statements from being misleading, not to disclose all material information to the plaintiff. Accordingly, the court held that the district court correctly refused to issue the plaintiff's proposed jury instruction and affirmed the judgment in favor of the defendants.

Securities Fraud Pleading Standards

Northern District of California Dismisses Securities Fraud Class Action Against Apple Supplier for Failure to Plead False or Misleading Statements

In re Invensense, Inc. Sec. Litig., No. 15-cv-00084-JD (N.D. Cal. Mar. 28, 2016)

District Judge James Donato dismissed a securities fraud class action brought against a technology company that supplies iPhone parts to Apple, finding that the plaintiff failed to plead with particularity that the defendant made false or misleading statements.

The plaintiff, representing a putative shareholder class, brought suit under Sections 10(b) and 20(a) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder, alleging that the defendant and its officers waited too long to write down the value of certain obsolete inventory and made inflated estimates about the company's gross margins. Specifically, the plaintiff alleged that the defendant had overstated the value of its inventory and presented unrealistic gross margin projections in various earnings calls.

In dismissing the complaint, the court concluded that while the plaintiff had presented substantial and detailed evidence that the defendant's statements relating to the value of its inventory were false and misleading, the plaintiff had nonetheless failed to meet the heightened pleading requirements of the Private Securities Litigation Reform Act (PSLRA) and Federal Rule of Civil Procedure 9(b) because it did not allege the source of its knowledge. The court further concluded that the defendant's gross margin projections were forward-looking statements protected by the PSLRA's safe harbor provision and were thus inactionable as a matter of law. Accordingly, the court dismissed the plaintiff's inventory-related claims with leave to amend but dismissed the gross margin-related claims with prejudice.

Finally, because the Section 20(a) claims against the defendant's officers were predicated on the plaintiff's Section 10(b) claims, those claims were likewise dismissed.

Misrepresentations

Southern District of California Dismisses Securities Fraud Class Action Against SeaWorld Arising From Alleged Mistreatment of Captive Killer Whales

Baker v. SeaWorld Entm't, Inc., et al., No. 14cv 2129-MMA (KSC) (S.D. Cal. Mar. 31, 2016)

District Judge Michael M. Anello dismissed a putative securities fraud class action brought against SeaWorld, its officers and its underwriters, finding that the plaintiffs had failed to plead with particularity that SeaWorld made false or misleading statements, as required by the Private Securities Litigation Reform Act and Federal Rule of Civil Procedure 9(b).

The plaintiffs, seeking to represent a class of SeaWorld shareholders that purchased shares in various public offerings, brought claims under Sections 11, 12 and 15 of the Securities Act and under Sections 10(b) and 20(a) of the Securities Exchange Act. They alleged that SeaWorld and its officers committed securities fraud by publicly denying that the documentary "Blackfish"—which severely criticized SeaWorld's orca breeding program—had an adverse impact on the theme park's attendance. Plaintiffs alleged, among other things, that the documentary must have caused attendance to decline because attendance did decline during the class period, SeaWorld's competitors' attendance rose during the class period, "Black-fish" caused SeaWorld tremendous negative publicity and the California legislature considered a bill banning SeaWorld's orca breeding program.

In dismissing the Exchange Act claims as well as the claims brought under Sections 11 and 15 of the Securities Act, the court concluded principally that the plaintiffs had failed to plead with particularly that SeaWorld's denials were false or misleading because the plaintiffs failed to plead the existence of reports or data analyzing SeaWorld's attendance figures and attributing the decline in attendance to the negative publicity and pending legislative action following the release of "Blackfish." The court further concluded that the plaintiffs' other evidence of falsity—including the comparisons to SeaWorld's competitors—was fatally flawed, because factors other than "Blackfish," including increased competition and poor weather, may have been responsible for SeaWorld's attendance decline.

Finally, the court dismissed the Securities Act Section 12(a)(2) claims against all defendants, though for different reasons. The court dismissed the 12(a)(2) claims against SeaWorld and its directors because the plaintiffs did not adequately allege that these defendants sold or solicited purchases of SeaWorld shares.

And it dismissed the 12(a)(2) claims against the underwriter defendants because the plaintiffs failed to allege that they purchased shares from any of the underwriters specifically.

Northern District of Illinois Dismisses Former Employees' Securities Fraud Claims for Failure to Meet Heightened Pleading Standard

Cornielsen v. Infinium Capital Holdings, LLC, No. 14-cv-00098 (N.D. Ill. Mar. 3, 2016)

Judge Andrea R. Wood dismissed without prejudice securities fraud claims brought under Section 10(b) of the Securities Exchange Act against a diversified alternative asset and risk management firm as well as certain officers and board members. The plaintiffs, former employees of the firm, claimed that the defendants made material misrepresentations and omissions regarding an employee program through which the plaintiffs' loans to the firm were converted into equity.

In dismissing the claims, the court concluded that the plaintiffs failed to adequately plead actionable misstatements under the heightened pleading standard of Rule 9(b) of the Federal Rules of Civil Procedure. The court reasoned that several of the plaintiffs' allegations failed because the plaintiffs did not identify the specific defendants who made the alleged misrepresentations or omissions, or the allegations were made "upon information and belief" with no supporting facts, as required by Rule 9(b). With respect to the omissions, the court reasoned that the plaintiffs failed to allege facts establishing that any defendant had a duty to speak. The court explained that there is generally no affirmative duty for a company to disclose all information that could potentially affect share prices, unless such silence renders an affirmative statement misleading. Finally, the court concluded that the plaintiffs failed to state with particularity how the alleged omissions rendered any affirmative statement misleading.

Colorado District Court Denies Motion to Dismiss Securities Fraud Claims Against Mining Corporation

In re Molycorp, Inc. Sec. Litig., No. 12-CV-00292-RM-KMT (D. Colo. Jan. 20, 2016)

Judge Raymond P. Moore declined to dismiss, in large part, claims that a mining company violated Section 10(b) of the Securities Exchange Act and Sections 11 and 12(a) of the Securities Act by allegedly stating that a particular mine contained deposits of heavy rare earth elements (HREEs) (the company's "principal" products), while daily analysis of the mine demonstrated that there were no HREEs present. The court found that three types of allegations raised a plausible inference that the defendants acted with scienter: (1) information from a former analytical chemist (a confidential witness) about daily ore analysis that was entered into a computerized system, to which senior management had access, (2) the discrepancy between certain defendants' sales of the company's stock during and after the class period, and (3) the position of certain senior executives within the company, which gave them access to and knowledge of the information concerning the daily ore analysis and absence of HREEs. The court also found that the plaintiffs had sufficiently pleaded loss causation because they alleged that the stock suffered an abnormal decline in value following a senior executive's disclosure at a conference that the company had not found any HREEs in the mine. However, the court held that the complaint failed to state a claim against the individual defendants for insider trading because it did not sufficiently allege that those defendants had knowledge concerning the absence of HREEs at the mine. The court also determined that the complaint stated a claim under Section 11 of the Securities Act for material misrepresentations in the company's registration statement. The court further held that the complaint stated a claim under Section 12 of the Securities Act against the underwriter defendants. Although the court noted the "express privity requirement" under Section 12 and observed that plaintiffs might not ultimately prevail on their claim, it nevertheless found that the plaintiffs had sufficiently pleaded that they had "purchased ... shares [of] Molycorp common and preferred stock in the February and June 2011 Offerings pursuant to the February and June 2011 [p]rospectuses" and that the "Underwriter Defendants were sellers, offerors, and / or solicitors of sales of the common and preferred stock" offered in connection with the registration statements at issue.

Omissions

Second Circuit Affirms Dismissal of Claims Against Online Video Advertisement Company

Medina v. Tremor Video, Inc., No. 15-2178-cv (2d Cir. Feb. 8, 2016) (Summary Order)

The Second Circuit affirmed the dismissal of claims brought by a putative class of investors alleging that an online video advertisement company violated Section 11 of the Securities Act by purportedly failing to disclose in a registration statement for the company's initial public offering certain material trends or uncertainties regarding delays in upfront ad buys, demographic pricing and ad buying. The plaintiffs alleged that the trends and uncertainties became apparent when the company released its quarterly financial results several months later. The court also affirmed the denial of the plaintiffs' request for leave to amend their complaint as futile. Reviewing those rulings *de novo*, the Second Circuit held that the complaint failed to allege sufficient facts to give rise to a plausible inference that defendants omitted material trends or uncertainties, and it noted that the registration statement included adequate cautionary language. The Second Circuit also held that the proposed amended complaint was flawed because it failed "to plausibly allege that defendants *knew* of the alleged uncertainties and trends at the time of the Registration Statement." The court rejected the plaintiffs' argument that because publicly available information placed defendants in a "position to know" that their statements were false or misleading, that actual knowledge could therefore be imputed to defendants. The court concluded that although "[w]ith the benefit of hindsight," those trends were apparent by the time the company released its financial results, the plaintiffs could not use "hindsight alone" to impute to the defendants knowledge that certain events that constituted the trends "were omens of future material problems."

SDNY Dismisses Putative Securities Fraud Class Action for Failure to State Claim

In re China Mobile Games & Entm't Grp. Ltd. Sec. Litig., No. 14-CV-4471 (KMW) (S.D.N.Y. Mar. 7, 2016)

Judge Kimba M. Wood granted the dismissal of claims that a Chinese developer and publisher of mobile games violated Sections 10(b) of the Securities Exchange Act by allegedly making false or misleading statements concerning the company's involvement in a bribery scheme and by failing to disclose certain related-party transactions. The plaintiffs alleged that the company assured investors in its offering documents that it had disclosed all material weaknesses of the company's operations but in fact failed to disclose that the company was paying bribes to maintain good relationships with its distributors and that the company's president's former company was one of the distributors receiving the alleged bribes. The court determined that the plaintiffs failed to sufficiently allege that the company's statements made in SEC filings were false at the time they were made because they were made more than three months before news articles and analysts reports speculated that the company had terminated employees for engaging in alleged bribery. Further, the court discredited the plaintiffs' confidential witness because the witness worked for the company's subsidiary, not the company itself.

In addition, although the court held that the company was under a duty to disclose related-party transactions, it determined that the plaintiffs failed to sufficiently allege facts showing that the company's president controlled his former company after he had sold his entire interest in it. The court also determined that the plaintiffs failed to adequately plead scienter. The plaintiffs' conclusory allegations that the company had a desire to conceal the alleged bribery and related-party transactions failed because the plaintiffs did not offer any factual support that the company benefited in some concrete or personal way from the alleged schemes or that the company concealed the alleged schemes in an effort to shore up its offering. Further, with respect to the alleged related-party transactions, the court determined that the company's president had divested all interest in his former company before joining the company, and no facts supported the allegation that the president's divestment was a sham. The court also reasoned that the plaintiffs failed to show that the company concealed the alleged bribery because the company did an independent investigation into the market's speculation of bribery and no misconduct was identified. Finally, the court found that the plaintiffs' reliance on the core operations doctrine failed because the mere fact that the company's publishing department was at the core of the company's business, without more, was insufficient to find an inference of scienter.

Eastern District of Michigan Dismisses Securities Fraud Claims Against Bank Holding Company and Its Officers

Lubbers v. Flagstar Bancorp. Inc., No. 14-cv-13459 (E.D. Mich. Feb. 10, 2016)

Judge Bernard A. Friedman dismissed a federal securities class action against a holding company and two corporate officers. The court held that the plaintiff failed to plead any actionable misstatements or omissions under Section 10(b) of the Securities Exchange Act and therefore also failed to state a Section 20(a) control person liability claim against the two corporate officers.

The plaintiff alleged that the defendants misrepresented or failed to disclose certain information in public filings, including: (1) the existence of regulatory investigations into the company's mortgage servicing practices, (2) the effect of cost reductions in the company's mortgage servicing business, and (3) the ongoing risk of liability notwithstanding its sale of certain of its mortgage servicing rights.

The court held that the company's disclosures were adequate, noting that the company was not required to disclose every fact that may have been of interest to potential investors. The court further stated that the plaintiff failed to show particular statements were misleading because the allegedly omitted information was not logically related to the subject of the statements.

SDNY Dismisses Putative Securities Fraud Class Action for Failure to State Claim

In re Sano! Sec. 4ItIG., No. 14-cv-9624 (PKC) (S.D.N.Y. Jan. 6, 2016)

Judge P. Kevin Castel granted a motion to dismiss a putative class action that alleged claims under Sections 10(b) and 20(a) of the Securities Exchange Act. The plaintiffs' claims arose from an alleged illegal marketing scheme whereby defendant Sanofi purportedly funneled millions of dollars to third-party consultants who "served as middlemen in a scheme to induce pharmaceutical retailers and hospitals to favor Sanofi's diabetes drugs over competing drugs." In reliance on a whistleblower's report, the complaint alleged that Sanofi undertook an internal investigation into nine potentially fraudulent contracts, which confirmed violations of internal policies and federal laws, but that the defendants nonetheless misrepresented Sanofi's legal compliance and corporate integrity. The complaint further alleged that the failure to disclose the alleged scheme boosted sales of Sanofi's diabetes products, but that once the company abandoned the scheme, sales of the products dropped off considerably.

The court first found that the plaintiffs had failed to allege the presence of an illegal scheme—or that Sanofi had conducted an internal investigation that confirmed the existence of the scheme—with the requisite particularity. Although the plaintiffs had pleaded that the whistleblower had learned that her co-workers had processed "improper inducement payments," they had pleaded no facts concerning the specific circumstances surrounding how the whistleblower had gained this knowledge. The plaintiffs also failed to identify the contracts in question or plead facts demonstrating that consultants had actually engaged in unlawful referral services on behalf of Sanofi, or that drug retailers and hospitals in fact received kickbacks. The court next determined that the complaint had not alleged that the defendants had made any material misstatements or omissions: Statements made on conference calls and in SEC filings about "efforts toward transparency, accountability, and disclosure" were mere "corporate puffery," too general to induce reliance. Furthermore, the CEO's Sarbanes-Oxley certification that the reports did not contain any untrue or misleading statements or omissions was not actionable because the plaintiffs did not allege that the CEO did not believe what he said. And although the plaintiffs complained of allegedly misleading statements made in SEC filings, press releases and conference calls concerning growth in diabetes products, "the allegation that a corporation properly reported income that is alleged to have been, in part, improperly obtained is insufficient to impose Section 10(b) liability." The court also held that the plaintiffs had failed to plead scienter. Knowledge of the alleged scheme could not be imputed to the CEO by virtue of his managerial position and the operation of corporate policies that would have, in the abstract, given him access to allegations concerning such a scheme. Finally, the court held that the plaintiffs had failed to allege loss causation because they had not pleaded any facts showing that Sanofi's alleged scheme in fact materially inflated sales of diabetes products. Because the complaint failed to state a primary violation of Section 10(b), it also did not state a claim under Section 20(a).

Scienter

Eighth Circuit Reverses Dismissal of Investors' Securities Fraud Claims Against Professional Services Company

Rand & Heart of New York, Inc. v. Dolan, No. 15-1838 (8th Cir. Feb. 10, 2016)

The Eighth Circuit affirmed in part and reversed in part a district court ruling dismissing a class action brought against the officers of a professional services company for alleged violations of Sections 10(b) and 20(a) of the Securities Exchange Act. The plaintiff investors alleged that, in a press release and during a conference call with analysts regarding second-quarter results, the company omitted material facts about the financial stability of its subsidiary, predicting double-digit growth while failing to disclose the subsidiary's loss of its largest customer. The plaintiffs sought to recover for losses they sustained between the date of the allegedly misleading statements and the date the company announced its appointment of a chief restructuring officer. The district court granted the defendants' motion to dismiss, reasoning that the plaintiffs failed to adequately allege scienter and establish loss causation for the second half of the period at issue.

The Eighth Circuit reversed the district court's ruling that the plaintiffs failed to adequately plead scienter, holding that the investors sufficiently alleged that the company's failure to disclose its subsidiary's loss of its largest customer was reckless. Pointing to the plaintiffs' allegation that the customer had formerly provided more than 50 percent of the subsidiary's business, the court concluded that the financial instability caused by this loss was so obvious that the defendants must have been aware of it. The court rejected the defendants' argument that the company's statements were protected by the Securities and Exchange Act's safe harbor provision, holding that the "boilerplate" cautionary language accompanying the statements was not "*meaningfully* cautionary" because it did not include "company-specific warnings based on a realistic description of the risks applicable to the particular circumstances."

The court affirmed the district court's ruling that the plaintiffs failed to adequately plead loss causation for the period between the company's second press release during the alleged time period, which disclosed the company's financial hardships and the lost customer, and its announcement that it had appointed a chief restructuring officer. Emphasizing that corrective disclosures must actually present new information to the market, the court concluded that announcing the appointment of a restructuring officer did not correct a misrepresentation but merely elaborated on the company's previously disclosed plan to restructure.

Fifth Circuit Sets Forth 'Special Circumstances' Under Which Officers' Positions May Give Rise to Inference of Scienter

Local 731 I.B. of T. Excavators & Pavers Pension Trust Fund v. Diodes, Inc., No. 14-41141 (5th Cir. Jan. 13, 2016)

The Fifth Circuit affirmed the dismissal of a securities class action against a semiconductor manufacturer and two of its officers, holding that the complaint failed to plead facts giving rise to a strong inference of scienter.

Plaintiffs alleged that the semiconductor manufacturer and its CEO and chief financial officer violated Section 10(b) of the Securities Exchange Act by failing to disclose that the company's labor policies exacerbated a labor shortage at the company's Shanghai facility. The plaintiffs alleged that the officer defendants must have known about the policies due to their executive positions. In response to defendants' motion to dismiss, the plaintiffs argued that although an officer's position alone does not suffice to create a strong inference of scienter, "special circumstances" taken together with an officer's position may support the requisite inference of scienter.

The Court of Appeals observed that the "'special circumstances' cases exhibit some combination of four considerations that might tip the scales in favor of an inference of scienter": (1) whether a company is small, such that the executives would be familiar with the intricacies of day-to-day operations, (2) whether the transaction at issue is critical to the company's vitality, (3) whether the alleged misrepresentation or omission would have been readily apparent to the speaker, and (4) whether the defendant's statements were internally inconsistent. The court held, however, that none of these factors was present in this case. First, the company had more than 4,000 employees at locations around the world, and it was not clear that senior executives in Dallas would be aware of labor policies in Shanghai. Second, the plaintiffs did not allege that the labor shortage jeopardized the company's existence. Third, the plaintiffs did not plead facts showing that the impact of Shanghai's labor policies would have been readily apparent to the officer defendants. Finally, the court held that the officers' statements were not inconsistent—the officers repeatedly informed investors of the labor shortage and accurately predicted the impact the shortage would have on the company's financial performance.

Northern District of California Dismisses Securities Fraud Class Action Against Electronic Payment Company

In re Verifone Sec. Litig., No. 5:13-cv-01038-EJD (N.D. Cal. Mar. 29, 2016)

District Judge Edward J. Davila dismissed securities fraud claims brought against a leading provider of secure electronic payment services, finding that the plaintiffs failed to adequately allege either the misrepresentation or scienter elements of their claims.

The plaintiffs, representing a putative shareholder class, brought suit under Sections 10(b) and 20(a) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder, alleging that the defendants hid and misrepresented the failure of the company's transition from a product-oriented to service-oriented business model. Specifically, the plaintiffs alleged that the defendants misled the market by claiming to have achieved "record revenues and record profit" during the transition period, even though the defendants knew that the company's business model transition was a failure. The plaintiffs also claimed that the defendants failed to disclose transition-related decreases in the defendant's research and development budget, among other things.

In evaluating the plaintiffs' claims, the court found that the plaintiffs adequately pleaded that the "record revenues and record profits" statement could constitute a material misrepresentation because such statements were capable of objective verification. The court nevertheless dismissed the plaintiffs' claims based on those statements, concluding that the plaintiffs had failed to establish a strong inference that the defendants made that statement with scienter. First, the timing of the statement—10 weeks before the defendant announced its actual financial results—did not give rise to the inference that the defendants must have known that the company would not achieve record revenues and profits when the statement was made. Second, the termination of key company employees more than two months after the statement was made did not support an inference of scienter in context, because the terminations were not obviously related to revelations of fraud. Finally, the plaintiffs' allegations regarding certain internal statements made by the defendant officers were insufficient to establish scienter because the plaintiffs failed to plead the time, place and context in which the statements were made.

The court then dismissed the claims predicated on the defendant's research and development budget, reasoning that the defendants had not made any affirmative statements that required the defendants to disclose its disinvestment in research and development in order to avoid misleading the market.

After dismissing the plaintiffs' Section 10(b) claims for failure to adequately plead falsity and scienter, the court dismissed the plaintiffs' Section 20(a) claims, which were predicated on the underlying 10(b) claims.

Northern District of California Refuses to Dismiss Securities Fraud Claims, Finds That Magnitude of Accounting Violations Created Strong Inference of Scienter

Thomas v. Magnachip Semiconductor Corp., No. 14-cv-01160-JST (N.D. Cal. Mar. 4, 2016)

District Judge Jon S. Tigar refused to dismiss securities fraud claims against a South Korean technology manufacturer, finding among other things that the plaintiffs pleaded sufficient facts to create a strong inference that the defendant made false or misleading statements with scienter.

The plaintiffs, a group of investors, brought suit principally under Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder, alleging that the defendant consistently inflated its financial results over a two-year period from 2011 to 2013 through widespread accounting irregularities. For example, in 2014, the defendant restated its earlier financial results, to report that it suffered a roughly $11 million loss in net income in 2011 rather than gained nearly $22 million, as it had previously reported. The plaintiffs alleged that the magnitude of the defendant's accounting violations, which the defendant admitted were "illegal," combined with the resignations of two top employees, were sufficient to show a strong inference that the company's accounting violations were committed with scienter.

In denying the defendant's motion to dismiss, the court found that because the accounting violations "dramatically affected" the defendant's financial results in ways that strongly suggested "a typical corporate executive should have noticed them," the plaintiffs had pleaded facts sufficient to create a strong inference of scienter. The court further reasoned that the defendant company's admission that its management was responsible for the accounting errors, combined with the magnitude of the errors, was enough to suggest that the individual officer defendants were at least reckless in reporting the company's financial results. Moreover, the court found that the resignation of two of the defendant's top employees soon after the purported wrongdoing came to light contributed to an inference of scienter.

While the court allowed the plaintiffs' Section 10(b) claims to proceed, it found that the plaintiffs' additional claims under the Securities Act were time-barred because the plaintiffs failed to file those claims within one year after a reasonably diligent plaintiff would have discovered facts constituting the violations.

"…[E]xcept For All the Others": A Compromise Proposal for Correcting the Incentives of Credit Rating Agencies in the Wake of the Dodd-Frank Act

By Lawrence Crane-Moscowitz

I. Introduction

Years after the "Great Recession," the consensus view of bankers, economists, lawyers, policymakers, and reporters is that Nationally Recognized Securities Ratings Organizations ("NRSROs") played some part in the 2008 "financial meltdown."[1] While debate continues about how central their role was,[2] the triple-A ratings that NRSROs gave to collateralized debt obligations ("CDOs")—securities that would go into default with far greater regularity than their triple-A rating would have suggested[3]—illustrated how errors made by NRSROs, in evaluating creditworthiness, rippled through other institutions with calamitous results.[4] Further, the recession highlighted the importance of the NRSRO's "quasi-regulatory" role in the financial system.[5]

Perhaps most importantly, the recession revealed just how little skin NRSROs have in the financial game once their ratings are released. As Professor Claire A. Hill has addressed, NRSROs have been slow, historically, to correct ratings errors once they become apparent.[6] Several scholars have attributed this to both the windfall nature of the NRSRO's compensation structure, and the conflicts of interest present in an NRSRO's "issuer pays" business model.[7] As Professor Frank Partnoy has articulated, even when times are good, NRSROs have little incentive to get their ratings "right."[8]

Thus, in the wake of this most recent financial crisis, rather than rely on the long-held belief that rating agencies would produce "good" ratings going forward,[9] political actors undertook legislative and administrative responses in the hopes of increasing ratings accuracy and "credibility," given the NRSRO's vital role in the financial system.[10] The Dodd-Frank Act gave the Securities and Exchange Commission ("SEC") greater authority to impose rules on NRSROs that would (1) improve the NRSRO's accuracy in rating default risk, and (2) reduce the features of the "duopoly plus" regime that NRSROs exploited to maximize profits—features that placed NRSROs front and center in the financial crisis.[11]

The SEC used this authority to form the Office of Credit Ratings ("OCR") and, through it, implement rulemakings. Feedback on the new rules has been mixed. While pushback from inside the NRSRO community was expected,[12] there remains debate amongst outsiders about whether the new rules go too far, or do not go far enough in addressing the problems with ratings and the agencies that produce them.

Both postures may have some merit. The SEC's rules largely conform to securities regulation's traditional principles that "sunlight is…the best of disinfectants; electric light, the most efficient policeman"[13] and that procedural reforms will resolve systemic ills.[14] The result, at an intra-firm level though, means the rules may go too far, as suggested by Representative Scott Garrett, since they impose (1) communication barriers between the firm's salespeople and modelers, and (2) more rigorous documentation procedures.[15]

However, the broader concern, and the view of this article, is that the SEC's efforts likely did not go far enough in creating the proper incentives at an inter-firm level to improve ratings quality. Recent legislation made some progress by opening up NRSROs to potential liability.[16] However, Congress's punt to the OCR left open how regulators would resolve conflicts and risks latent within the "issuer pays" system (that are often acknowledged in the existing academic literature).[17]

Since that punt, OCR's rulemaking efforts[18] have disappointed. For one, the OCR has shown little backbone in standing up to the industry it regulates.[19] Moreover, OCR has neglected two key issues that reform should address: (1) the windfall nature of the existing payout diagram for NRSROs[20]—even if their role as *ex ante* evaluator is important[21]—and (2) the asymmetric risk that comes from inaccurate ratings information.[22]

Even so, no obvious solution exists for the above points that the OCR has ignored. Consensus in this area is tough to find beyond agreement that the Great Recession was bad and ratings played a role. This article seeks to stake out a reasonable middle ground between competing schools of thought on how to reform NRSROs, while leaving in place certain assumptions regarding the system's "duopoly plus" structure and the "issuer pays" business model. The solution proposes tighter ties between the NRSROs and suggests partnership with the government, while also trying (1) realignment of an NRSRO's incentives to make the organization more mindful of a security's default risk over the long term, and (2) addressing the industry's broader anti-competitive tendencies.[23] While such a system is certain to have defects, the goal is to sketch a framework that (1) rewards an NRSRO for acting as a substantive check on an issuer, and (2) counters an NRSRO's tendency to materially understate default risk in pursuit of its own profitability and market share.

As an overview, Part II recounts recent history in the NRSRO field, including the NRSRO's behavior as corporate actors responding to ratings reform efforts. Part III discusses the existing market environment in which regulators will have to act, discussing the "duopoly" dynamics of S&P and Moody's, as well as the dynamics of the "plus"—epitomized by Fitch and other smaller NRSROs—who compete for residual shares of the ratings market with lower prices and product specialization.[24] Part IV recaps recent efforts by the legislators and the OCR to reform the existing market, and seeks to illustrate the gaps that remain with the OCR's rules (in spite of their largely well-intentioned aims). Part V proposes a system that the OCR should seek to promulgate via its rulemaking authority, building on the existing academic literature to close gaps that remain from regulatory efforts to date, as well as the legal arguments that could impede such regulations. This system would require that an NRSRO obtain a license which would impose on the firm certain constraints about how it could be compensated; the system would offset these limitations by providing cash bonuses (subsidized by competing NRSROs) if a firm were to deliver more accurate ratings than its peers. Part VI is the conclusion.

II. Recent History

In 1996, Thomas Friedman of the *New York Times* declared that "there [were] two superpowers in the world today…the United States and…Moody's Bond Rating Service."[25] By 2000, that opinion looked prescient: on September 30 of that year, Moody's Corporation engaged in an initial public offering, on the back of investor pressure, to decouple its highly profitable division from its underperforming parent company, Dun & Bradstreet.[26] The decision has since made unquestionable financial sense. Since Moody's IPO, the service has grown into a company with a market cap of roughly 20 billion dollars, and with net profit margins regularly at, and often in excess of, 30%.[27]

Profit margins across Moody's and its peers[28] reflect the centrality of ratings agencies in the debt markets. Since 1975, the SEC has been leveraging NRSROs, like Moody's, to determine what capital certain registered entities are able to hold on their balance sheets; entities are limited to holding certain minimum percentages of "investment grade" capital.[29] An NRSRO's evaluations of an asset's likelihood of default guide whether it is "investment grade."[30] Thus, the result is that a limited number of firms act as proxies for the SEC and serve as gatekeepers to the financial markets for firms seeking debt financing.[31]

Several commentators have questioned the reasoning behind allowing private participants to function as gatekeepers,[32] but a considerable number have also criticized the paucity of viable gatekeepers.[33] This paucity has been endemic to the system historically,[34] but has become increasingly frustrating to those observing the financial markets[35]— as well as those who seek to disrupt the existing market leaders.[36] This frustration is due to the fact that NRSROs (1) have often been slow to consume new information, which leads to ratings adjustments that are untimely and inaccurate,[37] and (2) are perceived (in part because of the "issuer pays" model's conflicts) as either "incompetent"[38] or "corrupt."[39]

Moreover, this paucity of options has persisted in spite of both economic downturns and pre-crisis reform efforts. Ratings agencies first began facing serious Congressional scrutiny in the wake of the 2001 recession.[40] The 2001 recession revealed many failures within private gatekeeping institutions, principally at accounting firms.[41] NRSROs found themselves in the regulatory crosshairs, and were harangued for failing to change the default risk of firms like Enron until only four days before the company's bankruptcy.[42] Because of this reluctance to act, Congress passed the Credit Rating Agency Reform Act of 2006.[43] The law had noble aspirations.[44] Unfortunately, it did next to nothing to modify market participant behavior or improve rating accuracy in the period leading up to the "Great Recession."[45]

Even after 2008, with regulatory fervor at levels unseen since the Great Depression (which, ironically, spawned the industry's emergence),[46] the NRSROs have largely escaped from underneath the regulatory net of Dodd-Frank. While certain statutory changes have made NRSROs more like other financial "experts,"[47]the industry's coordinated pushback on the statutory changes resulted in rulemaking that once again left NRSROs out of the reach of legal liability and monetary damages.[48]

While the SEC may someday prove itself capable of proactively policing these gatekeepers, when that day comes, NRSROs will likely be able to push back against future reform-oriented legislative and rulemaking activity. The industry has fully recovered financially from the 2008 crisis—attaining a level of profitability and prominence it had not seen since 1996.[49]

III. Current Environment

Even with rule changes afoot, the NRSRO's gatekeeper status has never been in doubt;[50] thus, acknowledging today's market participants is worthwhile. As mentioned above,[51] the number of NRSROs has always been lower than one would have anticipated, given the highly profitable nature of the gatekeeping business.[52] Today's regime is described as "duopoly plus."[53] The "duopoly" of S&P and Moody's controls about 80% of the credit ratings across products in the United States.[54] Fitch Ratings leads the "plus" category, which also includes eight other NRSROs, all of whom are competing for the residual market share.[55]

There are two primary theories that explain this paradigm. One theory couches its assessment of NRSROs as renters of "reputational capital."[56] Because the reputational capital of long-standing firms like S&P and Moody's is difficult to duplicate,[57] it serves as an insurmountable barrier to entry for other firms. The alternative theory takes a less charitable view. Rather than view reputation as the barrier to entry, it views the "duopoly" as inherently determined to protect its place atop the gatekeeping regime by using its first-mover advantage (and the cash that comes with it).[58] Because of its business model's ability to amass large volumes of cash, should a competitor arise, the duopoly can simply consume the competitor via a merger.[59]

Some commentators argue that these two theories represent a distinction without a difference.[60] However, that seems incorrect. If one believes that the "reputational capital" of the duopoly matters,[61] then the preferred regulatory fix is to permit competition, allowing the duopoly's errors (which damage their credibility) to spur new participants who would compete on accuracy.[62] Alternatively, the fix could be to remove licenses to rate securities from all but the duopoly, then require that both firms rate all securities (under strict oversight from the government). This would lessen "rate shopping" and related problems.

But history has shown that damage to "reputational capital" alone has neither altered market participants' views regarding the "duopoly" or forced any NRSRO to adjust its behavior.[63] As a result, the first mover advantage theory seems more correct. Accepting this theory helps explain why the market for ratings seems unable to both operate effectively and value accuracy in a meaningful way. Thus, the more apt regulatory response is probably to break the "duopoly" and recalibrate the market. Whether through adopting formal caps (which would reduce any single firm's volume of ratings to an "acceptable" level) or by better incentivizing the limited pool of alternative participants (thus lessening the ability of one firm's ratings to serve as a stalking horse for others), this result might be achievable—but only with some degree of intervention from regulatory actors.[64]

IV. Current Regulatory Response

Taking the recent history and the current marketplace as the baseline reveals three primary issues that a regulatory response must account for. First, because NRSROs are highly profitable gatekeepers, they retain a position that allows them to defend themselves from legislative threats and emergent market participants alike.[65] Second, since Congress's will to reform the financial sector largely crested with Dodd-Frank, any future regulatory action will require rulemaking from the SEC. This, in turn, implies that some level of compromise with NRSROs will probably occur during the notice and comment process, and that radical reforms to the industry's business model will likely be impractical.[66] Third, because efforts at increasing competition, coupled with insufficient deterrence mechanisms, had created possible incentives for overrating in the pre-crisis period,[67] regulatory responses for NRSROs going forward should be skeptical of unfettered competition as an unquestioned systemic good.[68]

In this light, justifying the rulemakings promulgated on the back of Dodd-Frank as representative of regulators' best efforts seems reasonable, given the frictions faced in practice.[69] Reform advocates have said as much, stating that the current rules mark a considerable improvement over earlier iterations.[70] Yet many more are critical of the rules for two reasons: (1) because the rules are primarily concerned with *ab initio* ratings, and thus do not create stronger incentives for continuous review of a security's default risk, and (2) because the SEC is reluctant to address the NRSROs compensation model.[71]

This section will review the regulatory response in four parts. Part A will address a central change encapsulated in Dodd-Frank's legislation, specifically the modifications to Section 11 liability, because this statutory change could have modified the NRSRO's role substantively. This change has since been undone via rulemaking. Part B will address more SEC rulemakings relating to an NRSRO business model. Because the rules fail to change the underlying practices relating to rate shopping or firm-level compensation, the primary bulwarks against meaningful reforms remain intact. Part C addresses a seemingly minor change enacted in Dodd-Frank that could have radical results: the government's decision to write NRSROs out of portions of the regulatory regime. Such a shift may create greater regulatory headaches, something that the proposal later aims to foreclose. Part D reviews a more controversial proposal, the Franken Amendment, which was left out of the Dodd-Frank legislation. Its removal from the bill illustrates that outside-the-box thought on ratings reform can at least enter regulatory circles; thus, meaningful change to the NRSROs' business model remains possible even without legislative traction—so long as that change can survive the rulemaking process.

A. Section 11 Exposure (and Its Demise)

Among the noteworthy changes in the Dodd-Frank Act, expanding legal liability to "experts" in actions brought by market participants had the greatest potential impact on NRSROs.[72] Before Dodd-Frank's passage, two primary avenues to sue credit ratings agencies existed: one could either pursue a cause of action under Rule 10b-5, or seek a misrepresentation claim under state law.[73] NRSROs, however, had been remarkably resistant to suit, because of both evidentiary difficulties for plaintiffs in proving a firm's scienter as an element,[74] and alternatively, because NRSROs have been able to use the First Amendment to defend poor ratings.[75]

Other than these two main options, some creative litigants chose to pursue the NRSROs under the "catch-all" liability of Section 11.[76] The benefits of Section 11 liability were, and still are, clear; because Section 11 has no scienter requirement and fewer elements, and because credit ratings are currently needed for most registered securities offerings,[77] a lawsuit against an NRSRO for misstatement in the security's registration document should present a plausible path forward in litigation.[78]

Yet, bringing such an action presented considerable hurdles, with the most substantive one generated by the government—not the NRSROs. The SEC's posture, before Dodd-Frank, was that NRSROs were not "experts" under Section 11.[79] As a result, the only avenue to pursue an NRSRO under "catch-all" liability was if they were an "underwriter" of the securities.[80] Most courts had been steadfast throughout in rejecting that assertion regarding NRSROs.[81]

Section 939G of Dodd-Frank was Congress's effort at removing the hurdle.[82] 939G had two critical provisions: (1) credit ratings were to be declared part of a security's registration statement, and (2) NRSROs were to be treated as "experts" for liability purposes under the statute.[83] These changes presented a clear path for litigating Section 11 claims and preempted the SEC's rulemaking on the issue.[84]

The NRSROs response to this statutory change was noteworthy, because of the speed and size of the concession ultimately extracted from the government. In the days leading up to Dodd-Frank's passage, NRSROs' communicated to market actors that they were unwilling to consent to including their ratings in registration statements, essentially freezing the market for asset-backed securities.[85] Before President Obama signed Dodd-Frank into law, the SEC had capitulated to the NRSROs not-so-veiled threat, issuing a statement confirming that the Commission would not enforce this provision for asset-backed securities.[86]

This exchange lends some credence to the view that the regulations currently attained represent an "optima" given existing parameters (though some might less charitably describe it as blackmail). Industry concentration and coordination—and, it could be argued, skill in providing *ex ante* default analysis[87]—provided NRSROs with weapons to use against regulatory efforts hostile to their existing interests.[88] The Commission, given its need for NRSROs as a regulatory force, had to make concessions to preserve other aspects of the legislation.[89]

However, this view ignores the fact that Dodd-Frank was intended to *change* those parameters, impose on an NRSRO the incentive to be accurate, and allow the SEC to tighten its control over all of the NRSROs. Indeed, one could look at this Section 11 failure and attribute it to the SEC's reluctance to use the tools Dodd-Frank had bestowed on it.[90] Indeed, the government's continued efforts since issuing its no-action letter—including carving references to NRSROs out of the regulations discussed below—appear to further lessen governmental leverage over NRSROs and ignore the reality of their role in the marketplace.[91] Though this example of the SEC's reluctance to oversee the entity in the vein that Dodd-Frank envisioned is troubling, it adroitly illustrates the need for a tightening of the leash on the SEC's private partners, not the loosening of already lax reins.[92]

B. Increased Disclosure Obligations and Conflicts of Interest Management

Another continued area of concern that Dodd-Frank addressed was the "close contact" between issuers and the ratings agencies.[93] While the relationship is sometimes compared to that of a hostage suffering from Stockholm Syndrome,[94] the more apt analogy is that of mutualistic animals—although who is the rhino and who is the oxpecker in this analogy remains unclear.[95] Under the "issuer pays" model, an investment bank profits from issuing its securities to the widest number of purchasers at the lowest cost of capital to its client.[96] A larger number of purchasers exists for securities that are less likely to default. So, an investment bank hires an NRSRO to evaluate that likelihood. In exchange, the NRSRO receives a fee from the investment bank.[97] This model is criticized due to the seemingly conflicted nature of this relationship: the credit rating of a security has an impact on both the prospective pool of purchasers and the likelihood of purchase,[98] yet the rater is paid by one who profits from expanding the purchaser pool and improving the likelihood of purchase—which seemingly contravenes its role as "quasi-regulator."[99]

In spite of this—or perhaps because of the importance of the existing industry—rather than legislate a teardown of the "issuer pays" model, the Dodd-Frank Act required further rulemaking by the SEC to reform these perceived conflicts of interest, as part of the statute's NRSRO registration provisions.[100] NRSRO registration had historically been something of a "black box" process,[101] and thus the statute suggests, when read along with the 2006 statute, a need for an NRSRO to clarify its relationships (to clients, to regulators, and to the market writ large) and articulate how it performs its statistical modeling before receiving the NRSRO label.[102]

The SEC, in this regard, has taken up the challenge to some degree, promulgating Rule 17g. Rule 17g-5 and related regulations have shown themselves to have some bite.[103] For example, under Rule 17g-5, the government has begun compiling a database containing the information an NRSRO uses to create its original rating and releasing it to others; certain ratings agencies have begun using the database to then produce a competing rating that may be considered conflict-free.[104] Similarly, the requirements of Form NRSRO allow the SEC to begin tracking transition and default rates of a NRSRO's client base—albeit in a non-standard way.[105] Additionally, many of the promulgated rules have focused on individual compensation and employee behavior, thus serving the clear purpose of precluding conflicts—either by restricting employee actions outright or mandating extensive disclosure.[106]

There are still problems, however. The influence of the issuer, while no longer explicitly allowed, may still be felt "implicitly" since certain issuer clients are more vital to an NRSRO's long-term corporate health. Nothing about the rules aims to adjust that dependency, since a firm's cash flow streams from clients will continue to depend on the flow of new securities—leaving open concerns about competition degrading ratings.[107] Moreover, as Professor Lynn Bai's research has discussed in depth,[108] an NRSRO's disclosure requirements often devolve into boilerplate-type statements and are much less extensive than those of other information-synthesizing "certifiers and predictors" who are often seen as conflicted—research analysts.[109] This leaves investors relying on a more "neutral" seeming NRSRO's opinion, which could have been "adjusted favorably" because of "qualitative factors" of which they were not informed.[110]

Lastly, while the backwards-looking provisions certainly expand the ability to evaluate performance retrospectively, and over time will allow for patterns to emerge, they do very little to change a firm's incentive prospectively. Professors Anil Kashyap and Natalia Kovrijnykh illustrate with their model that the incentive to inflate initial period ratings and then not adjust for mistakes after the initial payment remains a problem, even in what they define as an "optimal arrangement."[111] Thus, these retrospective rules, though useful in yielding tools that will provide meaningful future analysis, seem unlikely to prevent securities from being improperly deemed "investment grade" in the future. The value of a rating agency's *ex ante* analysis merits compensation,[112] but without a stronger curb on a firm's profit-maximization impulse, there remain strong incentives for rating agencies to fall short of a socially optimal level of accuracy *ab initio*;[113] the current disclosure rules do little to change that incentive.

C. Removal of References to NRSROs

One could interpret the above passages and conclude that Dodd-Frank was designed to impose tighter regulations on NRSROs because it views them as important to the regulatory framework; such a view, however, seems contravened by Congress's adoption of § 939A of the Act.[114] Section 939A tried to scrub from the existing U.S. rulebook any "NRSRO-dependent regulatory licenses" by 2012.[115]

In their place, agencies are supposed to define "requirement[s] of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations."[116] This shift, however, creates a troubling conundrum for regulators, the NRSROs, and market participants. For regulators, the language suggests an ambiguity: are NRSROs to be avoided, or can they be incorporated under whatever the agency determines to be its guide for "credit-worthiness"?[117] If the former is correct, then the NRSRO has to ask whether being a licensed NRSRO makes sense going forward, particularly for the "duopoly" and probably for Fitch as well.[118] If the market continues to value the opinions of Moody's and S&P on creditworthiness (and if indications are to be believed, it still does),[119] then these ratings agencies would have no need to subject themselves to the regulations. They could merely continue selling and issuing their "opinions" beyond the reach of the government.[120]

This circumstance seems particularly troubling for two reasons. First, assuming the NRSRO industry is already demonstrating indicia of market failure, the lack of direct NRSRO oversight would leave the market more susceptible to deceptive activity.[121] Second, while stripping NRSROs of their "quasi-regulatory" role at a federal level might serve some purpose, the NRSROs may still be relied on by states, which might lead to conflicting situations for market participants like state pension funds.[122] Similarly, if NRSROs are to be avoided, then considerable harm could befall smaller financial institutions unable to perform the sort of default risk analysis (with the sort of nonpublic information) that NRSROs perform.[123] In this way, the NRSROs—even in their current compromised state—are providing a "public good."[124] While removing them from the statutory framework might be seen as an effort to strip them of their "quasi-regulatory" status, it does not jar them from their valuable position in the market or reduce their ability to extract value from their status. As a result, with no viable replacement, this removal suggests nothing that would make market participants less susceptible to their errors, nor force NRSROs to change their business model.[125] If anything, it might serve to make them more powerful.

D. Excluding the Franken Amendment from Dodd-Frank

Similarly, whether because of extensive lobbying or faith in the existing system, the most aggressive check on NRSROs was excluded from Dodd-Frank: the Franken Amendment.[126] The Franken Amendment would have resulted in radical changes to the way NRSROs do business, by requiring the creation of an NRSRO-helmed self-regulatory organization that would determine which NRSRO should rate which issuances.[127] The pushback against this idea was swift, albeit for different reasons depending on the NRSRO's standing as part of the "Big Three" (the "duopoly" and Fitch) or the remaining "plus."[128] While there were many legitimate concerns with the amendment,[129] rather than include it and allow for experimentation and negotiation through the OCR via the rulemaking process, Congress abandoned the proposal, opting to include just a feasibility study of this approach instead.[130]

V. Academic Criticisms and Synthesized Proposal

Upon reviewing the rules and laws currently in place (and those not enacted), three problems reveal themselves. First, the capture of the OCR seems worryingly apparent, given the Commission's capitulation to NRSROs in response to their protest of the § 11 expansion. Second, assuming the disclosure mechanics of securities rating (and limitations on and disclosures of employee actions) make an NRSRO's financial interests more transparent and rating mechanics less opaque, the current rules still do little to enhance medium- and longer-term ratings accuracy. Even if the temptation to overinflate ratings has been abated somewhat *ab initio* by the recent rulemaking, there remains little incentive for a ratings agency to perform *ex post* re-evaluation of an already issued rating (or correct *ex ante* mistakes), since the financial compensation already has been provided in full.[131] Lastly, by removing the references to NRSROs throughout federal statutes without providing alternative measures of control, Congress and the regulatory agencies have reduced (if not eliminated) one of their most powerful tools for overseeing NRSROs—whose function derives value from the "quasi-regulatory" status of ratings in financial markets—and done so without exacting changes in the NRSROs' business model or reducing their power as market gatekeepers in return.[132]

As academics have reviewed the credit ratings agency landscape, and the rules governing it, the concern—pre- and post-Dodd-Frank—voiced by some thinkers is that without radical action, the public-private arrangement currently in place will remain suboptimal.[133] This has resulted in several proposed solutions;[134] some relate and interconnect nicely, others less so. The aim of this Part is to briefly summarize the schools of thought of several of these scholars, some of whom more closely align with the SEC's worldview and others of whom take more extreme approaches. The end goal is to synthesize these arguments into a "middle ground" built around three prongs: mandatory licensure, modified firm-level compensation, and cross-firm "competition" reforms.[135]

A. Academic Proposals

In considering the schools of academic thought around ratings reform, two broad camps exist: those who believe that—with minor changes—the "issuer pays" system can continue to operate in a way that serves the public good, and those who believe that the existing system will need to be radically modified for it to produce more accurate outcomes. Though it may seem as though the "centrists" and "radicals" would likely agree on little, the gulf between them is navigable. In fact, the tools of the "radicals" might be the best means of achieving the "centrist" aim of reforming the "issuer pays" model.

The "centrists'" views on NRSROs are similar to Churchill's views on democracy: it is the worst system, but for the alternatives.[136] Their general posture is one that seeks to manage the conflicts in the "issuer pays" approach through reforms and rulemakings.[137] The "centrists" typically look at the existing market of NRSROs and believe that, through regulatory measures, greater accuracy can be imposed on the firms that subscribe to the "issuer pays" model.[138]

The "radicals," in contrast, posit that extreme changes will be the only way to ensure accuracy in ratings. This camp, however, cleaves into (1) those that believe ratings accuracy can only improve under a forced shift to an "investor pays" approach,[139] and (2) those that believe that "investment grade" capital should not be determined by NRSROs at all, but rather by alternative measures available on the market.[140]

B. Synthesis

1. Mandatory Licensure for NRSROs

As many of the "centrist" papers note, underlying the "radical" posture (visible to some extent in Dodd-Frank) is a view that the root of these regulatory problem is the "quasi-regulatory" status of NRSROs in determining what equals "investment grade" capital. Even accepting that point, however, to now write the NRSROs out of the regulatory regime feels like a solution that will neither change established market norms, nor improve the accuracy of investors in gauging default risk—particularly since ratings agencies would remain in existence.[141] If anything, letting NRSROs escape regulatory scrutiny, either forcibly or volitionally, would do more harm than good, given the role that ratings agencies play for not just issuers, but also investors (in providing cover for pension funds' boards of investors should investments go awry).[142]

Thus, rather than loosen the government's grip on ratings agencies further, the proper regulatory response might be to tighten it and forcibly impose market competition. An argument has been advanced, primarily by the Obama Administration's Department of Justice, that an NRSRO currently registered with the Commission cannot volitionally rescind its license.[143] If this reading of the law is accurate, then the possibility exists for imposing more stringent licensure rules on NRSROs.[144] Ideally, imposing more stringent licensure could include some sort of fee paid by NRSROs in exchange for the privileged position of "quasi-regulator,"[145] although the current authorizing statute is silent on the ability of the SEC to extract fees during the registration phase.[146] This fee would not merely be an excise tax on NRSROs; rather, it would be split into two parts—each intended to serve a different systemic aim that would give some benefit to the NRSRO.[147]

Because it is likely to require fees (as well as a level of backbone unseen from the SEC in dealing with NRSROs), mandatory licensure might seem unlikely to gain traction. Implicit in that analysis, though, is an assumption that any extracted fees are to fund the government's further regulation of the industry. Those fees are not for that purpose, however. Rather, the fees are to stimulate and simulate a marketplace for accuracy amongst the existing monopolistic competitors.[148] By packaging mandatory licensure as the means for accessing a "bonus pool" for the NRSROs, the SEC can present the idea as more of a "carrot" and less of a "stick."[149] Moreover, by coupling it with the mechanism below,[150] the mandatory licensure approach offers an added barrier to entry for those firms currently registered—which may make them more receptive to being more fully incorporated into the regulatory apparatus.

2. Mandatory Deferred Compensation Regime and Offset Measures

Though it brings NRSROs more tightly into the regulatory fold, mandatory licensure still does nothing to address the need for ratings accuracy or change the underlying motivations of firms after initiating ratings.[151] While conflict-free ratings issued by other NRSROs from data collected by the SEC have some promise as an initial integrity check,[152] they do not unsound the proverbial bell of an initial rating ringing in the market's ear.[153] Nor do they enhance the need for vigilant monitoring after initiating ratings, since the NRSRO has already been paid in full for its work.[154]

The proposed solution that seems most deft in addressing these concerns comes from Listokin and Taibleson; their proposal ties an NRSRO's compensation to the asset they are rating directly.[155] Such a proposal ensures that the rater has skin in the game *ab initio*.[156] Moreover, the model requires parceling the debt obligations out over time, incentivizing the systemic monitoring of a security's likelihood of default during that span.[157]

The problems with adopting this approach full-scale (i.e., only compensating NRSROs with debt) are obvious.[158] Listokin and Taibleson acknowledge that this would radically change the industry, potentially forcing the NRSROs to consider factors not traditionally associated with default.[159] It might also create a severe set of cash flow issues for the firms.[160] Lastly, as Coffee points out, such a shift could trigger more regulatory requirements, turning NRSROs into other types of financial institutions.[161]

Moreover, Listokin and Taibleson have an additional flaw in their analysis: they treat as problematic in equal measure the overrating and underrating of a security's default risk.[162] While both are less "accurate," because of the existing rules on "investment grade" capital, the risk posed by underrating a security's likelihood of default (thus inflating its grade) is more severe. Grading a security AAA,[163] for example, typically permits its entry into systemically vital parts of our financial system like the repo market, while grading it AA would preclude it.[164] Grading a security as BBB[165] allows it to be considered "investment grade" and thus held by entities like state pension funds, while grading it BB would relegate the security to more peripheral financial institutions.[166] At a societal level, therefore, it would appear that systemic overrating of default risk could have greater benefits than even potentially perfect accuracy—or at least cause less harm than the current approach, which biases towards underrating default risk. Yet, as Listokin and Taibleson articulate, systemic misrating in either direction under a solely security-based compensation regime would be untenable, since the market would not support it.[167]

Fortunately, the "perfect" accuracy of Listokin and Taibleson becomes tougher to sustain as the payment methods and forms become non-uniform.[168] Thus, Listokin and Taibleson's compensation structure may be better thought of as a guidepost which can be modified to nudge rating agencies toward taking more conservative positions on an entity's likelihood of defaulting on a security. By elongating the payment time horizon of the NRSROs and requiring that some of their payments be received in the underlying security, an NRSRO would have at least competing considerations which would counteract the existing market preference for overrating securities, while also allowing for the continued operation of NRSROs under the "issuer pays" model. This likely requires adjusting Listokin and Taibleson's model to capture something closer to an NRSRO's profits, and requiring that portion to be parceled out under their framework.[169] Similarly, the government could choose to use part of the proceeds from the NRSRO's licensure fee as a means of rewarding firms that take more "conservative" postures on issuances that bear borderline ratings (while requiring NRSROs taking "aggressive" ratings positions to receive more compensation in the form of the underlying security).

While the design of such a system will conceivably complicate the operation of NRSROs, it also serves to shift the focus of NRSROs away from near-term payouts and ratings "consulting."[170] Moreover, in conjunction with the proposal below, the incentive for "rate shopping" and goosing ratings for market share should be curbed.

3. Cross-Firm "Competition"

Revising the nature of firm level compensation may encourage accuracy both *ab initio* and over future periods by tying firm profits more closely to accuracy, but it has the unfortunate consequence of creating barriers to entry in a market that already appears to be suffering from something akin to market failure (since cash flow will likely be impinged).[171] There also remains the possibility of coordination among actors; without enough motive to compete, the NRSROs might remain in a "win-win" position.[172]

Fortunately, Professor Robert Rhee has proposed a clever solution that would apply market discipline among the rating agencies, ensuring that some competitive motivation remains.[173] Using the remaining part of the licensing proceeds, a pool of money would be held by the government.[174] Then, the revenue could be reapportioned on the basis of accuracy. Much like a game of no-limit poker, the "main pot" would be equal to the maximum "bid" of the lowest revenue firm licensed (i.e., the percentage of income that the lowest revenue firm paid the government for its license, and matched by all the other firms).[175] There would a perpetual set of "side games," until presumably only S&P and Moody's would be left competing over their remaining residual balance.[176] While a competitive operation, the framework is, at core, one of cross-subsidy whereby inaccurate firms subsidize accurate firms operations.[177] This cross-subsidy, when combined with compensation reforms requiring more deferred compensation, creates a powerful motivator for better performance: additional cash liquidity.[178] Over time, this should lead to a shift towards more accurate firms among issuers, because the NRSROs that win the competition could cut prices (given the subsidy) and better compete for market share.

The challenge remains, though, regarding how one would determine "accuracy."[179] Fortunately, many professors,[180] as well as the NRSRO community,[181] have offered competing ideas about what measures would be proper. Reviewing these metrics makes clear that adjudicating "accuracy" is feasible, which resolves the largest concern raised by both Rhee himself and by Claire Hill in reviewing the design of the "competition."[182] While establishing any single standard (or even an aggregate basket of standards) might lend itself to gamesmanship and griping among competitors, and perhaps disincentivize rating certain products, establishing secondary competition would at least create another alignment mechanism that might make the market function in a more socially optimal way.

C. Cost Considerations and Other Possible Pitfalls

Underlying all of these reform efforts, there remains the question of costs. Even with mandatory licensure, extracting anywhere from five to twenty-five percent of an NRSRO's revenue would radically reshape an industry that already is bereft of competition. Presuming as well that none of those costs are used to fund the reconfigured regulatory apparatus, there still may be concerns that this process is doing nothing more than allowing the government to hand-select "winners and losers" by redistributing corporate profits to the shareholders of firms that subscribe to the government's definition of "accurate" ratings.[183] Such a criticism, though, would likely attach to any effort at reforming NRSROs.

Similarly, much of this analysis hinges on a belief that the judiciary will not interpret these impositions on NRSROs operations as a muzzle on "corporate opinions."[184] Yet, while *Citizens United* and its brethren might pose some concern, as long as the rules were drafted in a fashion that permitted—and perhaps encouraged—competing opinions on a security's risk of default, a court should find no such limits imposed. Moreover, NRSROs (instrumental as they are to the commercial markets) undoubtedly fall within the purview of an administrative agency like the SEC, and some level of judicial deference to the regulator would likely also be justifiable.

VI. Conclusion

In spite of how radical the aggregate system may look, the above-proposed approach to ratings reform may be the only meaningful way to retain the "issuer pays" model. To deny that ratings agencies add some value in making *ex ante* evaluations of a security's default risks is foolish, but to leave the current regime unaltered—even with enhanced disclosure requirements—is equally so. The "duopoly plus" regime forces firms to compete for market share, in order to increase their profits. The only viable approach, then, for firms to profit further is to give ratings at a suboptimal level of accuracy with an eye towards short-term profit seeking, at the expense of long-term accuracy—and in contravention of the NRSRO's "quasi-regulatory" role.

This proposed approach should close some of the gaps that remain after Dodd-Frank's regulatory efforts. By combining the work of "centrist" and "radical" scholars, the revised regulatory regime proposed should spur NRSROs to compete on accuracy in an "issuer pays" system through various "carrots" (increased governmental bounties, higher barriers to entry for new competitors) and "sticks" (mandatory registration, revisions to firm compensation).[185] While economic modeling will be needed to refine the proposed system's operation, the application of this scheme in the current market environment feels plausible. When presented with all other options, including a state-based board assigning NRSROs or the dissolution of regulatory oversight and removal of NRSROs from the regulatory purview,[186] the above proposal may be imperfect, but stands to improve existing outcomes.

Endnotes

1. *See* H.R. Rep. No. 110–155 (2008); The Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report xxv (2011), http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf; *see also* Moshe Silver, *Greedy Bankers Aren't to Blame for Ratings Agencies' Standards*, Fortune, Feb. 12, 2013, http://fortune.com/2013/02/12/greedy-bankers-arent-to-blame-for-ratings-agencies-standards/.
2. *See* Council on Foreign Relations, The Credit Rating Controversy 4 (2015), http://www.cfr.org/financial-crises/credit-rating-controversy/p22328.
3. The Financial Crisis Inquiry Commission, *supra* note 1.
4. *Id.*
5. *Id.*
6. *See* Claire A. Hill, *Why Did Rating Agencies Do Such a Bad Job Rating Subprime Securities?*, 71 U. Pitt. L. Rev. 585 (2009); Claire A. Hill, *Why Did Anyone Listen to the Rating Agencies after Enron?*, 4 J. Bus. & Tech. L. 283 (2009); Claire A. Hill, *Regulating the Rating Agencies*, 82 Wash. U. L. Q. 43, 65 n. 104 (2004).
7. *See* Kia Dennis, *The Ratings Game: Explaining Rating Agency Failures in the Build Up to the Financial Crisis*, 63 U. Miami L. Rev. 1111 (2009); Deryn Darcy, Survey, *Credit Ratings Agencies & the Credit Crisis: How the "Issuer Pays" Conflict Contributed and What Regulators Might Do About It*, 2009 Colum. Bus. L. Rev. 605 (2009).

8. *See* Frank Partnoy, *The Siskel & Ebert of Financial Markets?: Two Thumbs Down For the Credit Ratings Agencies*, 77 Wash. U. L.Q. 619 (1999).

9. *See* Claire A. Hill, *Why Did Anyone Listen to the Rating Agencies after Enron?*, *supra* note 6.

10. *See* Marilyn Blumberg Cane, et al., *Below Investment Grade and Above the Law: A Past, Present, and Future Look at the Accountability of Credit Rating Agencies*, 17 Fordham J. Corp. & Fin. L. 1063 (2012); Lynn Bai, *The Performance Disclosures of Credit Ratings Agencies: Are They Effective Reputational Sanctions?*, 7 N.Y.U. J. L. & Bus. 47 (2010); David Reiss, *Rating Agencies and Reputational Risk*, 4. J. Bus. & Tech. L. 295 (2009).

11. *See* Dodd-Frank Act § 932(a)(2)(A) (codified at 15 U.S.C. § 78o-7).

12. NRSRO's comments regarding the SEC rules were wide ranging, and included requests that ratings agencies be permitted, on their own, to determine what documentation would constitute a sufficient record of internal controls, as well as the ability for each firm to define for itself what issues would constitute "material weaknesses" in its own ratings. *See* 17 C.F.R. §§ 232, 240, 249, 249b (2014).

13. Louis Brandeis, Other People's Money 92 (1914 ed.).

14. *Cf.* Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 Harv. L. Rev. 641, 655 (1996) ("Yet for each system to survive, it could not have been grossly inefficient. At a minimum, its inefficiencies had to be counterbalanced by efficiencies elsewhere in the system.").

15. It should be noted though that rules precluding communications between certain divisions within a given institution are relatively common in the financial services where presumptions of privacy are necessary; for example, Chinese Wall restrictions in investment banks. Papanicolaou v. Chase Manhattan Bank, N.A., 720 F.Supp. 1080, 1086–87 (S.D.N.Y. 1989). These appear to have had a minimal impact on investment banking profitability. *See* Sy Harding, *Banks Making Record Profits Again While Consumers Still Have Losses!*, Forbes, June 2013, http://www.forbes.com/sites/sharding/2013/06/01/banks-making-record-profits-again-while-consumers-still-have-losses/.

16. *E.g.,* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 933(b)(2)(B), 124 Stat. 1376, 1883 (2010) (codified at 15 U.S.C. § 78u-4(b)(2)(B) (Supp. IV 2010)) (lowering 10b-5 pleading standards for suits specifically targeting credit ratings agencies for knowing or reckless failure in investigation, which thus permit greater enforcement by wronged parties).

17. Dodd-Frank Wall Street Reform and Consumer Protection Act, § 933(a)(8); *see also*

18. 17 C.F.R. §§ 232, 240, 249, 249b (2014).

19. Alison Fitzgerald, *After the Meltdown: Credit Rating Industry Dodges Reforms, Despite Role in Financial Meltdown*, Ctr. for Pub. Integrity (June 18, 2014, 10:51 AM), http://www.publicintegrity.org/2014/06/18/14936/credit-rating-industry-dodges-reforms-despite-role-financial-meltdown ("The ratings industry has mostly escaped reform despite its central role in the financial crisis because the Securities and Exchange Commission has failed to implement many proposed changes and the companies themselves have fought off others.").

20. *See* Yair Listokin & Benjamin Taibleson, *If You Misrate, Then You Lose: Improving Credit Rating Accuracy Through Incentive Compensation*, 27 Yale J. on Reg. 91 (Winter 2010); Jeffrey Manns, *Rating Risk After the Subprime Mortgage Crisis: A User Fee Approach For Rating Agency Accountability*, 87 N.C. L. Rev. 1011, 1030 (2009).

21. John Patrick Hunt, *Credit Rating Agencies and the "Worldwide Credit Crisis": The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement*, 2009 Colum. Bus. L. Rev. 109 (2009).

22. On this second point, while accuracy in ratings is ideal, more harm accrues to investors and the economy when systemic underrating of default risk occurs than when systemic overrating arises. *See* Mark J. Flannery, et al., *Credit Default Swap Spreads As Viable Substitutes For Credit Ratings*, 158 U. Pa. L. Rev. 2085 (2010); Frank Partnoy, *Second-Order Benefits From Standards*, 48 B. C. L. Rev. 169 (2007).

23. *See* Robert J. Rhee, *Incentivizing Credit Rating Agencies Under the Issuer Pay Model Through a Mandatory Compensation Competition*, 33 No. 4 Banking & Fin. Serv. Pol'y Rep. 11 (April 2014); *see also supra* notes 20–21.

24. *See supra* note 23; *see also* European Sec. & Market Auth. [ESMA], *Credit Rating Agencies' 2014 Market Share Calculations for the Purposes of Article 8d of the CRA Regulation*, at 7, ESMA/2014/1583 (Dec. 22, 2014) (highlighting the product specialization of various "plus" rating agencies).

25. *PBS NewsHour with Jim Lehrer* (PBS televisions broadcast Feb 13 1996).

26. Kenneth N. Gilpin, *Dun & Bradstreet Will Spin Off Moody's*, N.Y. Times, Dec. 16, 1999, http://www.nytimes.com/1999/12/16/business/dun-bradstreet-will-spin-off-moody-s.html.

27. Moody's Corp., Google Finance, https://www.google.com/finance (search ticker symbol "MCO" then scroll to the bottom of the page).

28. *Credit Where Credit's Due*, The Economist, Apr. 19, 2014, http://www.economist.com/news/finance-and-economics/21601020-ratings-industry-has-bounced-back-financial-crisis-credit-where; *cf.* Mary Ellen Blery, *Accounting Firms Tally High Margins*, Forbes, Mar. 29, 2013, http://www.forbes.com/sites/sageworks/2013/03/29/profitability-of-accounting-firms-high-among-industries/ (highlighting that similarly situated gatekeepers also extract high margins).

29. *See* Hill, *Regulating the Rating Agencies*, *supra* note 6, at 54.

30. *Id.*

31. Questions have arisen about the nature of the relationship between the NRSROs and those who regulate them, specifically regarding the perceived lack of antipathy between the Commission and NRSROs. *See* Cane et al., *supra* note 10, at 1069.

32. Division of Trading & Markets, U.S. Sec. & Exch. Comm'n, Report to Congress on Assigned Credit Ratings as Required by Section 939F of the Dodd-Frank Wall Street Reform and Consumer Protection Act (2012) (report prepared in response to the Franken Amendment, which evaluated the feasibility of an independent selection process for matching rating agencies to securities, rather than allowing the market to dictate).

33. *See Rating the Rating Agencies: The State of Transparency and Competition: Hearing Before the Capital Mkts. Subcomm. of the H. Fin. Servs. Comm.*, 108th Cong. 219–30 (2003); *see also* Hill, *Regulating the Rating Agencies*, *supra* note 6, at 54.

34. *See* Cane et al., *supra* note 10, at 1076; *see also* Hill, *Regulating the Rating Agencies*, *supra* note 6, at 54. As both articles express, there is some tension as to how much of this lack of alternatives is due to the SEC's actions and how much is due to market forces. While the SEC's reluctance to publish guidelines on how to become a NRSRO clearly lends credence to the first theory, one could look at the 2000 acquisitions by Fitch Ratings of Duff & Phelps Credit Rating Co. and Thomson Financial BankWatch as evidence of the second. *See Duff & Phelps Acquired*, N.Y. Times, Mar. 9, 2000, http://www.nytimes.com/2000/03/09/business/duff-phelps-acquired.html. This issue will be discussed further in Part III.

35. *See, e.g.,* U.S. Gov't Accountability Office, GAO-12-240, Credit Rating Agencies: Alternative Compensation Models for Nationally Recognized Statistical Rating Organizations (2012); U.S. Sec. & Exch. Comm'n, Annual Report on Nationally Recognized Statistical Rating Organizations (2011).

36. *Exclusion Zone*, The Economist, Feb. 6, 2003, http://www.economist.com/node/1564776 ("In 1997 the SEC proposed criteria for recognition; but since then it has given no guidance to applicants. One of these, Sean Egan, managing director of Egan-

Jones Ratings Co, says that an SEC official told him: 'We won't tell you the criteria, otherwise you might qualify.'").

37. *See* Manns, *supra* note 20, at 1046; *see also* Hill, *Why Did Anyone Listen to the Ratings Agencies After Enron?*, *supra* note 6.

38. *See* Jonathan Portes, *Why We Should Ignore the Credit Ratings Agencies*, The Independent, Dec. 21, 2011, http://blogs.independent.co.uk/2011/12/21/why-we-should-ignore-the-credit-rating-agencies/.

39. *See* Rupert Neate, *Ratings Agencies Suffer 'Conflict of Interest' Says Former Moody's Boss*, The Guardian, Aug. 22, 2011, http://www.theguardian.com/business/2011/aug/22/ratings-agencies-conflict-of-interest. (Internal S&P emails from 2006 appear to show that the agency was well aware of the risks of rating CDOs. "Let's hope we are all wealthy and retired by the time this house of cards falters," one S&P employee said in an email which was presented as evidence during a US government investigation into the financial crisis last year. Another email warned, "This is like another banking crisis potentially looming!!"). It should be noted however, that it is not just issuers who prefer inflated ratings, but also pension funds and other investors who are also restricted in what assets may be in their holdings. *See* John C. Coffee, Jr., *Ratings Reform: The Good, the Bad, and the Ugly*, 1 Harv. Bus. L. Rev. 231 (2011).

40. *See* Paul J. Justensen, *Ratings Recall: Will New Reform Proposals Make Lasting Impact?*, 35 J. Corp. L. 193, 200–01 (2009).

41. *See* Douglas M. Branson, *Too Many Bells? Too Many Whistles? Corporate Governance in the Post-Enron, Post-WorldCom World*, 58 S.C. L. Rev. 65, 95 (2006).

42. *See* Justensen, *supra* note 40.

43. Credit Rating Agency Reform Act of 2006, Pub. L. No. 109–291, 120 Stat. 1327 (codified as amended in scatted sections of 15 U.S.C.).

44. *Id.* ("An Act To improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating agency industry.").

45. Arguably, the defining feature of the bill—its reduction in requirements to become a NRSRO—could have exacerbated the problem further, as the rule stripped the SEC of its authority to license NRSROs and encouraged the pursuit of "ratings arbitrage." This change, however, did nothing to modify the behavior of market participants acting in the existing "issuer pays" environment. *See generally* Daniel Scheeringa, *Dodd-Frank Credit Rating Agency Reform in the Crosshairs*, Ill. Bus. L. J. (Mar. 29, 2011 9:21 PM EST), http://www.law.illinois.edu/bljournal/post/2011/03/29/Dodd-Frank-Credit-Rating-Agency-Reform-in-the-Crosshairs.aspx. The failure of the 2006 regulatory response should lend credence, therefore, to the view that the market-based reform efforts centered just on competition are not ideal for this setting. These points are addressed in Parts III & V.

46. *See* Hill, *Regulating the Rating Agencies*, *supra* note 6, at 54.

47. *See, e.g.*, Dodd-Frank Act, Title IX, § 939B (provisions subjecting NRSROs to § 436 liability under the Securities Act of 1933, and their being subject to § 11 liability).

48. *See* Scheeringa, *supra* note 45. Worth noting here is that the NRSROs have had no fear in using their financial clout to attempt to persuade lawmakers of their value, as the firms spent over $3.5 million in federal lobbying during 2010, an amount that has steadily increased since 2001. *See* Stephen Braun, *Credit Rating Agencies Spend $1.76 Million Lobbying Over Regulations*, Associated Press, Aug. 1, 2011, http://www.huffingtonpost.com/2011/08/01/credit-raters-spend-millions-to-lobby-washington_n_915125.html.

49. *See Credit Where Credit's Due*, *supra* note 28.

50. *See* Braun, *supra* note 48 ("The firms were targeted again in 2009 by the Dodd-Frank bill, which created a new ratings oversight office within the SEC and ordered federal agencies to rewrite their rules to minimize the government's use of ratings. The SEC, Treasury, Internal Revenue, Federal Reserve and the Federal Deposit Insurance Corporation have all begun to move away from using the firms, but are still modifying their regulations, officials said. The Federal Reserve said last week *it had identified 46 references to ratings companies in its regulations, but was still working on how it would reduce using the firms*.") (emphasis added). There is also an argument that even without formal regulation, NRSROs' approval will still be necessary as a market signal of quality, and that removing the references to NRSROs does little to change their centrality. *See* George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 Calif. L. Rev. 1073, 1110 (1995) (discussing the role of rating agencies and other securities intermediaries in reducing risk by distilling ambiguous information into clearer signals for markets). Indeed, ratings agencies emerged as a private market response to fill gaps in the regulatory landscape after the Great Depression. *See generally* Marc Flandreau et al., *To Err is Human: Rating Agencies & the Interwar Foreign Government Debt Crisis* (Bank for Int'l Settlements, Working Paper No. 335, 2010), http://www.bis.org/publ/work335.pdf.

51. *See supra* Part II.

52. *See supra* notes 24–31 and accompanying text.

53. *See* Robert J. Rhee, *On Duopoly and Compensation Games in the Credit Rating Industry*, 108 Nw. U. L. Rev 85, 93 (2013).

54. *Id.*; *see* U.S. Sec. & Exch. Comm'n, Annual Report on Nationally Recognized Statistical Rating Organizations 8 (2011).

55. This competition can take many forms. Fitch, for instance, prided itself on its "specialization" in the run-up to the 2008 financial crisis, in being able to value products like CDOs. However, given the existence of the "issuer pays" model, much of the competition from the "plus" is couched in the inflating of ratings, and extracting a fee from the issuer by providing a more favorable rating than a member of the duopoly. *See* Coffee, *supra* note 39, at 234 (2011); *see generally* Thomas J. Fitzpatrick, IV & Chris Sagers, *Faith-Based Financial Regulation: A Primer on Oversight of Credit Rating Organizations*, 61 Admin. L. Rev. 557 (2009) ("While it is commonly argued that they will thereby be penalized when the poor quality of their information is disclosed, that argument presumes competitive markets.").

56. *See generally* Hunt, *supra* note 21.

57. Indeed, most firms that sell securities will ensure that the bond they issue bears a rating from either Standard & Poor's (S&P) or Moody's for credibility purposes. *See generally* Council on Foreign Relations, *supra* note 2. In several instances before recent reforms, the SEC's default position appeared to favor NRSROs like Moody's and S&P because of their extended histories. *See also* John C. Coffee Jr., Gatekeepers: The Professions and Corporate Governance 289 (2006).

58. *See* Herwig Langhor & Patricia Langhor, The Rating Agencies and Their Credit Ratings: What They Are, How They Work, And Why They Are Relevant 410 (2010); Arthur R. Pinto, *Control & Responsibility of Credit Rating Agencies in the United States*, 54 Am. J. Comp. L. 341, 348 n. 40 (2006) (noting that the industry consolidation has typically arisen via merger since the SEC's establishment of the NRSRO distinction in the 1970s).

59. *See Duff & Phelps Acquired*, *supra* note 34, *see also* Braun, supra note 48.

60. *See* Langhor & Langhor, *supra* note 58.

61. *See* Darcy, *supra* note 7, at 630 (2009). This perspective appears to be the general view shared by the SEC during the pre-crisis period, based on the comments of other firms seeking to register as NRSROs.

62. *See generally supra* Part II. This approach mirrored that of the Reform Act of 2006.

63. *See* Rhee, *supra* note 53. If anything, the decisions of S&P and Moody's appear to reflect that of the Nash Equilibrium. *See also* Khyati Malik, *Is Competition the Right Answer? A Case of Credit Rating Agencies* 7–9 (London School of Econ. Working Paper, 2014),

available at http://www.lse.ac.uk/IPA/images/Documents/PublicSphere/2014/4-Malik-Competit.pdf.

64. *See* Malik, *supra* note 63; *infra* Part V.C (discussing mechanisms that can recalibrate the market to better value "accuracy").

65. *See* Braun, *supra* note 48; *see also* Coffee, *supra* note 39, at 259 (explaining that investors, as well as the rating agencies, would likely lobby against systemic modifications that would modify NRSRO behavior that would increase their costs, such as forcing a "subscriber pays" model).

66. *See* Coffee, *supra* note 39, at 247.

67. *See* Dimitar Rafailov, *Failures of Credit Rating Agencies During the Global Financial Crisis—Causes and Possible Solutions*, 1 Econ. Alternatives 35, 39–40 (2011); *see also* Greg Gordon, *Industry Wrote Provision That Undercuts Credit-Ratings Overhaul*, McClatchy (D.C.), Aug. 7, 2013, available at http://www.mcclatchydc.com/2013/08/07/198739/industry-wrote-provision-that.html#.Uidbt6ypeSo.

68. *See generally supra* notes 42–45, 54–57.

69. *See* Cane, et al., *supra* note 10, at 1119 ("[O]nce the SEC is better equipped [i.e. staffed] to handle the ratings industry, it is certain that the sweeping changes laid out in Dodd-Frank will be a push in the right direction for dealing with rating agencies").

70. Letter from Micah Hauptman, Fin. Serv. Counsel, Consumer Fed'n of America, to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n. (Mar. 3, 2014), http://www.sec.gov/comments/s7-18-11/s71811-78.pdf.

71. *See* David Dayen, *Remember This Moment When the Next Financial Crisis Strikes*, The New Republic, Aug. 28, 2014, http://www.newrepublic.com/article/119256/rating-agency-regulations-why-secs-new-rules-wont-fix-them (aggregating viewpoints of dissenters).

72. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §939G, 124 Stat. 1376, 1887–89 (2010) (codified in 15 U.S.C. § 77k (2012)).

73. *See, e.g.*, Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers* 88 (Univ. of San Diego Legal Studies Research Paper Series, Research Paper No. 07-46, May 2006), http://ssrn.com/abstract=900257; *see also* Christopher Schmitt, *Holding the Enablers Responsible: Applying SEC Rule 10b-5 Liability to the Credit Rating Agencies*, 13 U. Pa. J. Bus. L. 1035, 1037–38 (2011); *see generally* Arthur R. Pinto, *Control and Responsibility of Credit Rating Agencies in the United States*, Am. J. Comp. L. 341, 353 (2006).

74. *See* Steven McNamara, *Informational Failures in Structured Finance and Dodd-Frank's "Improvements to the Regulation of Credit Ratings Agencies*,*"*17 Fordham J. Corp. & Fin. L. 665, 744 (2012).

75. Thomas J. Pate, *Triple-A Ratings Stench: May the Credit Rating Agencies Be Held Accountable?*, 14 Barry L. Rev. 25, 44 (2010) (highlighting the applicability of unsolicited ratings in preserving a First Amendment defense for NRSROs).

76. *See* In re Lehman Bros. Mortgage-Backed Sec. Litig., 650 F.3d 167, 175–85 (2d Cir. 2011).

77. 15 U.S.C. § 77k(a) (2012); *see also* Office of Inv. Educ. and Advocacy, Sec. & Exch. Comm'n, Investor Bulletin: The ABC's of Credit Ratings 1 (Oct. 2013), http://www.sec.gov/investor/alerts/ib_creditratings.pdf.

78. *See generally* McNamara, *supra* note 74.

79. 17 C.F.R. § 230.436(g) (2014) ("[T]he security rating assigned to a class of debt securities, a class of convertible debt securities, or a class of preferred stock by a nationally recognized statistical rating organization…shall not be considered a part of the registration statement prepared or certified by a person within the meaning of sections 7 and 11 of the Act.").

80. 15 U.S.C. § 77b(a)(11) (2012); 15 U.S.C. § 77k(a)(5).

81. *See Lehman*, 650 F.3d at 184 (covering the existing case law across jurisdictions precluding NRSROs from suit as underwriters).

82. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 939G, 124 Stat. 1376, 1887–89 (2010) (codified in 15 U.S.C. § 77k (2012)).

83. *Id.*

84. *Id.*

85. Anusha Shrivastava, *Ford Scuttles Debt Deal as Overhaul Chills Market*, Wall St. J., Jul. 21, 2010, http://www.wsj.com/articles/SB10001424052748703954804575381644138678302.

86. *See generally* Letter from Katherine Hsu, Senior Special Counsel, Sec. & Exch. Comm'n, regarding Ford Motor Credit Co. LLC (Nov. 23, 2010) (reviewing the details regarding the Commission's initial no-action determination and its determination to sustain the no-action provision). In the SEC's defense, the Commission did state the requirement would remain in place for corporate debt issuances. Currently, the Commission has left this no-action letter in effect indefinitely, leaving up in the air when or if Section 11 liability will be available against NRSROs for the foreseeable future.

87. Symposium, *Do the Credit Rating Agencies Deserve to Exist?*, int'l econ, Fall 2008, at 1 (various commentators acknowledging that NRSROs do add some value—even if reforms are likely needed), http://www.international-economy.com/TIE_F08_CreditRatingSymp.pdf.

88. *See generally McNamara*, *supra* note 74.

89. *See* Letter from Katherine Hsu, *supra* note 86.

90. *Id.*; *see* Darcy, *supra* note 7, at 648–51 (reviewing the limited number of rules promulgated during CRARA period related to NRSROs, and their focus almost primarily on disclosure and not litigation); *see also* Anschutz Corp. v. Merrill Lynch & Co., Inc., 785 F. Supp. 2d 799, 829 (N.D. Cal. 2011) (noting that the SEC is not the exclusive body able to pursue litigation against NRSROs but acknowledging a lack of enforcement litigation from the Commission).

91. *See* Jason Parsont, *NRSRO Nullification: Why Ratings Reform May Be In Peril*, 77 Brook. L. Rev. 1015 (2012).

92. See *infra* Part V.B, which proposes a synthesis of academic writings in a manner that creates such a relationship.

93. *See* Cane et al., *supra* note 10, at 1091–92.

94. *Id.*

95. *See generally* New Eng. Complex Sys. Inst., Evolution & Mutualism (2012), http://www.necsi.edu/projects/evolution/co-evolution/mutualistic/co-evolution_mutualistic.html

96. *See* Panayotis Gavras, *Ratings Game*, 49 Int'l Monetary Fund Fin. & Dev. J. 1 (2012).

97. *Id.*

98. *See* Douglas Sikorski, *The Global Financial Crisis*: *Explanations and Implications in* The Impact of the Global Financial Crisis on Emerging Financial Markets 84–85 (Jonathan Batten & Peter Szilagyi eds., 2011).

99. *See* Lynne L. Dallas, *Short-Termism, The Financial Crisis, & Corporate Governance*, 37 J. Corp. L. 265, 292 (2012). It should be noted here that this symbiotic tension is not only existent in the "issuer pays" model. In an "investor pays" system, the pension fund or asset manager would essentially be paying a rating agent to approve the addition of a security to its portfolio of assets. Given the intimate nature of an issuer pays approach, where NRSROs will often see non-public information about the security, it is possible that relevant knowledge of default likelihoods will be lost with a "investor pays" model, while not resolving this perceived conflict (since pension funds have strong incentive to boost their returns through buying overrated—read, riskier—securities). *See generally* Anil Kashyap & Natalia Kovrijnykh, *Who Should Pay for Credit Ratings and How?* 24 (U. Chi. Booth School of Bus. Working Paper, 2014) (noting that the "investor pays" model, while more accurate than the "issuer pays" model, are less accurate than a "central

planner" model, remain susceptible to information leakage and free-riders, and yield overconsumption of ratings in a fashion that is not socially efficient).

100. 15 U.S.C. § 78o-7(a) (2012).

101. *See* Letter from Daniel Curry, Pres., DBRS, Inc., to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n., regarding re-proposed rules for Nationally Recognized Statistical Rating Organizations (Mar. 24, 2009).

102. Roel Campos, *Government Shows Its Teeth to Credit Rating Agencies*, The Hill (Feb. 6, 2015 12:00 PM), http://thehill.com/blogs/congress-blog/economy-budget/231923-government-shows-its-teeth-to-credit-rating-agencies.

103. 17 C.F.R. § 240.17g-5b (2014).

104. *See* Sofya Abdurakhmanova, Note, *Using Unsolicited Ratings to Regulate the Credit Rating Agencies*, 18 Fordham J. Corp. & Fin. L. 451, 472 (2013).

105. Restrictions on gifts, the nature of compensation, and relationship disclosures both intra- and inter-firm are all addressed in part with these rules. *See* Lynn Bai, *On Regulating Conflicts of Interest in the Credit Rating Industry*, 13 N.Y.U. J. Legis. & Pub. Pol'y 253, 272–77 (2010).

106. *See* 15 U.S.C. § 78o-7(a)(1)(B) (2015); *see also* Dodd-Frank Act, sec. 932(a)(8), § 15E(s), 124 Stat. at 1879.

107. Indeed, the SEC seems to acknowledge as much by requiring the NRSROs to disclose their largest clients. *Id.*

108. Bai, *supra* note 105, at 296–99.

109. *See FINRA Guide to Understanding Securities Analyst Recommendations*, FINRA, http:// www.finra.org/Investors/SmartInvesting/AdvancedInvesting/UnderstandingSecuritiesAnalystRecommendations (last visited Apr. 12 2015); Bai, *supra* note 105, at 300–302.

110. U.N. Conference on Trade and Development, *Credit Rating Agencies and Their Potential Impact on Developing Countries*, at 5, U.N. Doc. UNCTAD/OSG/DP/2008/1 (Aug. 12, 1992) (listing qualitative factors open to adjustment as inclusive of an organization's ability to service debt, management's willingness to pay debt, and the entity's labor flexibility).

111. *See* Kashyap & Kovrijnykh, *supra* note 99.

112. Some firms may even value their reputational capital so much as to do an effective job *ex ante*, and perceive it as affecting profitability. *See generally* Steven Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. Ill. L. Rev. 1 (2002); Hill, *Regulating the Rating Agencies*, *supra* note 6.

113. *See, e.g.*, Rhee, *supra* note 53; *see* Hill, *Why Did Anyone Listen to the Rating Agencies After Enron?*, *supra* note 6; Kashyap & Kovrijnykh, *supra* note 99.

114. Dodd-Frank Act, Pub. L. No. 111-203, § 939A, 124 Stat. 1376, 1885–87 (2010).

115. These removals are to be done at an agency level as well. *Id.*

116. *Id.*

117. The presumption under *Chevron* would likely be the latter, but the statute's intention is clearly replacing reliance on NRSROs. *See Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984).

118. Parsont, *supra* note 91, at 1082–84.

119. *See supra* Part II; *see also* Gretchen Morgenson, *Pension Funds Dancing a Two-Step With Ratings Firms*, N.Y. Times (June 14, 2014), http://www.nytimes.com/2014/06/15/business/pension-funds-dancing-a-two-step-with-ratings-firms.html?_r=0.

120. *See Abu Dhabi Commer. Bank v. Morgan Stanley & Co.*, 651 F. Supp. 2d 155 (S.D.N.Y. 2009). This case ultimately settled, with S&P neither admitting nor denying wrongdoing for its opinion. Patricia Hurtado & Bob Van Voris, *Morgan Stanley Settles Washington, Abu Dhabi Lawsuits*, Bloomberg Business (Apr. 26, 2013 11:01 PM), http://www.bloomberg.com/news/articles/2013-04-26/morgan-stanley-settles-washington-abu-dhabi-lawuits. In the press release, S&P's parent company noted that S&P "has settled…without any admission of liability or wrongdoing." *Id.* But even if private litigants have difficulty suing over opinions, the Department of Justice may have the potential to litigate matters pertaining to NRSROs under certain fraud statutes. *See, e.g.*, Andrew Ross Sorkin & Mary Williams Walsh, *U.S. Accuses S. & P. of Fraud in Suit on Loan Bundles*, N.Y. Times: Dealbook (Feb. 4, 2013 2:38 PM), http://dealbook.nytimes.com/2013/02/04/u-s-and-states-prepare-to-sue-s-p-over-mortgage-ratings/?ref=business&_r=0. NRSROs, however, likely will continue to rely on their free speech arguments. *Id.* For more on the interplay between NRSRO litigation and the First Amendment, *see generally* Caleb Deats, Note, *Talk That Isn't Cheap: Does the First Amendment Protect Credit Rating Agencies' Faulty Methodologies From Regulation?*, 110 Colum. L. Rev. 1818 (2010).

121. *See* Cane, et al., *supra* note 10, at 1077; *see also supra* notes 115–17.

122. *See* Dennis, *supra* note 7, at 1143.

123. *See Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934*, Fed. Sec. L. Rep. (CCH) ¶80,450 (2013), 2012 WL 8476088 (C.C.H.)

124. *See* Rhee, *supra* note 53.

125. *Id.*; *see also* Darcy, *supra* note 7.

126. *See* Dean Baker, *Credit Rating Agencies Likely to Evade Dodd-Frank Provision to End Conflict-of-Interest*, Center for Econ.& Pol'y Research (May 14, 2013), http://www.cepr.net/index.php/blogs/beat-the-press/credit-rating-agencies-likely-to-evade-dodd-frank-provision-to-end-confltict-of-interest.

127. Issuers could still solicit secondary ratings, and unsolicited ratings would still be available under the amendment. *See* Rhee, *supra* note 53, at 110–11.

128. Big firms interpreted this as an effort to dissolve their market-leading share, while little firms saw this as a tool to entrench the "Big Three." *See* Michael Corkery, *Al Franken's Credit Rating Amendment Is No Joke*, Wall St. J. (May 13, 2010, 6:47 PM), http://blogs.wsj.com/deals/2010/05/13/al-frankens-credit-rating-amendment-is-no-joke/; *see* Dayen, *supra* note 71.

129. *See* Division of Trading & Markets, *supra* note 32, at 35. The report notes potential coercion concerns with the government forcing "one private party to deal with another private party of the government's choosing in a private business transaction," thus triggering First and Fifth Amendment concerns. *Id. See also* Olivia Schmid, *Rebuilding the Fallen House of Cards: A New Approach to Regulating Credit Rating Agencies*, 2012 Colum. Bus. L. Rev. 994 (2012) (noting concerns over the regulatory capture of the "Board," the likelihood of undesirable lobbying, and the prospect of market-chilling).

130. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 939F(b)(2), 124 Stat. 1376, 1889 (2010) (codified at 15 U.S.C. § 78o–9 (2010)).

131. *See* Listokin & Taibleson, *supra* note 20; *see also* Bai, *supra* note 105.

132. *See* Parsont, *supra* note 91, at 1082–84.

133. *See* Kashyap & Kovrijnykh, *supra* note 99; *cf.* Fischer Black, Merton H. Miller, and Richard A. Posner, *An Approach to the Regulation of Bank Holding Companies*, 3 J. Bus. 51, n.3 (1978) (describing the similarities of regulatory approaches to banks as analogous to those of lenders and borrowers). Since the rating agencies are in essence borrowing the government's regulatory authority, the constraints on them should be roughly analogous to those of a lender, in a "rough" public-private partnership.

134. *See supra* notes 20–21, 53–57.

135. *See supra* notes 69–70.

136. *See* Bai, *supra* note 105; *cf.* Winston Churchill, Speech, House of Commons (1947), *reprinted in* Winston S. Churchill: His Complete Speeches, 1897–1963 (Robert Rhodes ed., 1974).

137. *See* Bai, *supra* note 105, at 294–97.

138. *See* Coffee, *supra* note 39. *See also* Hunt, *supra* note 21 for writings that predominate in this vein. In general, the view is one of administrative fixes which do not upend the existing, common business practices of rating agencies.

139. *See* Dallas, *supra* note 99. Authors in this camp see the primary way of diverting NRSROs from short-term profit seeking is by reforming their business models, and making them revert to the model of "investor pays" which was common in the 1970's. *See, e.g.*, John (Xuefeng) Jiang et al., *Does It Matter Who Pays for Bond Ratings? Historical Evidence*, 105 J. Fin. Econ. 3 (2012), https://www.msu.edu/~jiangj/Jiang%20Stanford%20Xie%202012.pdf.

140. Scholars in this camp are typified by Frank Partnoy, whose writings center on the use of alternative measures of evaluating default risk, and the removal of NRSROs from the regulatory architecture. *See* Mark J. Flannery, et al., *Credit Default Swap Spreads As Viable Substitutes For Credit Ratings*, 158 U. Pa. L. Rev. 2085 (2010); Frank Partnoy, *Second-Order Benefits From Standards*, 48 B. C. L. Rev. 169 (2007); Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down For the Credit Rating Agencies*, 77 Wash. U. L.Q. 619 (1999).

141. *See* Coffee, *supra* note 39. Moreover, this scenario would seem the one most likely to generate the SEC's deepest held fear: that "fly-by-night" rating agencies will pop up and essentially perpetrate fraud by producing over-inflated ratings. *Id.*

142. *See* Morgenson, *supra* note 119.

143. *See Constitutionality of Mandatory Registration of Credit Rating Agencies*, 2009 WL 4325372, at *1 (O.L.C. Oct. 22, 2009). Such a rule might seem to contravene the statutory section of Dodd-Frank permitting voluntary withdrawal, but the terms of voluntary withdrawal from an NRSRO license are solely within the purview of the Commission to determine. *See* 17 U.S.C. § 78o–7 (2012) ("[An NRSRO] may, *upon such terms and conditions as the Commission may establish*…, withdraw from registration….") (emphasis added). Moreover, voluntary withdrawal is subject to the constraints the SEC deems "necessary in the public interest," meaning such withdrawal could be made exceedingly difficult. *Id.*

144. How stringent those licensure rules could be depends on how the rules would be drafted, and whether such rules fall within the purview of the existing statutory grant bestowed on the SEC and other agencies. Considerations would have to be given to Constitutional issues, likely balancing an NRSRO's role as an instrumentality of commerce against an NRSRO's oft-cited First Amendment rights. *See generally* Nan Ellis et al., *Is Imposing Liability On Credit Rating Agencies A Good Idea?: Credit Rating Agency Reform in the Aftermath of the Global Financial Crisis*, 17 Stan. J.L. Bus. & Fin. 175 (2012) (discussing competing Constitutional and regulatory considerations for NRSRO reform). Alternatively, there are questions as to whether certain types of rulemakings could survive even the deferential standard of *Chevron*, if for example, a rule was finalized that required NRSROs to follow an "investor pays" model or be subject to a penalty should they refuse, which might be arbitrary and capricious under the existing grant. *See* Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984).

145. It also seems relevant to note here again, the impracticality that arises from trying to force NRSROs out of this position or permit them to leave it, given their encompassed position, not just in the U.S. regulatory framework, but internationally as well. *See e.g.*, Bank for Int'l Settlements, Progress Report on Basel III Implementation (Oct. 2012), http://www.bis.org/publ/bcbs232.pdf (showing that legislation remains in draft stages in the U.S. as the Basel III accords references to NRSROs are reconciled with the Federal Reserve Board's efforts to comply with Dodd-Frank's requirements to remove references to NRSROs from regulation).

146. It would be necessary that any such fee imposed on the NRSRO impose a meaningful benefit on the NRSROs, as otherwise the fee could be viewed as a tax, which "is a legislative function, and Congress[ ] is the sole organ for levying taxes…." *See* Nat'l Cable Television Ass'n, Inc. v. United States, 415 U.S. 336, 340 (1974). While it is conceivable to devise a way to extract this registration charge as a "fine [or] other penalty" for not "conduct[ing] business in accordance with the policies, procedures, and rating methodologies of the [NRSRO]"—perhaps by imposing a rule requiring an NRSRO to adopt an "investor pays" model— the SEC would seek a stronger legislative hook to pursue this approach. *See* 15 U.S.C. § 78o–7.

147. *See infra* Part V.B.2–3.

148. *See* Gavras, *supra* note 96 ("The licensing and regulation of credit rating agencies have been astonishingly limited. Agencies are selected mainly because of market recognition, rather than codified regulatory requirements or licensing. Systems of assessment and validation of methodologies used, processes for authorization of the rating agencies, and monitoring systems to ensure accountability have been weak—cursory at best.") (citations omitted).

149. *See* Rhee, *supra* note 53.

150. *See infra* Part V.B.2.

151. *See* Listokin & Taibleson, *supra* note 20, at 104; *see also* Dallas, *supra* note 99, at 199. *But see* Kashyap & Kovrijnykh, *supra* note 99. (claiming slow ratings downgrades are a feature, not a bug, under even an optimal compensatory regime).

152. *See* Abdurakhmanova, *supra* note 104.

153. *See* Langhor & Langhor, *supra* note 58.

154. The SEC might respond that Rule 17g–8 might serve to address this concern. That seems unlikely as (1) the rule only applies when there is a "significant error" found in a methodology (leaving unresolved a firm's incentive to monitor its models and look for mundane changes) and (2) it provides no guidance as to who would judge an error's significance, or even what would constitute an error. *See* 17 C.F.R. § 240.17g-8 (2014); *see also* Julia Zukina, *A Step Short of Change: Examining the Recent Regulation of Credit Rating Agencies and its Shortcomings in a Global Market*, 13 J. Bus. & Sec. L. 259, 281 (2013).

155. *See* Listokin & Taibleson, *supra* note 20, at 104–07.

156. *Id.*

157. *Id.*

158. *Id.* at 110–12.

159. *Id.* at 110.

160. *Id.* at 111.

161. Coffee, *supra* note 39, at 254 (noting that without some limitation on liquidation of the securities, the model does nothing different than the existing iteration, and if a limitation is imposed, the NRSRO may become an "inadvertent" investment company).

162. *See* Listokin & Taibleson, *supra* note 20, at 105.

163. *See e.g.*, McNamara, *supra* note 74, at 668–70; *see* Office of Inv. Educ. and Advocacy, *supra* note 77, at 2.

164. *See supra* notes 120–23.

165. *Id.*; *see also* Morgenson, *supra* note 119.

166. *See supra* notes 120–23; *see also* Morgenson, *supra* note 119.

167. Listokin & Taibleson, *supra* note 20, at 107.

168. *See id.* at 112.

169. The choice to measure in accord with approximate profits dovetails with the idea of Part V.B.1, in that it would allow the "duopoly" to retain a prominent position given its existing size, as competitors' ability to reinvest and gain scale would likely be curbed by having proceeds tied up in securities that would be parceled out over

time. While fixing the market's participants might seem anti-competitive, the intention is that Part V.B.3 becomes the means of providing cash to highly accurate firms. Moreover, as has been shown in the literature, unbridled competition in the ratings market leads to diminished accuracy. *See e.g.*, Malik, *supra* note 63.

170. Listokin & Taibleson, *supra* note 20, at 105.

171. Yasuyuki Fuchita & Robert E. Litan, Financial Gatekeepers: Can They Protect Investors? 4 (Brookings Inst. Press 2007); *see* McNamara, *supra* note 74, at 709–16.

172. *See* Rhee, *supra* note 53, at 95.

173. *Id.* at 113–18.

174. Per Rhee's model, the seed money per firm was roughly 5% of each firm's revenue. Rhee, *supra* note 53, at 116. While this may present a change in valuations for these firms (though unlikely given that the competitive nature of the process assures that no one would win indefinitely), an alternative tactic would be for the U.S. government to provide the bounty. *Cf.* U.S. Gov't Accountability Office, GAO-12-240, Credit Rating Agencies: Alternative Compensation Models for Nationally Recognized Statistical Rating Organizations (2012) (discussing a "user-fee" based approach; for this approach, the reasonable assumption could be that the user is the government). Such bounty propositions for information goods that serve the public (i.e. patents) have been proposed in alternative contexts. *See* John R. Thomas, *Collusion & Collective Action in the Patent System: A Proposal for Patent Bounties*, 2001 U. Ill. L. Rev. 305, 342 (2001).

175. *See* Rhee, *supra* note 23; Rhee, *supra* note 53. In Rhee's model, an incubation period would be necessary for smaller firms to develop a reputation and get to the scale of the "Big Three" (Fitch is a necessary participant). This seems like a reasonable approach for the interim, but presumably once more entities attain something resembling scale, they would be required participants. *See* Rhee, *supra* note 53, at 125.

176. *Id.* at 117–18.

177. *See* Russell D. Roberts, *Financing Public Goods*, 95 J. Political Econ. 420, 421 (1987).

178. *See* Rhee, *supra* note 53.

179. *See* Rhee, *supra* note 53, at 127.

180. *See* Bai, *supra* note 10, at 103; Hunt, *supra* note 21. *See also* Parsont, *supra* note 91, at 1063 (summary of competing methods).

181. *See* Letter from Michel Madelain, President & Chief Operating Officer, Moody's Investors Serv., to Elizabeth M. Murphy, Sec'y, Sec. Exch. Comm'n 6 (Sept. 13, 2011), http://www.sec.gov/comments/4-629/4629-23.pdf; Letter from Robert Dobilas, President, Morningstar Credit Ratings LLC, to Elizabeth M. Murphy, Sec'y, Sec. Exch. Comm'n 6 (Sept. 13, 2011), http://www.sec.gov/comments/4-629/4629-24.pdf.

182. For example, Professor Rhee expresses concerns that the volatility of Professor Portnoy's suggested gauge of accuracy (Credit Default Swaps) would lead to consumption of variables that should not necessarily be encompassed when weighing default. *See* Rhee, *supra* note 53, at 106. The rebuttal, however, might be best raised in Rhee's own article; were a combination of CDS and additional measures applied in the accuracy gauge, it may be sufficient for a trial to evaluate the game. "[L]e mieux est l'ennemi du bien." (The best is the enemy of the good). *Id.* at 131.

183. *Cf. Winners and Losers in the U.S. Financial Bill*, Reuters Factbox (Jun. 25, 2010), http://blogs.reuters.com/financial-regulatory-forum/2010/06/25/factbox-winners-and-losers-in-the-u-s-financial-bill/.

184. Citizens United v. Fed. Elec. Comm'n, 558 U.S. 310, 393 (2010) (Scalia, J. Concurring) ("Indeed, to exclude or impede corporate speech is to muzzle the principal agents of the modern free economy.").

185. Claire Hill, *The Motivating Force of a Bonus Pool and Other Objections*, 108 Nw. L. Rev. Online 271, 276 (2014).

186. *See* Parsont, *supra* note 91; Dallas, *supra* note 99.

Lawrence Crane-Moscowitz was in the Class of 2016 at Vanderbilt University Law School.

Book Review

Commercial Litigation in New York State Courts, 4th edition

Reviewed by Samuel F. Abernethy

Robert L. Haig and his platoon, or should I call it a company, of authors are at it again. They have brought forth the Fourth…Edition, that is, of *Commercial Litigation in New York State Courts*, updating the Third Edition, which made its appearance in 2010. Haig and his team have unflaggingly managed to periodically produce these four editions since 1995, and this time they have added twenty-two new chapters and two new volumes, bringing the total of this impressive work to 127 chapters and eight volumes, plus a soft cover volume of tables and an index.

And the timing is excellent, as the Commercial Division of the New York State Supreme Court marked its 20th Anniversary in November 2015, having opened its doors in New York and Monroe Counties in 1995. With the growth of the Division to 29 judges in ten jurisdictions throughout the State, business disputes can be assigned to judges with experience and qualifications to sensibly and efficiently manage the often complex, motion-laden matters they are called upon to consider.

The combination of comprehensive coverage of business-related topics and authorship of unquestioned experience and competence has produced a truly useful series for those litigating practitioners seeking guidance in areas with which they are not completely familiar. And the coverage is not simply one of breadth. The authors, led by Haig, who is a litigation partner at Kelley Drye & Warren LLP and a former president of the New York County Lawyers' Association, provide depth of substantive law analysis, supported by case citations, and it is this depth of coverage in the substantive law in combination with civil procedure coverage that makes this series so valuable to business law practitioners.

The first four volumes of this eight volume set address the litigation process, starting with initial fact gathering, case evaluation, forum selection, jurisdictional issues, and complaint drafting. They continue with issues related to responding to the complaint, third-party practice, motion practice, removal, trial, appeals, and enforcement of judgments. The Fourth Edition also incorporates chapters on mediation and the current practices of the Commercial Division to streamline the management of court cases (including a comparison with comparable efforts in the federal courts). All this is covered with strategic analysis thrown in. The material is organized in logical sequence, and the table of contents and index are thorough. These four volumes alone are valuable to litigation counsel.

But for those of you who work in the business law community, the series earns its spurs with the remaining four volumes. In addition to well-traveled matters such as contracts, securities, M&A, banking, insurance, IP, UCC, and agency disputes, to name just a few, the Fourth Edition adds new chapters devoted to derivatives, licensing, structured finance, project finance, sports, and entertainment law, again to name just a few. Altogether, there are 53 substantive law chapters.

By way of example, the derivatives law chapter starts with an overview and description of the various types of derivative products, the provisions of an extensive standardized body of contractual documents sponsored by the International Swaps and Derivatives Association, and continues with a thorough discussion of the case law developed in the New York courts. The chapter author discusses the availability and application of various causes of action and affirmative defenses that are widely found in commercial disputes arising from derivative transactions. To a practitioner not steeped in commodities law, this chapter is a superb introduction and very useful in preparing assertion of, or defense to, a claim or cause of action. Not all substantive chapters in this series have as extensive discussion of the case law, but all cover case evaluation, claims, and strategic considerations.

As alternative dispute resolution is an increasingly accepted avenue to address grievances and claims, as New York State now sports an International Arbitration Center in midtown New York City, and as courts routinely provide for mediation of commercial disputes, Haig and his authors appropriately devote three chapters to mediation, domestic arbitration, and international arbitration. The chapter on mediation provides a "practical roadmap" with considerations and observations with which an experienced litigator may already be familiar, but of real value to those new to the field. The coverage of the chapter on arbitration, long supported by New York (see CPLR Art 75), includes useful detail of the often complicated processes of either compelling, or avoiding, arbitration, and the chapter on international arbitrations, one of whose authors is the late Chief Judge Judith S. Kaye, provides good guidance on drafting and enforcing arbitration agreements, which often are between parties from diverse jurisdictional, political, and cultural backgrounds.

Commercial litigators will continue to benefit immensely from this new edition, especially if their practices are diverse and they are confronted with new substantive matters. Like good wine, Haig and his company seem to be getting better with age and each edition. The Fourth Edition comes with a CD-Rom containing jury instructions, forms, and checklists which are contained in the printed volumes.

Samuel F. Abernethy is a partner in the firm Menaker & Herrmann LLP, where he focuses on commodity, derivatives and securities law. He is Chair of the NYSBA Electronic Communications Committee, a past member of the NYSBA Executive Committee and a past Chair of the Business Law Section.

Banking Law Committee

A meeting of the Banking Law Committee was held during the NYSBA Annual Meeting in January; our theme was "Hot Topics for January 2016." We were very fortunate to have Joy Feigenbaum from the New York State Department of Financial Services and Alan Lawitz from the Office of Children & Family Services discussing elder financial abuse and the state's initiative to provide training sessions for financial professionals on effectively recognizing, preventing, and reporting elder financial abuse. Our panel also included Scott Wortman, who spoke about the Telephone Consumer Protection Act, recent FCC rulings regarding robo-calling, and relevant litigation. As those who attended will attest, it was a very lively discussion, especially with Joy and Alan, but they told me they very much enjoyed the give-and-take! Scott's presentation was also well-received, and very informative—I now will monitor my cell robo-calls much more intensively.

A Banking Law Committee meeting was held on May 13, 2016, during the NYSBA Business Law Section spring meetings in New York, New York. The topic was "Regulatory Roundup 2016" and featured speakers from the legal divisions of the FDIC's New York Office, the Office of the Comptroller of the Currency's (OCC's) New York Office and the Federal Reserve Bank of New York, along with the General Counsel and COO of the New York Bankers Association. The panelists discussed issues of importance to their agencies and the New York Bankers Association.

The audience was very attentive to the presentations and posed thoughtful questions. At the meeting, it was announced that the new chair of the committee beginning June 1 will be Tanweer Ansari, succeeding Kathleen Scott. The next Banking Law Committee meeting will be scheduled sometime this fall.

Kathleen Scott, Chair

Bankruptcy Law Committee

The Bankruptcy Law Committee presented a relevant panel discussion during the afternoon session of the Business Law Section annual Spring Meeting on May 13, 2016 in New York City at the Harvard Club. The three panelists presented a program titled Current Topics & Trends: Oil & Gas, Equitable Mootness, Education and Even Marijuana. While certain of the topics had evident interest value, even equitable mootness became a source of interest through the engaging presentation. The panel consisted of attorneys Mike Riela of Vedder Price, Jeff Bernstein and Nicole Leonard of McElroy Deutsch Mulvaney & Carpenter LLP, and the presentation was well-received by an interactive and knowledgeable audience.

Scott Bernstein, Chair

Corporations Law Committee

No report submitted (see report of the Securities Regulation Committee, below).

Richard DeRose, Chair

Derivatives and Structured Products Law Committee

The Derivatives and Structured Products Law Committee has had an active Winter / Spring season with respect to keeping up with the changing regulatory environment by arranging many opportune meetings for its members. The Committee has facilitated CLE programs in the areas of Cross-border Derivatives from a U.S. Law Perspective (hosted by Morrison & Foerster), the Evolving Professional Responsibility Issues Confronting Derivatives Lawyers (hosted by Sidley & Austin), the EU Rules on Margin for Non-cleared derivatives (hosted by Reed Smith), Security-Based Swaps and Beyond (hosted by Alston & Bird), an Update on Canadian Regulation on Derivatives and Futures (hosted by Stikeman Elliot) and most recently the Development of Blockchain Technology for Derivatives and other Financial Transactions (hosted by Stroock & Stroock & Lavan). All of these meetings have been well attended by enthusiastic participants.

Ilene K. Froom, Chair

Franchise, Distribution and Licensing Law Committee

The Franchise, Distribution and Licensing Law Committee had hoped that, over time, it would be able to reach a mutual understanding with the New York State Attorney General's Office with respect to the proposed modifications to the New York State Franchise Sales Act, originally proposed by our Committee and currently scheduled for eventual consideration by the New York

State Legislature. After a hiatus of several months, the Committee's negotiating team of David Oppenheim, Tom Pitegoff and Richard Rosen, together with Kevin Kerwin, NYSBA legislative liaison, met with representatives of the Attorney General's office on December 7th, 2015 for the purpose of addressing several of the open issues in connection with the proposed legislation. The meeting did not result in significant progress regarding these issues.

In addition, the Committee held a meeting on January 27, 2016, in conjunction with the Bar Association's Annual Meeting. At the meeting, Alan Schacter, CPA, and Committee Chair Richard Rosen made a presentation, for full CLE credit, which addressed the topic of the means, methods and protocols to be considered and utilized in the context of the economic valuation of a franchised business. During the presentation, attendees exchanged questions and answers with Mssrs. Schacter and Rosen. On a personal note, as my term as Chair of the Franchise, Distribution and Licensing Law Committee will soon be coming to an end, I would like to take this opportunity to express how much I have enjoyed participating in the area of franchise law (which has been, for many years, so dear to my heart) with the other members of the Committee and also to welcome Justin Klein, a terrific and well respected franchise attorney, as the new Chair of this Committee. Best of luck, Justin.

Richard Rosen, Chair

Legislative Affairs Committee

The Legislative Affairs Committee has joined with members of the International Law Section to form a joint legislative committee to propose repeal of Section 630 of the Business Corporation Law and Subsections (c) and (d) of Section 609 of the New York Limited Liability Company Law. These laws make the ten largest shareholders of closely held corporations and the ten largest members of limited liability companies personally liable for wages. The position of the joint committee is that these laws should be repealed because:

- They discourage new businesses from incorporating in New York and they act as an impediment to business and employment in the state.
- They violate the bedrock principle of shareholder and member limited liability that applies throughout the United States.
- They are unfair. Passive owners are liable jointly and severally and regardless of knowledge or fault.
- This type of wage protection is an anachronism. Workers are protected today by veil piercing principles and by labor and bankruptcy laws that did not exist when New York first imposed shareholder liability for wages in 1848.

The matter has now been placed on the Agenda of the NYSBA Executive Committee, which would need to approve it before the NYSBA can undertake lobbying efforts to repeal Section 630. As noted above in the report of the Franchise, Distribution and Licensing Law Committee, the Legislative Affairs Committee is also in continuing discussions with the New York Attorney General's Office in an effort to revise the New York Franchise Sales Act.

Thomas M. Pitegoff, Chair

Membership Committee

Our Section stands at 3,831 members, of which about 27 percent are new lawyers or students (admitted less than 10 years). Part of our strategic plan for the Section going forward is to involve and provide value not only to those members who are already part of our Section, but also to this new influx of younger members through the Pathways to the Profession. This new initiative involves connecting the NYSBA to the fifteen law schools within New York to provide resources and opportunities to those students who are looking to join us in our practice. The Business Law Section is always looking for people who want to become more involved in the Section and in turn provide value to all of our members through committee work, speaking opportunities, writing pieces for the *NY Business Law Journal*, or through our legislative initiatives. No idea is too small (or too large!), and your input is welcome.

Sarah Gold, Chair

Not-for-Profit Corporations Law Committee

The Not-for-Profit Corporations Law Committee continued to collaborate with the State Law Revision Commission, the New York City Bar Association, the Lawyers Alliance for New York, and the Nonprofit Coordinating Committee of New York to identify aspects of the Non-Profit Revitalization Act of 2013 needing improvement. The Committee's view is that although the Act significantly improved many aspects of corporate structures and transactions, parts of the Act present challenges and problems in implementation that could be alleviated without impairing the overall purposes of the Act. The group's efforts over the winter and spring culminated in a consensus proposal addressing independent directors, related party transactions, and committees. We also engaged with the Attorney General's Charities Bureau and legislators. A bill based on our proposal was introduced in the 2016 session (S.7913 / A10365).

In our Spring meeting, the Committee also discussed common problems practitioners encounter in advising not-for-profit corporations and the emerging trend of forming non-profits in other jurisdictions, primarily Delaware, including the related topic of re-incorporating existing non-profits in another state. Finally, the Committee discussed possible issues or subjects that could or should be addressed by the Committee in the future, including other parts of the Not-for-Profit Corporation Law that need attention and other New York statutes that apply to non-profits, such as the Religious Corporations Law.

Frederick Attea, Chair

Public Utility Law Committee

No report submitted.

Kevin Long, Chair

Securities Regulation Committee

The Securities Regulation Committee is made up of lawyers practicing in the areas of state and federal securities laws, including securities registration, securities and Investment Company Act exemptions, broker-dealer and investment adviser regulation, and related areas, such as the Municipal Advisor Rules. The Chair of the Committee is Anastasia Rockas and the Program Chair is Kelly Basham. The past Chair, Peter LaVigne, completed his three-year term in June.

On January 27, in connection with the Bar Association's Annual Meeting in New York City, the Securities Regulation Committee and Corporations Law Committee offered a panel discussion on "Corporate and Securities Law Developments: The Year in Review," with presentations by Peter LaVigne and Anastasia Rockas along with Jeff Bagner and Richard De Rose of the Corporations Law Committee.

The Securities Regulation Committee holds monthly dinner meetings, generally on the third Wednesday of every month. During 2016 speakers have presented on the following topics, among others:

- "A Guide to Preparing Clients for Effective Cybersecurity"
- "'The Power to Investigate Carries With It the Power to Defame and Destroy': *SEC v. Caledonian Bank*"
- Updates on proxy access, executive compensation regulation and trends and tactics in shareholder activism
- FINRA developments
- "Why Recent Criticisms of SEC Enforcement Efforts Are Unfair"
- "Ethically Advising Clients in Regulatory Matters: Hypotheticals Under Section 1.2(d) of the Rules of Professional Conduct."

The Committee also has a Subcommittee on Private Investment Funds, which generally meets every three months with substantive meetings for CLE credit on various regulatory and other topics relevant to private investment fund lawyers. Recent topics at Subcommittee meetings include SEC Examinations of Investment Advisers, Delaware Partnership and Limited Liability Company Fiduciary and Other Issues, and Crisis Management for Investment Advisers. Linda Smith will be continuing and Kristine Koren will be joining her as the Co-Chairs of the Subcommittee. Anastasia Rockas was the founding Chair and Linda Smith was the founding Vice-Chair of the Subcommittee.

Committee and Subcommittee meetings provide a good opportunity for experienced and less experienced attorneys to get together to discuss new developments in the law and to revisit established law. Committee and Subcommittee membership is open to any member of the Business Law Section.

Peter LaVigne, Chair

Technology and Venture Law Committee

The Technology and Venture Law Committee held a well-attended session at the Spring 2016 NYSBA meeting in New York City. Views on topical issues were offered by (i) Robert Clarida, a partner at Reitler Kailas & Rosenblatt LLC, in his presentation entitled "Music Licensing Online: Who Pays for What?" and (ii) Sanjay Gandhi, President and General Counsel of Oxford Valuation Partners Inc., in his presentation entitled "Do you know the Exit Hurdle? Advising Companies in a Changing Market."

All Committee members are invited to suggest topics and formats for upcoming meetings, as well as to participate in Committee activities.

Peter W. Rothberg, Chair

Nominations Sought: David S. Caplan Award for Meritorious Service

The Business Law Section of the New York State Bar Association, in order to recognize the importance and value to the Business Law Section of the many hours of volunteer service provided to the Section and its Committees by its members, has established the David S. Caplan Award for Meritorious Service. The award is named in honor of Mr. Caplan, former Chair of the Technology and Venture Law Committee, who, despite his personal physical challenges, was always willing to volunteer his time, his effort, and his ideas for the benefit of the Section. The Caplan Award for 2017 will be presented at the Annual Meeting of the Business Law Section held in conjunction with the Annual Meeting of the New York State Bar Association in January 2017 and an announcement identifying the award recipient will be included in the Summer 2017 *NY Business Law Journal*.

All members of the Business Law Section are invited to nominate any current member of the Section to receive the Caplan Award. The recipient of the award shall be selected by a committee consisting of the three most immediate past chairs of the Section. For 2017, the committee consists of Jay Hack (jlh@gdblaw.com), James Everett (everettlaw@juno.com), and David Oppenheim (oppenheimd@gtlaw.com). Please send your nomination by email to any or all of them, along with a statement of any factors you wish them to consider with respect to your nominee.

A list of all award recipients appears on the Section's website.

2016 Honoree:
Recipient: Frederick G. Attea, Esq.

Frederick G. Attea is a corporate lawyer at Phillips Lytle LLP (Buffalo). He concentrates his practice on mergers and acquisitions, securities laws, corporate governance and legal compliance programs. He has been a member of the New York State Bar Association since 1965 and has served as a member of the House of Delegates, Chair of the Business Law Section, Chair of the Corporations Law Committee, and is currently Chair of the recently organized Not-For-Profit Corporations Law Committee. He is a leader in the Western New York community, dedicating his time to his practice and to community service, especially in education and the arts. He has authored numerous articles and lectured on a variety of legal topics.

Past Award Recipients:
2015—Samuel F. Abernethy, Esq.
2014—David L. Glass, Esq.

Publication Policy and Manuscript Guidelines for Authors

All proposed articles should be submitted to the *Journal*'s Editor-in-Chief. Submissions should be e-mailed or sent on a disk or CD in electronic format, preferably Microsoft Word (pdfs are not acceptable). A short author's biography should also be included.

The editors reserve the right to edit the manuscript to have it conform to the *Journal*'s standard in style, usage and analysis. All citations will be confirmed. Authors should consult standard authorities in preparing both text and footnotes, and should consult and follow the style presented in *Bluebook: A Uniform System of Citation*. An *Author's Guide* can be obtained by contacting the Editor-in-Chief. The revised manuscript will be submitted to the author for approval prior to publication.

The views expressed by the authors are not necessarily those of the *Journal*, its editors, or the Business Law Section of the New York State Bar Association. All material published in the *Journal* becomes the property of the *Journal*. The *Journal* reserves the right to grant permission to reprint any articles appearing in it. The *Journal* expects that a manuscript submitted to the *Journal*, if accepted, will appear only in the *Journal* and that a manuscript submitted to the *Journal* has not been previously published.

A manuscript generally is published five to six months after being accepted. The *Journal* reserves the right (for space, budgetary, or other reasons) to publish the accepted manuscript in a later issue than the issue for which it was originally accepted.

Manuscripts are submitted at the sender's risk. The *Journal* assumes no responsibility for the return of the material. Material accepted for publication becomes the property of the Business Law Section of the New York State Bar Association. No compensation is paid for any manuscript.

The Section's Committees are also encouraged to submit for publication in the *Journal* notices of committee events, Annual Meeting notices, information regarding programs and seminars and other news items of topical interest to the members of the Business Law Section.

Manuscripts are to be submitted to:

David L. Glass
Editor-in-Chief
NY Business Law Journal
Macquarie Group Ltd.
125 West 55th Street
New York, NY 10019
telephone: (212) 231-1583
e-mail: david.glass@macquarie.com

Subscriptions

Subscriptions to the *Journal* are available to non-attorneys, universities and other interested organizations.
The 2016 subscription rate is $135.00. Please contact the Newsletter Department, New York State Bar Association, One Elk Street, Albany, NY 12207 or call (518/487-5671/5672) for more information.

Accommodations for Persons with Disabilities:

NYSBA welcomes participation by individuals with disabilities. NYSBA is committed to complying with all applicable laws that prohibit discrimination against individuals on the basis of disability in the full and equal enjoyment of its goods, services, programs, activities, facilities, privileges, advantages, or accommodations. To request auxiliary aids or services or if you have any questions regarding accessibility, please contact the Bar Center at (518) 463-3200.

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, second and third best, provided they are of publishable quality and otherwise meet the criteria of the Competition, will receive cash prizes of $2,000, $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 Albany 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.

The Editors congratulate the winners of the 2015 Student Writing Competition:

Amanda Evans, Richmond Law School

Amanda Godkin, Albany Law School

Matthew Mobilia, Albany Law School

NEW YORK STATE BAR ASSOCIATION
BUSINESS LAW SECTION
One Elk Street, Albany, New York 12207-1002

ADDRESS SERVICE REQUESTED

NON PROFIT ORG.
U.S. POSTAGE
PAID
ALBANY, N.Y.
PERMIT NO. 155