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Inside

NEW YORK STATE BAR ASSOCIATION

Business Law Section

ANNUAL STUDENT WRITING COMPETITION

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

Articles submitted will be judged on the following criteria:

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

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

To enter, the student should submit an original, unpublished manuscript in Word format to David L. Glass, Editor-in-Chief, NYSBA *NY Business Law Journal* (david.glass@macquarie.com).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

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To paraphrase Thomas Paine, these are the times that try lawyers' souls. Among the many challenges facing the profession is a perfect storm in legal education: the cost of obtaining the JD degree continues to escalate at the same time that the recent financial crisis has "decimated the legal industry" and exacerbated an ongoing glut of new lawyers (*Gomez-Jimenez et al. v. New York Law School*, 36 Misc. 3d 230 (New York Cty. 2012)). The result has been a continuing bleak employment outlook generally for new law graduates, who typically have incurred massive amounts of debt in pursuit of a degree, the economic value of which is increasingly problematical. Given the nature of the profession and the ingenuity of its members, it is perhaps not surprising that some of these disgruntled students have hit upon a practical way of putting their new knowledge to work: suing their law schools.

In the *Gomez-Jimenez* case, decided earlier this year, Judge Melvin Schweitzer of the New York State Supreme Court dismissed an action brought under General Business Law (GBL) Section 349 by nine graduates of New York Law School, alleging in effect that they were fraudulently induced to attend the School and pay its annual tuition in excess of $47,000 by misleading information used in promotional materials distributed by the School and posted on its website, with respect to the percentage of its graduates who find jobs and the average starting salary for new graduates (similar actions have been brought in other jurisdictions against other law schools under similar theories; to date, none has been successful). Under GBL 349, an action will lie 1) if the defendant's alleged conduct was consumer-oriented; 2) if it was deceptive or fraudulent in a material way; and 3) if the plaintiff suffered injury in fact. In dismissing the complaint, Judge Schweitzer noted among other things that the School's disclosures complied with ABA requirements and thus were consistent with how other law schools disclose this information; that the limitations of the information presented (such as a small sample size) were duly disclosed; that the plaintiffs (most of whom in fact are employed at present) failed to establish individual injuries in fact; that their proposed measure of damages, the difference between their actual earnings and the earnings alleged to be promised by the School's promotional materials, was entirely too speculative, especially given the intervening financial crisis; and, perhaps most tellingly, that the law mandates that the material allegedly relied upon must be deceptive to a "reasonable" consumer before it will be actionable. In the latter regard, the plaintiffs were hoist by their own petard: the record showed that they were sophisticated and knowledgeable about the plethora of information available on the Internet and elsewhere regarding legal employment prospects, so that a "reasonable" consumer in their position would not reasonably have relied exclusively on the alleged misrepresentations.

More generally, Judge Schweitzer's opinion is a thoughtful exposition of the current crisis in the legal profession, and well worth reading for that reason alone. Bottom line, quoting a *New York Times* article on the subject: "Since it is unlikely, based on overall economic conditions, that the demand for legal services will grow robustly for the foreseeable future, the legal industry will be forced to live with uncertainty for some time to come."

Given the uncertainty of the outlook for demand for their services, business lawyers may be well advised to seek areas into which to diversify their practice. One of the few clear growth areas in legal practice relates to health care law—especially in the wake of the Patient Protection and Affordable Care Act, a.k.a. Obamacare. But the complexity of the new law, and the remaining uncertainties surrounding its implementation, create a minefield for the unwary practitioner. In "Proceed With Caution: Matters to Consider for Business Lawyers Transitioning into Health Care," Craig Garner provides both scholarly analysis and practical advice for the business lawyer considering a foray into health care law. Mr. Garner, a practicing attorney and consultant in the health care field, is a former CEO at Coast Plaza Hospital in Los Angeles, and currently is an adjunct professor of health care law at Pepperdine University. He brings his perspective to bear from both the legal and managerial sides of the profession.

As this issue went to press (our deadline was before Election Day), electoral politics dominated the news. Partisan considerations aside, one prominent feature of this election was the historically low 11 percent approval rating of the U.S. Congress—as one wag put it, "there are toothaches that have a higher approval rating." Perhaps predictably, our Congress has sought to give the appearance, however cosmetic it may be, that it is changing its evil ways. Scott Colesanti, an adjunct professor at Hofstra Law School and a prior contributor to the *Journal*, has highlighted one such measure: the Stopping Trading On Congressional Knowledge, or STOCK, Act. In "Taking Stock of the STOCK Act," Mr. Colesanti notes that the new law, enacted at the request of the President, actually adds little to the existing array of enforcement tools against insider trading, since there is no indication that Congress is at present immune from such prosecutorial measures as the "Misappropriations Theory," which applies generally to third parties who trade on inside information. Thus, the law may in substance be little more than a "feel good" measure designed to impress the public that Congress is attempting to police itself; however, the author notes that it does at least highlight the issue and change the tone of the debate. More generally, Mr. Colesanti provides a concise refresher and overview of the development of insider trading law.

Next up is our ethics guru, Evan Stewart of Zuckerman Spaeder, who revisits a topic he has lucidly explored in earlier issues: the attorney work product doctrine, a leading candidate for the endangered species list. Lamenting along with the singer-songwriter Joni Mitchell ("You don't know what you got 'til it's gone"), Mr. Stewart shows how the sensible approach to the doctrine taken in the Second Circuit *Adlman* case is again under threat from a recent case in the federal district court for the western district of New York. The underlying issue is when attorney work product may be said to be produced "in anticipation of litigation," so as to be exempt from discovery under FRCP 26(b)(3). In his usual clear and engaging prose, Mr. Stewart gives a heads-up to business lawyers who may think their work product is protected from discovery, as long as it is prepared "the right way."

Buried in the 2,400 pages of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 are several provisions that, on their face, seem to have little to do with the law's main objectives of preventing another financial crisis and protecting consumers, but serve other Congressional agendas. One prominent example is the so-called "conflicts mineral" rule, intended to promote transparency in the resource extraction market, and more particularly to exert moral suasion against resource companies contemplating payments to certain foreign governments for the right to develop natural resources therein—akin, perhaps, to the shooting of an admiral on the deck of his ship in Voltaire's *Candide* "pour encourager les autres" (to encourage the others). This provision amends the Securities Exchange Act of 1934 to apply to issuers of securities in the United States; but as always, and especially with Dodd-Frank, the devil is in the details. The Securities and Exchange Commission has now issued rules to govern the required disclosures. In "New SEC Rules for Resource Extraction Issuers to Disclose Payments to Governments," Guy Lander of Carter Ledyard & Millburn, along with his colleagues Steven Glusband, Bruce Rich, and Gideon Even-Or, explain what is required and provide a practical guide to preparing the relevant forms. Mr. Lander is a past Chair of the Business Law Section and a frequent contributor to the *Journal*.

Apart from Dodd-Frank, another area of financial regulation which has escalated dramatically in recent years is the "Know Your Customer" ("KYC") requirement, which applies to all financial firms. In large part the legacy of the September 11 attacks and the USA PATRIOT Act enacted thereafter, the regulators have continued to ramp up the KYC requirement, aimed at preventing the use of the financial system to launder money for purposes of terrorism or criminal activity. In "New FINRA Know Your Customer and Suitability Rules Require Brokerage Changes," Morrie Simkin of McLaughlin & Stern, a Section member and expert in broker-dealer law, explains the new rules issued by the Financial Industry Regulatory Authority, which to some extent replace former rules of the National Association of Securities Dealers, FINRA's predecessor, and the New York Stock Exchange. While noting that the new KYC rule appears simple on its face, Mr. Simkin explains that in practice it is quite complex when read together with the new suitability rules, which pertain to assuring that investments recommended and sold to customers are suitable for those customers. Indeed, as he explains, FINRA has already issued three Regulatory Notices to implement and clarify the new rules. Mr. Simkin's article provides practical "takeaways" for broker-dealer firms to consider as they undertake implementation of the new requirements.

Another of the less-noticed aspects of the Dodd-Frank reform law is the creation of a new Federal Insurance Office ("FIO"). Historically insurance, unlike other financial services, has been and continues to be regulated exclusively at the state level—a 1944 federal law, the McCarran-Ferguson Act, provides that no federal law applies to insurance unless by its terms it "specifically relates" to insurance. The financial crisis, and specifically the government bailout of insurance giant AIG, renewed calls for a greater federal role in insurance regulation. In the end, as a compromise FIO was created with a more limited mandate—essentially to oversee and study insurance regulation and make recommendations to the umbrella regulator created by Dodd-Frank, the Financial Stability Oversight Council ("FSOC"). In "Why FIO Matters," Ethan T. James and Amanda G. Wise, both partners at Debevoise & Plimpton, clarify exactly what FIO is and is not expected to do. While FIO has no direct regulatory responsibilities, the authors explain how it is serving a key role in both national and international policymaking with respect to regulation of the business of insurance.

"Inside the Courts," a summary of currently active securities-related litigation prepared by the attorneys of Skadden Arps, has proven to be one of the most valuable ongoing features of the *Journal*. As concise as it is comprehensive, this issue's version covers the gamut from Auction Rate Securities to Statutes of Repose. The compendium leads off with a case recently accepted by the United States Supreme Court, *Amgen, Inc. v. Conn. Retirement Plans and Trust Funds*, in which the Court will consider whether a securities fraud plaintiff alleging a "fraud on the market" theory must establish materiality in order to gain class certification.

This issue concludes with yet another echo of the financial crisis. In "Lender Beware: Eleventh Circuit Court of Appeals Allows TOUSA Decision to Stand," attorneys Alan Lepene, William Schrag, John F. Isbell and Andrew

L. Turscak, Jr. of Thompson Hine LLP discuss a case that has reverberated through the lending community and the bankruptcy bar since the bankruptcy court initially decided it in 2009. TOUSA, Inc. was a large residential developer and builder that went under during the financial crisis due to its exposure to the Florida real estate market. The lower court avoided payments made to prior lenders as a fraudulent conveyance under the Bankruptcy Code, because certain subsidiaries of TOUSA had pledged assets to secure a new loan to repay the existing debt even though the subsidiaries were not themselves liable on the prior loan, holding that the subsidiaries did not receive reasonably equivalent value for the assets they transferred. Although the District Court reversed, the Court of Appeals largely reinstated the lower court's decision, and this summer the Eleventh Circuit Court of Appeals denied a petition for *en banc* review. The authors note that while this apparently closed the door on one chapter of the TOUSA story, the case may hold broader implications for future financing structures. For this reason, their article is well worth the attention of all business attorneys—not just those engaged in bankruptcy or secured lending practice.

David L. Glass

Proceed With Caution: Matters to Consider for Business Lawyers Transitioning Into Health Care

By Craig B. Garner

Introduction

While the subject of health care law makes headlines daily across the nation, there is still a sizeable chasm between health care lawyers and their business counterparts. Sometimes complicated, health care law is by no means exclusive, and opportunities abound for an able practitioner. Notwithstanding this, in today's climate of reform it is essential that those practicing American health care law honor and obey the hierarchy surrounding its discipline as it struggles to stay afloat amid a rising tide of constitutional, partisan and fiscal challenges.

In most states, attorneys are mindful that when venturing into areas of law outside their usual practice, rules of professional conduct apply. A District Court in the District of Columbia recently repeated a familiar quote that health care law, and the Medicare statutes in particular, are "among the most completely impenetrable texts within human experience." Complications notwithstanding, there is a pressing need to advance this body of authority, not to mention the nation's health care system, beyond its fledgling form (commonly referred to as the Affordable Care Act). What began as a mere 2,700 pages of codified reform may eventually be tens of thousands. This will require active participation from attorneys representing practically all areas of law, although when it comes to matters of health care law, it is always best to proceed with caution.

When venturing into areas of law outside their usual practice, attorneys should be mindful of the state-specific standards to which they are held. Rule 3-110 of the California Rules of Professional Conduct sets the standard on the west coast, just as Rule 1.1 of the New York Rules of Professional Conduct applies on the east. Absent the requisite skill to accommodate a client's needs, an attorney may still engage and adhere to the statutory definition of competence by "associating with or, where appropriate, professionally consulting another lawyer reasonably believed to be competent" or "by acquiring sufficient learning and skill before performance is required."[1] In 2003, a California Appellate Court explained: "attorneys are expected 'to possess knowledge of those plain and elementary principles of law which are commonly known by well informed attorneys, and to discover those additional rules of law which, although not commonly known, may readily be found by standard research techniques.'"[2]

However, due to the sheer volume and complexity of information generated regularly in the wake of reform, modern health care law exists in a league of its own. To be sure, there is nothing otherworldly about health care law,[3] and a conscientious advocate can find the answers he seeks given enough time and resources. Yet even the savviest business lawyer should be mindful before accepting a new assignment involving health care concerns, as the fiduciary pathway can be treacherous and unforgiving. The ever-evolving body of laws governing today's health care industry bears at least partial blame for the inherent disconnect between traditional notions of business (referenced occasionally in a state's Corporations,[4] Corporations and Associations[5] or General Business Code,[6] for example) and the business of health care (found within a plethora of statutory domiciles in various states, including California,[7] New York[8] and Texas,[9] among others).[10] Regardless of where it is encountered, health care law should never be underestimated, even if its underlying logic exists outside the scope of case law and statutes frequented by a business lawyer on any given day.

The False Claims Act, 150 Years in the Making

To further confuse the issue, many of the core tenets central to health care law are inherently inconsistent with those meanings employed on a regular basis by the corporate attorney, such as "goods and services," "financial interests," "referrals," "discounts" and "rebates." The situation has not improved with the passage of the Patient Protection and Affordable Care Act,[11] as amended by the Health Care and Education Reconciliation Act[12] (collectively referred to as the Affordable Care Act or health care reform) particularly in regard to matters of health care fraud and abuse. Dating back to the American Civil War, the False Claims Act (FCA) has over time become both the federal and state governments' "primary litigative tool for combating fraud."[13] At its core, the FCA imposes liability on anyone who "knowingly presents, or causes to be presented, a false or fraudulent claim for payment or approval."[14]

What began as a way to protect the Union Army from purchasing substandard horses, faulty weaponry, and inedible provisions has evolved considerably since Congress passed the FCA in 1863.[15] In its present incarnation under the Affordable Care Act, a health care provider must return any "overpayment" of federal funds within sixty days after identifying the error or risk liability under the FCA.[16] However, the meaning of the term "overpayment" extends beyond a simple miscalculation of price in response to which a refund or store credit will suffice.

Under federal law, overpayments can result from unintentional billing errors, overutilization or by working with an excluded vendor. They can also occur when a facility does not employ accurate procedures for billing and collecting in connection with hard work on behalf of real patients, unnecessary work with not-so-real patients, and necessary work for patients within 72 hours of a hospital inpatient admission or discharge.[17] An overpayment may include a duplicate payment to a hospital by a patient and her automobile insurer.[18]

It may also apply in "the situation where a provider is given money by Medicare to pay for certain health care services, and the provider contracts with a third party who, in turn, provides those services, but the provider fails to liquidate the liability by paying the third party within a designated period of time."[19] There may exist both "anticipated" overpayments as well as "erroneous" overpayments,[20] and a delay of as much as fourteen years in attempting to recover an overpayment should be considered reasonable.[21]

Exclusion From the Medicare Program

Yet another concept that has grown far more expansive under the Affordable Care Act is the notion of what it means to be "excluded" from participation in a health care program funded at least in part by the Federal government, and the potential ramifications of such exclusion from a business standpoint.[22] As a general rule, the Federal government requires advanced approval of every entity that participates in the delivery of health care under a federal program such as Medicare. In the event that any one participant in a provider's delivery of health care is either unauthorized or excluded[23] from participation by the Federal government, everything related to the actual remuneration of these health care services by the Federal government may constitute an overpayment and / or false claim.[24] In essence, any items or services furnished by an excluded individual or entity are not reimbursable by any Federal health care program, including monies paid to another, third party provider or supplier that is an authorized participant, such as a doctor or hospital. This creates an implied indemnification of any health care provider who receives Federal funds in exchange for the delivery of medical services, yet fails to afford that same provider any viable remedy against a third party who bears technical culpability for the break in the chain, thereby rendering the entire reimbursement *void ab initio*. A single weak link effectively nullifies the entire chain.

No matter where on the vertical ladder of delivery an excluded provider may stand, reimbursement is not permissible for anyone, and violations may result in potential criminal penalties.[25] This includes those administrative and management services that are not directly related to health care but are nonetheless a necessary component in the ultimate delivery of health care services. Services performed by excluded parties such as nurses, pharmacists, ambulance drivers, social workers, claims processors, or even the person who sells, delivers and / or refills an order for a medical device are thereby prohibited.[26] Failure to follow these rules closely exposes a health care provider to potential civil money penalties of $10,000 for each item or service that bears some nexus to an excluded individual, treble damages for the amount of each specific claim, and possible exclusion for the health care provider himself or herself, who may have been unaware of the circumstances rendering his or her treatment problematic in the eyes of the government.[27]

It should thus come as no surprise that under the Affordable Care Act, participation in the Medicare program may require a heightened level of advanced screening, such as criminal background checks, fingerprinting, licensure verification and unannounced visits.[28] As of March 25, 2012, these procedures will apply to nearly everyone involved in the delivery of care under the Medicare program, either directly or indirectly.[29] While this may on the surface appear to be somewhat disruptive, its intent is to protect providers from unwittingly collaborating with excluded parties who may cause them not only to forfeit their right to reimbursement, but also incur substantial penalties. Although typically associated with criminal law cases, the legal metaphor "fruit of the poisonous tree"[30] provides an excellent analogy for the ways in which the slightest oversight can lead to substantial financial penalties.

The Fraud and Abuse Labyrinth

In an attempt to curtail the ever-present specter of medical fraud, both state and federal governments have created a series of provisions designed to police providers and highlight areas where conflicts of interest may arise. Fraught with complexity and comprised of volumes upon volumes of information in the form of statutory authority, case law decisions, and secondary references, Stark laws, Anti-Kickback statutes and laws governing outpatient referral[31] give the Commerce Clause[32] a run for its money in terms of complexity. And yet, it is not the nature of the laws that is problematic from the viewpoint of a business lawyer, but rather the 28 pages of double-columned regulatory exceptions (also known as "Safe Harbors")[33] to the criminal penalties for acts involving federal health care programs.[34] When used accordingly, these statutory exceptions can potentially insulate a health care provider from liability under the Stark and Anti-Kickback laws, not to mention the few hundred advisory opinions generated by the Office of the Inspector General.[35]

Some of the more common Safe Harbor provisions include investment interests, office space and equipment rental, personal services and management contracts, the sale of a practice, referral services, discounts, employees, group purchasing organizations, waiver of beneficiary coinsurance and deductible amounts, physician recruitment, investments in group practices, ambulatory surgical centers, ambulance replenishing, and electronic health records.[36] Outside of the health care context, many such transactions are considered ordinary at best, and there are without question other specialty areas among business lawyers that also include higher standards of care. However, with health care expenditures (NHE) accounting for almost 18% of the nation's gross domestic product, amounting to approximately $2.5 trillion as of 2009,[37] it is not entirely unexpected that health care law is trying to keep pace, and the physical and mental demands such labyrinthine legislation may impose upon the unwary business lawyer should never be underestimated. With such an expansive regulatory reach and potential liability emanating from so many possible points of origin, extreme vigilance and an ever-present eye to copious, sometimes seemingly unreasonable or unfair, details must serve as the foundation for any health care law practice.

Health Care's Version of the Recall

It is not uncommon for federal or state laws to mandate that businesses notify their customers in certain events, such as during product safety recalls in automobiles, potential health threats relating to food products, and substantive or technical concerns in the pharmaceutical industry. Due to concerns over patient privacy, the health care industry must take the idea of patient notification to a whole new level. Under the Health Information Technology for Clinical and Economic Health (HITECH) Act,[38] any "covered" entity that maintains "unsecured" protected health information (PHI) and "discovers" a "breach of such information" must notify each individual whose PHI "has been, or is reasonably believed by the covered entity to have been, accessed, acquired, or disclosed as a result of such breach."[39] This rule also applies to business associates working with an entity for which disclosure is required under the HITECH Act.[40]

The regulations provide for the method of notification (mail, email, or telephone, in certain instances),[41] establish protocol should the issue involve more than ten individuals, and set forth further requirements for issues involving more than 500 individuals.[42] Federal regulations also specify what the notice must include for each type of infraction.[43] Finally, there is often a fine when a breach is proven, and neither HITECH nor HIPAA (Health Insurance Portability and Accountability Act of 1996)[44] offers exceptions. With civil penalties ranging from $100 to $50,000 for each HIPAA or HITECH-related violation, cumulative penalties can amount to as much as $1,500,000 in any calendar year.[45] Where there is an "intent to sell, transfer, or use individually identifiable health information for commercial advantage, personal gain, or malicious harm, the penalty may not exceed $250,000, imprisonment up to 10 years, or both."[46]

We Cannot Refuse the Right to Serve

In an effort to counteract "patient dumping," wherein hospitals refuse to treat people due to lack of insurance or inability to pay, Congress passed the Emergency Medical Treatment and Active Labor Act (EMTALA) in 1986.[47] EMTALA requires every hospital that receives federal funding to treat any patient with an emergency condition in such a way that, upon the patient's release, no further deterioration of the condition is likely. No hospital may release a patient with an emergency medical condition without first determining that the patient has been stabilized, even if the hospital properly admitted the patient. Under EMTALA, patients requesting emergency treatment can only be discharged under their own informed consent or when their condition requires the services of another hospital better equipped to treat the patient's concerns.[48]

There has been an abundance of debate regarding the propriety of these requirements, specifically regarding their impact on the emergency health care system in the United States.[49] Simply put, the idea behind EMTALA places a considerable burden on participating emergency departments by allowing a buyer of certain goods (*i.e.*, the patient) to obtain certain goods (*i.e.*, medical care) from a seller of certain goods (*i.e.*, the hospital), though the seller must still perform his or her duties regardless of whether the buyer is able to pay, and there exists no viable remedy to prevent such a scenario from happening repeatedly. While other industries have specific remedies for addressing such issues,[50] these methods rarely apply in the health care sector.[51] Even provisions to protect business transactions upon seller's discovery of buyer insolvency do not translate well in the realm of health care law,[52] placing providers in the unenviable position of having to provide their services atop a business model too weak to allow for continued sustainability.

Health care law is by no means exclusive, and opportunities abound for an able practitioner hoping to transition at any stage of his or her career. In today's climate of reform, it is essential that those practicing American health care law honor and obey the hierarchy surrounding its discipline as it struggles to stay afloat amid a rising tide of constitutional challenges. It comes as no surprise that even after the Supreme Court's landmark decision in June confirming the constitutionality of the Affordable Care Act,[53] health care law continues its reign in the spotlight. Even though Chief Justice Roberts set the stage for the November elections while casting uncertainty for the future of the Affordable Care Act,[54] health care lawyers are sure to remain standing.

Endnotes

1. Cal. Rules of Prof'l Conduct R. 3-110(C) (1992); *see also* Ala. Rules of Prof'l Conduct R. 1.1 (2012); Colo. Rules of Prof'l Conduct R. 1.1 (2008); N.Y. Rules of Prof'l Conduct R. 1.1(b) (2009); Tex. Disciplinary Rules of Prof'l Conduct R. 1.01 (2005).
2. Camarillo v. Vaage, 130 Cal. Rptr. 2d 26, 32 (Cal. Ct. App. 2003) (quoting Smith v. Lewis, 530 P.2d 589, 595 (Cal. 1975)); *see also* McIntyre v. Comm'n for Lawyer Discipline, 169 S.W.3d 803, 807–08 (Tex. App. 2005); *In re* Jayson, 832 N.Y.S.2d 696, 698 (App. Div. 2007); Davis v. Alabama State Bar, 676 So.2d 306, 310 (Ala. 1996);

Disciplinary Counsel v. Hoppel, 2011-Ohio-2672, 129 Ohio St. 3d 53, 54, 950 N.E.2d 171, 173.

3. *But see* Catholic Health Initiatives—Iowa v. Sebelius, 841 F. Supp. 2d 270, 271 (D.D.C. 2012) ("Picture a law written by James Joyce and edited by E.E. Cummings [sic]. Such is the Medicare statute, which has been described as 'among the most completely impenetrable texts within human experience.'") (quoting Rehab. Ass'n of Va., Inc. v. Kozlowski, 42 F.3d 1444, 1450 (4th Cir. 1994)). The District Judge also noted that "[t]he Court clarifies, however, that by making this analogy, it is referring not to Joyce's early work, such as *Dubliners* or *A Portrait of the Artist as a Young Man*, but his later period, specifically *Finnegan's Wake.*" *Catholic Health*, 841 F. Supp. 2d at 271 n.1.

4. *See, e.g.*, Cal. Corp. Code.

5. *See, e.g.*, Md. Code Ann., Corps. & Ass'ns Code.

6. *See, e.g.*, N.Y. Gen. Bus. Law.

7. *See e.g.*, Cal. Health & Safety Code, Cal. Welf. & Inst. Code, Cal Ins. Code, Cal. Lab. Code, and Cal Gov't Code, among others.

8. *See, e.g.*, N.Y. Ins. Law, N.Y. Pub. Health Law, N.Y. Mental Hyg. Law, N.Y. Retire. & Soc. Sec. Law, N.Y. Vol. Ambul. Workers' Ben. Law and N.Y. Workers' Comp. Law, among others.

9. *See, e.g.*, Tex. Health & Safety Code Ann. and Tex Loc. Gov't Code Ann., among others.

10. *See also* 42 U.S.C. (2012) (Public Health and Welfare); 25 U.S.C. §§ 1601–83 (2012) (Indian Health Care); 31 U.S.C. (2012) (Money and Finance); 38 U.S.C. §§ 7301–68 (2012) (Veterans Health Administration). In addition to these state and federal statutes, there exists an equally expansive body of state and federal regulatory authority. *See, e.g.*, 8 U.S.C. (2012) (Industrial Relations); 17 U.S.C. (2012) (Public Health); 28 U.S.C. (2012) (Managed Health Care); *see also* 25 C.F.R. (2012) (Indians), 38 C.F.R. (2012) (Pensions, Bonuses, and Veterans' Relief), 42 C.F.R. (2012) (Public Health).

11. Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (2010).

12. Healthcare and Education Reconciliation Act of 2010, Pub. L. 111-152, 124 Stat. 1029 (2010).

13. United States *ex. rel.* v. Boeing Co., 9 F.3d 743, 745 (9th Cir. 1993) (quoting Senate Judiciary Committee, False Claims Amendments Act of 1986, S. Rep. No. 345, 99th Cong., 2d Sess. 2 (1986), *reprinted in* 1986 U.S.C.C.A.N. 5266).

14. 31 U.S.C. § 3729(a)(1)(A) (2012).

15. *See* 12 Stat. 696 (Mar. 2, 1863).

16. *See* 42 U.S.C. § 1320a-7k (2012); *see also* 18 U.S.C. § 1035 (2012) (false statements relating to health care matters); 18 U.S.C. § 1001 (2012) (false statements as to matters under federal jurisdiction); 31 U.S.C. § 3729(a)(1) (the Fraud Enforcement and Recovery Act). *Cf.* Medicare Program; Reporting and Returning of Overpayments, 77 Fed. Reg. 9179 (Feb. 16, 2012) (to be codified at 42 C.F.R. pts. 401 and 405) (clarifying the requirements for providers and suppliers receiving funds under the Medicare program to report and return overpayments).

17. *See generally* 42 U.S.C. § 1320a-7b (2012) (outlining criminal penalties for acts relating to federal health care programs).

18. Buckner v. Heckler, 804 F.2d 258, 259–60 (4th Cir. 1997).

19. *See In re* Slater Health Center, 398 F.3d 98, 100 (1st Cir. 2005).

20. Carleson v. Unemployment Ins. Appeals Bd., 64 Cal. App. 3d 145, 153 (Cal. Ct. App. 1976); *see also* Holy Cross Hosp. of Silver Spring, Inc. v. Maryland Employment Sec. Admin., 421 A.2d 944, 946 (Md. 1980).

21. *See generally* Robert F. Kennedy Med. Ctr. v. Department of Health Srvs., 61 Cal. App. 4th 1357 (Cal. Ct. App. 1998).

22. This includes Medicare and Medicaid.

23. The Federal government, and specifically the Office of the Inspector General, is required by law to exclude from participation in all Federal health care programs individuals or entities convicted of certain offenses, such as Medicare or Medicaid fraud, patient abuse or neglect, or felony convictions for other health care related fraud or misconduct. *See, e.g.*, 42 U.S.C. § 1320A-7(a) (2012). The OIG also has discretion to exclude from participation in all Federal health care programs individuals or entities with misdemeanor convictions related to health care fraud, fraud in a non-health care program that is funded by a federal, state or local government agency, or for providing unnecessary or substandard service. *See, e.g.*, 42 U.S.C. § 1320A-7(b) (2012).

24. *See, e.g.*, 42 C.F.R. § 1001.1901 (2012).

25. 42 U.S.C. § 1320a-7b (2012).

26. *See, e.g.*, 42 U.S.C. § 1395x(b) (2012) (defining inpatient hospital services).

27. *See, e.g.*, 42 U.S.C. § 1320a-7a (2012); 42 C.F.R. § 1001.3002 (2012).

28. 42 U.S.C. § 1866j(2) (2012).

29. Medicare, Medicaid, and Children's Health Insurance Programs; Additional Screening Requirements, Application Fees, Temporary Enrollment Moratoria, Payment Suspensions and Compliance Plans for Providers and Suppliers, 76 Fed. Reg. 5862, 5865 (Feb. 2, 2011).

30. *See* Nardone v. United States, 308 U.S. 338, 341 (1939) (first use of the phrase "fruit of the poisonous tree"); Silverthorne Lumber Co. v. United States, 251 U.S. 385 (1920) (first articulation of the concept behind the phrase).

31. *Stark* (the Medicare self-referral prohibitions, codified at 42 U.S.C. § 1395nn (2012)), *AKS* (the Federal Anti-Kickback statutes, 42 U.S.C. § 1320a-7b(b) (2012), and *PORA* (California's Physician Outpatient Referral Act, Cal. Bus. & Profs Code § 650, *et seq.*).

32. U.S. Const. art. I, § 8, cl. 3 ("To regulate commerce with foreign nations, and among the several states, and with the Indian tribes.").

33. *See* 42 C.F.R. § 1001.952 (2012).

34. *See, e.g.*, 42 U.S.C. § 1320a-7b (2012).

35. The OIG issues advisory opinions about the application of its fraud and abuse authorities to the requesting party's existing or proposed business arrangement. 42 U.S.C. § 1320a-7d(b) (2012); 42 C.F.R. § 1008 (2012).

36. *See* 42 C.F.R. § 1001.952 (2012).

37. United States Department of Commerce, Bureau of Economic Analysis; Centers for Medicare & Medicaid Services, Office of the Actuary, National Health Statistics Group. The NHE calculates total annual spending for health care in the United States (goods and services), in addition to total administrative spending each year, as well as the net cost of private health insurance, among other things. *See* Micah Hartman et al., *Health Spending Growth at a Historic Low in 2008*, 29 Health Aff. 147 (Jan. 2010) (citing Centers for Medicare & Medicaid Services, national health expenditure accounts: definitions, sources, and methods used in the NHEA 2008).

38. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, Feb. 17, 2009, 123 Stat 115.

39. 42 U.S.C. § 17932.

40. 42 U.S.C. § 17931(a).

41. 42 U.S.C. § 17932(e).

42. 42 U.S.C. §§ 17932(e)(3), (e)(4).

43. 42 U.S.C. § 17932(b), (f).

44. Health Insurance Portability and Accountability Act, Pub. L. No. 104–191, Aug. 21, 1996, 110 Stat 1936.

45. 42 U.S.C. § 1320d-5(a)(3).

46. 42 U.S.C. § 1320d-6(b)(3).

47. An Act to provide for reconciliation pursuant to section 2 of the first concurrent resolution on the budget for fiscal year 1986 (S. Con. Res. 32, Ninety-ninth Congress), Pub. L. No. 99–272, Apr. 7, 1986, 100 Stat 82.

48. 42 U.S.C. § 1395dd (2012). Notwithstanding the requirements of EMTALA, including an undisputed obligation to treat undocumented or illegal aliens, the Affordable Care Act does not provide for any mechanism to insure this same category of individuals.

49. *See, e.g.*, Renee Y. Hsia, M.D., *Factors Associated with Closures at Emergency Departments in the United States*, 305 (19) JAMA 1978 (May 18, 2011); S. Trzeciak and E.P. Rivers, *Emergency Department Overcrowding in the United States*, 20 EMERG. MED. J. 402–05 (2003).

50. *See. e.g.*, CAL. PENAL CODE § 487 (grand theft larceny); MINN. STAT. § 609.52 (theft); FLA. STAT. § 812.012 (theft, robbery and related crimes); U.S. CONST. amend. V (Takings Clause).

51. A recent California Supreme Court decision held that emergency department physicians who do not contract with a health maintenance organization (HMO) may not bill the HMO's members for any amounts that remain unpaid by the HMO, an industry practice commonly known as "balance billing." Prospect Med. Grp. v. Northridge Emerg. Med. Grp., 198 P.3d 86 (Cal. 2009); *but see* CAL. PENAL CODE § 484b ("Any person who receives money for the purpose of obtaining or paying for services, labor, materials or equipment and willfully fails to apply such money for such purpose…and wrongfully diverts the funds to a use other than that for which the funds were received, shall be guilty of a public offense….").

52. *Compare* CAL. COM. CODE § 2702 *and* IND. CODE § 26-1-2-702 ("Where the seller discovers the buyer to be insolvent he may refuse delivery except for cash including payment for all goods theretofore delivered under the contract, and stop delivery….") *with* Christopher Palmeri, *California Faces Cash Shortfall by March on Low Receipts, Controller Says*, BLOOMBERG, Jan. 31, 2012, http://www.bloomberg.com/news/2012-01-31/california-faces-cash-crisis-by-march-controller-chiang-says.html ("Unlike 2009, when [Controller John Chiang] was forced to issue IOUs to creditors, the controller said the current cash shortfall can be managed through payment delays, as well as external and internal borrowing.").

53. Nat'l Fed'n of Indep. Bus. v. Sebelius, 132 S. Ct. 2566 (2012).

54. Although the Affordable Care Act survived the Supreme Court, whether or not it will escape partisan politics unscathed remains to be seen. In his conclusion, Chief Justice Roberts aptly set the stage for what is to come in November: "the Court does not express any opinion on the wisdom of the ACA. Under the Constitution, that judgment is reserved to the people." *Id.* at 2608.

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Taking Stock of the STOCK Act

By J. Scott Colesanti

Introduction

In the spring of 2012, in response to infamously low approval ratings and a direct request from the President, Congress passed a law to stop itself and other federal officials from insider trading.[1] The measure was offered and received as a remedy for a loophole. In actuality, the law adds little to the prosecutor's insider trading arsenal, but, like many celebrated proposals of the year,[2] it does send messages about tolerance and priorities.

Background

The modern insider trading prohibition hails from 1961[3] and is primarily combated via Securities and Exchange Commission ("SEC" or "Commission") Rule 10b-5.[4] That rule can be used by the Commission, private litigants, and criminal prosecutors alike. Whoever acts as the party in interest must work from a short list of court-blessed theories bridging the vaguely worded prohibition and the suspect trading.

Judicial approbation of the "classic" theory governing corporate "insiders" (*i.e.*, Board members, management, employees) dates from 1968. At that time, application extended to "anyone in possession of material inside information."[5] Subsequent courts drew distinctions between the duties of insiders and outsiders to corporate shareholders and/or the market.

In the landmark *Chiarella v. United States* case of 1980, the Supreme Court clarified that mere possession of insider information did not violate Rule 10b-5: both the status of the acquirer of information and the means by which the information was acquired were vital. One *Chiarella* dissent (penned by Chief Justice Burger) urged prosecutors to fashion a theory that could reach those outside of the corporation who obtain an informational advantage by means other than "industry" or insight.[6] The ensuing doctrine ensnaring "outsiders" (*i.e.*, non-employees of the corporation in issue) was primarily concerned with finding a breach of the duty of confidentiality to the source of the information, and was termed "the misappropriation theory."

The Misappropriation Theory was first upheld by the Second Circuit in 1981[7] and ultimately approved by the Supreme Court in 1997.[8] Throughout this long march, the Theory successfully avoided codification by Congress, which chose to follow the wishes of the SEC in entrusting the minefield over the roadblock to the agency instead.[9] To be sure, via court victory or its own rulemaking, the Commission succeeded over the years in vastly broadening the inquiry into the underlying duty of confidentiality. Thus, Rule 10b-5 was satisfied by findings of relationships centering on employment/former employment,[10] printing services for hire,[11] a newspaper and its reporter,[12] management and stock analysts,[13] investment advisors/broker-dealers and clients,[14] a father and his son,[15] other familial ties,[16] Board membership, mere attendance at Board meetings,[17] patient-client confidences,[18] and various other duties "of trust or confidence."[19]

Meanwhile, cases that exposed weaknesses in the Misappropriation Theory have focused on relationships so attenuated as to defy any rational application of the moniker "fiduciary." A rare example alleged a duty of confidentiality between country club members.[20] However, even when the Misappropriation Theory has faltered, often an appellate court has reversed to find culpability, affirming/expanding Rule 10b-5's coverage to include competing shareholders or outright thieves.[21]

In short, in addition to there being no empirical support for the notion that Congress enjoyed immunity from prosecution for insider trading, there is scant evidence that the SEC's arsenal needed enhancing. Analyzed as either an employer-employee relationship or simply one characterized by confidences, the position of United States Congressman or staffer placed its holder on (at best) equal footing with every other citizen in the crosshairs of an insider trading investigation.

Accordingly, securities case law being bountiful,[22] and the Misappropriation Theory having successfully caught outsiders for over 15 years, it might seem odd that Congress should seek to specifically alter the equation in 2012. But the STOCK Act had been garnering attention as a feel-good measure espoused by various Bill sponsors since at least 2006.[23] Those proposals had consistently proven to be long on message and short on substance; the final incarnation is similarly subject to rebuke.

Specific Provisions

In December 2011, the SEC's Division of Enforcement testified in Washington on the pending STOCK Act, essentially endorsing the proposed set of measures as helpful. But the Division also cautioned that a broad Bill could serve to hinder future Commission actions against those not holding federal office.[24] Nonetheless, the law was adopted in March 2012. The nation's first insider trading statute targeting Congress went effective in early July 2012 and read as follows:

> SEC. 4. PROHIBITION OF INSIDER TRADING.
>
> (a) AFFIRMATION OF NON-EXEMPTION.—Members of Congress and

> employees of Congress are not exempt from the insider trading prohibitions arising under the securities laws, including section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.
>
> (b) DUTY.—
>
> …(2) AMENDMENT.—Section 21A of the Securities Exchange Act of 1934 (15 U.S.C. 78u-1) is amended by adding at the end of the following:
>
> (g) DUTY OF MEMBERS AND EMPLOYEES OF CONGRESS.—
>
> (1) IN GENERAL.—Subject to the rule of construction under section 10 of the STOCK Act and solely for purposes of the insider trading prohibitions arising under this Act, including section 10(b) and Rule 10b-5 thereunder, each Member of Congress or employee of Congress owes a duty arising from a relationship of trust and confidence to the Congress, the United States Government, and the citizens of the United States with respect to material, nonpublic information derived from such person's position as a Member of Congress or employee of Congress or gained from the performance of such person's official responsibilities.[25]

The referenced "rule of construction" within the Act preserved existing rights of the SEC to pursue fraud. A similar "Affirmation of Non-Exemption" provision located later in the STOCK Act extended the prohibition to "executive branch employees," "judicial officers," and "judicial employees."[26] Both provisions concluded with the definition of subject information tied to the individual's "position" in government, or official responsibilities.

Significantly, the STOCK Act also modified the reporting protocol established decades ago in the Ethics in Government Act of 1978 ("EGA").[27] The modifications chiefly served to shorten the time periods for reporting by the President, the Vice President, members of Congress, and certain Presidential appointees of stock transactions (from annually to 30/45 days). Additionally, commencing in the Fall of 2012, these disclosures were to be made available online; for decades, the EGA had limited such disclosures to parties identifying themselves and their organization.

Separately, the STOCK Act tersely prohibited officials delineated in the EGA from participating in initial public offerings "in any manner other than is available to members of the public generally."[28]

Analysis of the Measure

The updated disclosure schedule for financial disclosures mandated of government employees is perhaps long overdue.[29] Tightening EGA requirements brings the efforts of political watchdog groups much more up to date. Further, the more frequent recordkeeping and notice of stock transactions would undoubtedly aid any SEC insider trading investigation.

But, upon inspection, the targeted insider trading prohibition both replicates precedent and augurs poorly for future cases.

First, in terms of the range of possible defendants, federal precedent readily demonstrates both that the extant Misappropriation Theory is potent and that government employees have felt its punch. A famed private action from the 1970s succeeded in exacting justice from federal government agents found to have traded on inside information in their dealings with Native Americans persuaded to sell tribal stock.[30] The *Affiliated Ute* Supreme Court readily applied Rule 10b-5 to the silently misleading sales tactics of the two defendants, stating that the pair "possessed the affirmative duty" under the rule to disclose relevant facts to the sellers.

Also, the case that has drawn perhaps the most criticism in recent years of the government's arsenal actually centered on a state government employee and his inside knowledge of his locale's lottery system. In *United States v. Bryan*, the federal government brought criminal charges against a director of the Virginia lottery system (*i.e.*, a state government employee) based upon the duty between a "government official and his constituency."[31] Never questioning the premise of a government-employee relationship as a premise for a misappropriation case, the Fourth Circuit found the "in connection with" and "deception" elements of the government's Rule 10b-5 action to be lacking, and reversed Bryan's conviction (only to be mooted two years later by the Supreme Court's *O'Hagan* decision).

Concurrently, rather than reflect any temerity with the rule, the pre-STOCK Act case law more readily supports fears of an over-expansive juridical interpretation of the prohibition's scope. As the Fourth Circuit rationalized in denouncing the boundless nature of the Misappropriation Theory:

> …Section 10(b) is not concerned with the general fairness of securities transactions themselves, so long as there is no evidence of deception in connection with a securities transaction, in the form of material misrepresentations or omissions made to persons connected with a securities transaction…It should come as no surprise that the provision is un-

> concerned with the fairness of conduct toward persons such as family members, employers, medical patients, or other parties to the infinite number of similar trust relationships who are not in any way connected with or even interested in a purchase or sale of securities.[32]

The very fears detailed by the *Bryan* Court came to fruition two years later in the famed *O'Hagan* decision. In *O'Hagan*, a law firm partner was found to have violated, among other prohibitions, Rule 10b-5 via his purchases of the stock of a company to be acquired by his law firm's client. Justice Ginsburg's opinion clarified that the duty of O'Hagan—an outsider—ran to both his law firm and the firm's client.[33] Further, numerous cases later affirmed that—like "classic" insider duty—the misappropriator's duty may be inherited by his tippee.[34]

Indeed, since 1997, so thoroughly open-ended has been the resulting Misappropriation Theory that leading textbook authors concluded (well before the passage of the STOCK Act) that the theory would reach the law clerk trading ahead of her judge's opinion and the government employee improperly benefiting from a confidential government report.[35] Not surprisingly, the SEC website has long summarily described government employees as subject to the Misappropriation Theory.[36]

And such reference by the Commission is hardly braggadocio. Both before and after receiving the Supreme Court's blessing in *O'Hagan*, the Commission has exhibited a willingness to charge government officials and parties affiliated therewith. In 1988, the SEC charged an independent consultant for the United States Navy with insider trading in connection with the procurement of a deal for a prototypical airship.[37] Specifically, that consultant (while allegedly earning only $4,657 from his insider trading) was charged under Rule 10b-5 with obtaining and using information that Westinghouse-Airship Industries was likely to win the airship contract.

In 1993, a former employee of the Office of the Comptroller of the Currency ("OCC") was charged with trading in certain bank securities while in possession of material, nonpublic information obtained from his position at the OCC.[38] In 2004, the Commission found that the chief investment officer of the Utah Retirement System had engaged in insider trading for his own account and another.[39] And in 2011, the Commission captured headlines for its charges that an FDA chemist illegally traded in advance of at least 27 public announcements of agency approvals of new drugs.[40] Thus, the SEC has exhibited neither fear nor restraint in applying its ever-growing insider trading prohibition to government employees.

Second, the STOCK Act clouds the issue of subject "inside information." By oft-referring to "profits" or "private profits" (while not simultaneously referencing "losses avoided"), the law runs directly counter to the definition in Section 20A of the Securities Exchange Act.[41] Moreover, the dependence upon the illicit conduct being gleaned from the performance of "official responsibilities" arguably creates a loophole for tips learned after hours or collateral to work efforts. One could justifiably question whether a staffer at a Washington, D.C. cocktail party has learned information via his position as an "employee of Congress."

On the troublesome topic of IPO allocation, the STOCK Act is at its most symbolic. The SEC has long conceded that Wall Street firms—absent kickbacks or "quid pro quo" deal making[42]—are free to select recipients of much coveted IPO shares,[43] thus making a nullity out of any imprecise legislative effort to make that process more egalitarian.

Finally, the STOCK Act expands the concept of insider trading to reaches perhaps unsupportable. Classic Theory posits that the insider breaches a duty to the company's shareholders, who also serve as the victims of the breach. Misappropriation Theory proffers a triangular analysis under which the buying / selling outsider breaches a duty to the source of the information to the resulting detriment of third parties (*i.e.*, all buyers / sellers in that stock on a given trading day[44]). Under the STOCK Act, the breaching federal official harms the entirety of the American public to their detriment, thus rendering damages unfathomable. Moreover (and more importantly), situations with far less codified duties run the risk of falling short of the grade—thus animating the SEC's 2011 fears of the existing insider trading arsenal being depleted. Stated otherwise, everyone from the outside Board Director to the legal intern who fails to sign a confidentiality agreement possibly stands a better chance at defense post-STOCK Act (which has now tied culpability to statutory notice of a duty to protected counterparties).

The Real Contribution

In September 2012, the STOCK Act provisions calling for public disclosure of EGA trading information were stymied by a federal court. Specifically, Judge Alexander Williams of the District of Maryland enjoined the disclosure of trading data, thus halting the online posting of information relating to approximately 28,000 executive branch employees.[45] The plaintiff class (comprised of various anonymous federal officials and represented by the ACLU) had argued in August 2012 that the disclosures violate both Constitutional rights and the Administrative Procedure Act. Judge Williams cited Fourth Circuit precedent in preventing publication of the data, stating that the STOCK Act "prescribes the publication of sensitive financial information."[46]

But the symbolic contribution of the STOCK Act cannot be overlooked. By tightening the reporting periods for stock trades by Congress and others, the Act strengthens post-Watergate ethics legislation while signaling obligations of public officials akin to the regime governing corporate officers. To wit, current regulations springing from Section 16 of the Exchange Act obligate officers, directors, and 10% shareholders of exchange-listed public companies to report all transactions in the company's stock within two days of the transaction.[47] The two day deadline is extended to three days where the subject party can show a delay in notice of the transaction.[48] Likewise, the shortened time period for Congressional reporting of stock transactions observes a 30 day / 45 day distinction between notice and the actual transaction. The foremost legal lesson to be learned from the STOCK Act may be that the now codified duty of government employees to "promptly report" stock transactions is starting to look a lot like the venerable duty of corporate officials to their shareholders.[49]

Likewise, the foremost investigative addition of the new law may be its insistence that regulators and trial attorneys alike be provided the tools to more meaningfully survey suspicious trading patterns and practices. In that regard, the STOCK Act succeeds in extolling the idealistic goal of the nation's storied insider trading prohibition: The elimination of informational asymmetries, wherever they may be found. Indeed, such calls for inclusiveness in surveillance have resounded among SEC observers for decades.[50] If universal, Internet review of Congressional trading has been slowed by the courts, the need for enhanced regulatory tools when suspect trading commences with the federal government itself has nonetheless been popularized.

Conclusion

Election year barbs at Congress notwithstanding,[51] Wall Street's observers seem to be more focused on the question of whether the crime of insider trading is simply ubiquitous.[52] Meanwhile, Wall Street itself seems to have become a bit desensitized to Congressional maneuvers.[53] And the real money seems to be wagering on the reason the Dodd-Frank Act of 2010 has proven to have so few teeth, and whether the next swipe at banking regulation reform will revert to New Deal philosophies.[54]

It is axiomatic that the Securities and Exchange Commission has fought a long, noble fight to craft a non-codified insider trading prohibition. That fight, and the Commission's lauded resolve, depend on ad hoc decision-making that more often than not establishes a duty in misappropriation cases. The STOCK Act, while adding its own vagaries, at times counters the gains heroically achieved by the SEC through nearly 50 years of case law.

The Act did add to the debate on insider trading, weighing in heavily on the side of increased detection and deterrence. But in terms of altering existing law on who can be liable, little was achieved. The true test of the nation's tolerance of the crime may lie in pending disputes over its ever-ratcheting penalties, or the degree of inaction triggered by a duty of confidentiality, two topics at the epicenter of pending cases / appeals in separate Circuits.[55]

Endnotes

1. Stop Trading on Congressional Knowledge Act of 2012, Pub. L. No. 112-105, 126 Stat. 291 (Apr. 4, 2012) [hereinafter the STOCK Act].
2. *See, e.g.*, Mark Halperin & Elizabeth Dias, *Between the Lines*, Time, June 18, 2012, at 14 (noting local measures in 2012 banning the sale of oversized soft drinks, the feeding of wild animals, the wearing of pants too low, and the use of plastic bags at supermarkets adopted by Councils in, respectively, New York, Oregon, Chicago, and Los Angeles).
3. *See In re* Cady, Roberts & Co., 1961 WL 60638 (1961). The administrative decision's "abstain or disclose theory" was blessed years later by the Second Circuit in S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).
4. 17 C.F.R. § 240.10b-5 (2012).
5. *Texas Gulf Sulphur*, 401 F.2d at 848.
6. Chiarella v. United States, 445 U.S. 222, 239–40 (1980) (Burger, C.J., dissenting).
7. *See* United States v. Newman, 664 F.2d 12 (2d Cir. 1981).
8. *See* United States v. O'Hagan, 521 U.S. 642 (1997).
9. *See, e.g.*, Insider Trading and Securities Fraud Enforcement Act of 1988, Pub.L. 100-704, 102 Stat. 4677 (Nov. 19, 1988) (requiring, among other things, that financial service firms implement written insider trading procedures, but not defining the violation itself).
10. S.E.C. v. Cherif, 933 F.2d 403, 410 (7th Cir. 1991).
11. S.E.C. v. Materia, 745 F.2d 197, 202–03 (2d Cir. 1984).
12. United States v. Carpenter, 791 F.2d 1024, 1026 (2d Cir. 1986).
13. 17 C.F.R. § 243.100 (2012).
14. *In re* Investors Management Co., 1971 WL 120502, at *8–9 (1971).
15. United States v. Reed, 601 F. Supp. 685 (S.D.N.Y. 1985).
16. S.E.C. v. Falbo, 14 F. Supp. 2d 508 (S.D.N.Y. 1998).
17. S.E.C. v. Talbot, 530 F.3d 1085 (9th Cir. 2008).
18. S.E.C. v. Willis, 777 F. Supp. 1165 (S.D.N.Y. 1991).
19. 17 C.F.R. § 240.10b5-2. The Rule sets forth three separate bases establishing the duty, ranging from explicit agreement to maintain confidentiality, to information sharing between spouses, siblings, or parent and offspring. *See id.*
20. United States v. Kim, 173 F. Supp. 2d 1035 (N.D. Cal. 2001) ("Violations of confidences under these circumstances may warrant expulsion from the club, and even shunning by fellow members, but it [sic] does not fall within the criminal laws of the United States").
21. *See, e.g.*, SEC v. Cuban, 2010 WL 3633659 (5th Cir. 2010) (reinstating complaint against the famed entrepreneur Mark Cuban, who was alleged to have been tipped by management to news of a stock offering that would devalue his company stock); SEC v. Dorozhko, 574 F.3d 42 (2d Cir. 2009) (finding no need to establish a duty where a foreign hacker's affirmative "deception" violated Rule 10b-5).

22. For example, the *Howey* decision, S.E.C. v. W.J. Howey Co., 328 U.S. 293 (1946), which provides the most popular means of defining securities for purposes of the securities laws, has been cited over 2,500 times to date. Separately, the *O'Hagan* decision, United States v. O'Hagan, 521 U.S. 642 (1997), which provides the most discernible definition of insider trading, has itself been cited over 1,500 times.

23. An earlier version of the STOCK Act ("H.R. 5015") had been introduced by Representatives Brian Baird and Louise Slaughter in the 109th Congress.

24. Stephanie Condon, *STOCK Act faces skepticism in the House*, CBS News Online (Dec. 6, 2011), http://www.cbsnews.com/8301-503544_162-57337711-503544/stock-act-faces-skepticism-in-the-house/.

25. STOCK Act § 4.

26. STOCK Act § 9.

27. STOCK Act § 6 ("Prompt Reporting of Financial Transactions"). The EGA, Pub. L. No. 95-521, 92 Stat. 1824, was passed in response to political abuses of the 1970s.

28. STOCK Act § 12.

29. Section 102(a)(5)(b) of the EGA requires reporting of purchases, sales or exchanges exceeding $1,000 in value "in stocks, bonds, commodities futures, and other forms of securities."

30. Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972).

31. United States v. Bryan, 58 F.3d 933, 951 (4th Cir. 1995). The *Bryan* Court cautioned that "[a]bsent clearly defined rules, investors find themselves the targets of *ad hoc* decision-making or pawns in an overall litigation strategy known only to the SEC."

32. *Bryan*, 58 F.3d at 952–53.

33. *O'Hagan*, 521 U.S. at 655 n. 7.

34. *See, e.g.*, United States v. Kim, 173 F. Supp. 2d 1035, 1043 (N.D. Cal. 2001).

35. John C. Coffee, Jr. & Hillary A. Sale, Securities Regulation / Cases and Materials 1201 (11th ed.).

36. "Examples of insider trading cases that have been brought by the SEC are cases against:…Government employees who learned of such information because of their employment by the government…." The Commission webpage states that it was last modified in 2001 (*i.e.*, the agency's firm belief that its insider trading prohibition applied to government employees existed for years prior to passage of the STOCK Act). *See* United States Securities and Exchange Commission, Insider Trading, www.sec.gov/answers/insider.htm (last visited June 21, 2012).

37. SEC v. Mills, 41 S.E.C. Docket 1257, 1988 WL 902330.

38. SEC v. Acree, 53 S.E.C. Docket 1823, 1993 WL 75102.

39. Enforcement Proceedings Against Richard L. Cherry, SEC Digest 2004-153-3, 2004 WL 1775591 (Aug. 10, 2004).

40. SEC v. Cheng Yi Liang, SEC Litigation Rel. No. 21907, 2011 WL 114504.

41. 15 U.S.C. § 78t(b)(1) (2011).

42. *See, e.g.*, Financial Industry Regulatory Authority (FINRA) Rule 5131, *available at* www.finra.org/Industry/Regulation/FINRA Rules. The Rule, which took effect on May 27, 2011, prohibits "*quid pro quo*" allocations of initial stock offerings, as well as the unsavory practice of "spinning" (*i.e.*, allocating popular IPO shares in return for recommendations/future business).

43. *See Why Individuals Have Difficulty Getting [IPO] Shares*, SEC.gov, *available at* http://www.sec.gov/answers/ipodiff.htm, last visited June 23, 2012 ("The SEC does not regulate the business decision of how IPO shares are allocated.").

44. Section 20A of the Securities Exchange Act ("Liability to Contemporaneous Traders for Insider Trading") explains that the insider trader is liable to the entire range of trading partners on any given trading day. 15 U.S.C. § 78t.

45. Sheri Qualters, *Judge Delays Stock Act provision requiring federal employees to disclose financial data*, Nat'l L.J. (Sept. 13, 2012).

46. *Id.*

47. SEC Rule 16a-3(g).

48. SEC Rule 16a-3(g)(4).

49. *Compare* Section 16(a)'s reporting exemptions, including "transfers pursuant to divorce decrees and domestic relations orders" and "ERISA profit-sharing plans," Client Memorandum of Gibson, Dunn & Crutcher LLP, "SEC Adopts New Section 16 Reporting Rules" (August 28, 2002), *with* Office of Government Ethics Form 278-T (June 2012), exempting "transactions solely by and between" the filer and spouse or dependent child, and transactions in "Thrift Savings Plan Accounts."

50. *See, e.g.*, Roberta S. Karmel, *Outsider Trading on Confidential Information—A Breach in Search of a Duty*, 20 Cardozo L. Rev. 83,133 (Sept. 1998) (opining that SEC regulatory policies should "focus on preventing insider trading by compelling more prompt disclosure of material information by public companies, bidders, *and market participants with informational advantages*") (emphasis added). Professor Karmel is a former SEC Commissioner.

51. Convicted lobbyist Jack Abramoff has publicly alleged that members of Congress derive inside information from their government employment. *See* Eamon Javers, *Congress Members Took Part in Insider Trading*, CNBC Online (Nov. 11, 2011) ("These people should not be using whatever information they gain as public servants to benefit themselves, any more than they should be taking bribes…."), *available at* http://www.cnbc.com/id/45249857/Congress_Members_Took_Part_in_Insider_Trading_Abramoff (last visited June 21, 2012).

52. *See, e.g.*, Gretchen Morgenson, *Is Insider Trading Part of the Fabric?*, N.Y. Times (May 19, 2012).

53. *See* Max Abelson, *JPMorgan's Jamie Dimon to Testify Before Congress, but Wall Street Shrugs It Off*, Wash. Post Online (June 11, 2012).

54. *See, e.g.*, Rana Foroohar, *The Case for Banking Regulation*, TIME (June 4, 2012), at 22.

55. *See* the Reply Sentencing Memorandum on Behalf of Raj Rajaratnam, S2 09-CR-1184 (RJH), *available at* http://www.scribd.com/doc/64712849/Rajaratnam-s-Sentencing-Memo (arguing that successive DOJ and SEC fines for the same set of insider trades are excessive), *and* Motion to Dismiss, *SEC v. Cuban*, *available at* http://www.law.du.edu/index.php/corporate-governance/sec-and-governance/sec-v-cuban (last visited June 23, 2012) (arguing that the duty to maintain confidence does not imply a commensurate duty not to trade).

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Good Golly Miss Molly!: The Attorney Work Product Doctrine Takes Another Hit

By C. Evan Stewart

In 1970, the legendary singer-songwriter Joni Mitchell wrote and recorded "Big Yellow Taxi," which included the memorable lyrics: "Don't it always seem to go, that you don't know what you've got till it's gone?"[1] If things keep going the way they have been, it will not be long before folks are singing a similar tune for the attorney work product doctrine.

Readers of this column will recall that there has been some prior mischief in this field.[2] Now, there is more bad news.

Forward Into the Past[3]

Before we get to the most recent bad stuff, let us briefly review the bidding. At first, there was good news. In *United States v. Adlman*,[4] Second Circuit Judge Pierre Leval wrote a decision that appeared (once and for all) to clear up a lot of confusion (both in the judiciary and for litigants) as to the proper standard for evaluating when attorney work product materials were prepared "in anticipation of litigation," and thus entitled to protection from discovery pursuant to Federal Rule of Civil Procedure 26(b)(3). Judge Leval ruled that the determinative issue was whether the document was created "because of" the prospect of litigation.

Adlman was a sound decision, and it provided years of certainty—until the First Circuit turned it on its head in *United States v. Textron*.[5] In *Textron*, an *en banc* panel (by a three to two vote) endorsed a new test: whether the documents were created "for use" in litigation; in other words, would the materials "in fact serve any useful purpose for Textron in conducting litigation if it arose."[6] Obviously, by the *Textron* "for use" standard the universe of protected attorney materials was reduced exponentially—at least in the First Circuit (and courts influenced by the *en banc* ruling).[7]

If that were not bad enough, *Adlman* is now being retrenched within the walls of the Second Circuit. Is nothing sacred?

You Press the Button, We Do the Rest[8]

On September 17, 2012, Magistrate Judge Marion Payson (W.D.N.Y.) lowered the boom on the Eastman Kodak Company, ordering the crippled firm to produce communications between its lawyers and an auditing firm they had retained.[9] The lawsuit concerns a dispute in which Kodak is suing Kyocera, which was granted a license in 2002 to use and sell Kodak's digital camera technology. Under the terms of the agreement, Kodak was entitled to hire an independent auditor to determine whether Kyocera was properly paying royalties owed to Kodak. Believing it was not getting its fair share, Kodak invoked that right in 2005; Deloitte & Touche was retained, and it issued three reports: in 2005, in 2006, and in 2009. Kodak sued Kyocera in 2010.

During discovery, Kodak produced 500 communications with Deloitte, but withheld 37 documents and redacted 40 others, all on the basis of the attorney work product doctrine. Kyocera moved to compel the production of those withheld and redacted materials, and the Magistrate Judge granted that motion.

Critical to the discovery dispute is the fact that, after Deloitte's 2005 and 2006 reports—clearly done pursuant to the 2002 agreement and with Kyocera's consent / approval—Kodak notified Kyocera that it was in violation of the 2002 agreement. Kodak's outside counsel *thereafter* retained Deloitte for additional work in 2008. With respect to *that* assignment, Deloitte sent a letter to Kodak's outside counsel setting forth: (i) that it had in fact been retained by Kodak's outside counsel in connection with Kodak's dispute with Kyocera; (ii) that its work "will be covered by the attorney work-product privilege and other applicable privileges;" and (iii) that Deloitte would treat all of its work papers and communications with counsel in connection with the assignment as confidential.[10] Thus, the additional audit work was clearly contemplated as being beyond the earlier, consensual work called for by the 2002 agreement, and by its clear terms it was being done in contemplation of litigation at the direction of Kodak's outside counsel.

Not surprisingly, it was the 2008–2009 work product and communications that Kyocera wanted and that were put at issue before the Magistrate Judge. Given how carefully Kodak's counsel and Deloitte had structured the auditor's work to be consistent with Rule 26(b)(3), what went wrong?

Applying *Adlman*?

The Magistrate Judge started her legal analysis by paying homage to *Adlman* and its forebearers,[11] but then veered off course because of the supposed "heavy burden" that *Adlman*'s "because of" standard imposes on parties that seek to invoke its protections. Really?

The Magistrate Judge next articulated the reasons why Kodak had not met that "heavy burden": (i) a 2011 decision by Judge Harold Baer (S.D.N.Y.) (*GenOn*),[12] which the Magistrate Judge believed to be on all fours; and (ii) her conclusion that the materials were not in fact prepared "because of" the prospect of litigation. Let us look at each separately.

First off, *Adlman* imposes no such "heavy burden"; this is a big foot that Judge Baer decided to place on the scale in his *GenOn* decision, a big foot happily adopted by the Magistrate Judge. Why judges (most of whom grew up as litigators) have a history of imposing glosses on Rule 26(b)(3) is not at all clear;[13] perhaps it is because, like the *en banc* panel in *Textron*, some have a desire to see one side prevail.[14]

Next off, Judge Baer's ruling in *GenOn* is not on "all fours" with the Kodak situation. In *GenOn*, all that was represented to the audited company was that the counterparty firm had retained the auditor pursuant to the parties' contract. That factual predicate then allowed Judge Baer to conclude that the audit, because it was merely triggered under the two companies' contractual arrangement, was done in the "ordinary course of business"; as such, the fact that the audit report was subsequently routed through and used by GenOn's counsel to prepare for litigation did not confer protection under Rule 26(b)(3).

While that is not inconsistent with *Adlman*, it is clearly not the 2008 situation structured by Kodak's counsel with Deloitte. Not leaving well enough alone, Judge Baer—influenced by an Illinois court's ruling that missed the boat on *Adlman*[15]—then took a wrong fork in the road when he also wrote, in dicta, that where a party specifically engages an auditor in anticipation of litigation, the work papers created are not Rule 26(b)(3) work product because such papers do not contain attorneys' mental impressions or litigation strategies. Of course, if that were correct (and it most definitely is *not*), then *no* auditor's work could *ever* be covered by the work product doctrine–by definition, auditors are not lawyers and thus their work can *never* reflect "attorneys' mental impressions or litigation strategies." *Adlman* and Rule 26(b)(3) certainly do *not* stand for that proposition, however; yet the Magistrate Judge (as we will see below) followed Judge Baer's unfortunate dicta detour on this score in the *Kodak* case.[16]

Finally, there is the Magistrate Judge's examination of the withheld / redacted documents themselves.[17] As to the most important documents at issue—those which reflected communications between Deloitte and Kodak's counsel concerning Kyocera's failure to cooperate with the 2008 audit (i.e., Kyocera withheld requested information)—the Magistrate Judge posed a rhetorical non-sequitur which, frankly, makes no sense: "Any suggestion that Kodak would not have questioned Deloitte about Kyocera's cooperation in the audit and disclosure of documents had it not anticipated litigation strains credulity." Huh? And / or so what! In any event, falling back on *GenOn*, the Magistrate Judge waived away all the documents on the basis that none of them "analyze potential legal claims against Kyocera or discuss potential litigation." And so Kodak lost all of the documents it had every reason to believe would be protected from disclosure.[18]

Conclusion: Devil with a Blue Dress On[19]

For a long time after *Adlman*, lawyers and their clients felt reasonably sure that courts would afford attorney work product (i.e., their work done in anticipation of litigation, as well as the work done by third parties expressly at their direction) confidential treatment—if the lawyers did it the right way. Other courts outside the Second Circuit started to chip away at that state of affairs, however; and now the bad seed has spread into the courts of the Second Circuit. Until the Court of Appeals acts to stem this unfortunate tide, litigating work product issues will likely be quite dicey; as the Sergeant in *Hill Street Blues* used to say: "Be careful out there!"

Endnotes

1. Joni Mitchell, Ladies of the Canyon (Reprise 1970). Covers of Ms. Mitchell's definitive version of her song have, to be charitable, not been very good (*e.g.*, Maire Brennan, Amy Grant, Counting Crows, Pinhead Gunpowder).
2. *See* C. Evan Stewart, *Caveat Corporate Litigator: The First Circuit Sets Back the Attorney Work Product Doctrine*, 14 N.Y. Bus. L.J. 46 (Summer 2010). For more recent troubling decisions, see C. Evan Stewart, *Ohio Takes a Bite Out of the Big Apple*, N.Y. L.J., Sept. 7, 2012, at 4, col. 1.
3. As all Firesign Theatre aficionados know, this is the immortal line delivered by Catherwood, the butler—who is in reality Dan, the husband of Melanie Haber (a / k / a Audrey Farber a / k / a Susan Underhill a / k / a Betty Jo Bialowski—"everyone knew her as Nancy")—as he enters a time machine to transport him back to Ancient Greece ("where burning Sappho loved and stroked the wine-dark sea, in the temple by the moonlight, wah de doo dah…."). *See* Firesign Theatre, The Further Adventures of Nick Danger (Columbia 1969).
4. United States v. Adlman, 134 F.3d 1194 (2d Cir. 1998).
5. United States v. Textron Inc. & Subsidiaries, 577 F.3d 21 (1st Cir. 2009) (en banc).
6. *Id.* at 27, 30.
7. For a more fulsome analysis of *Textron* and its ramifications, see Stewart, *supra* note 2.
8. In 1888, George Eastman commercially introduced his new camera, which he called Kodak, with this slogan. For a very long time, the Eastman Kodak Company was the dominant player in the world's camera markets (in 1976, it had a 90% market share in the United States). On January 19, 2012, the company filed for Chapter 11 bankruptcy protection.
9. Eastman Kodak Co. v. Kyocera Corp., No. 10-CV-6334-CJS, 2011 WL 1432038 (W.D.N.Y. Apr. 14, 2011).
10. Kyocera was informed of the additional retention (by Deloitte), and was told the 2008 assignment related to the parties' dispute; neither Kyocera's consent nor its approval was sought by Kodak or its counsel, and Kodak never shared with Kyocera its lawyers' representation arrangement with Deloitte (*e.g.*, Deloitte's letter to Kodak's counsel).
11. Hickman v. Taylor, 329 U.S. 495 (1947).
12. The Genon Mid-Atl., LLC v Stone & Webster, Inc., No. 11 CV 1299(HB)(FM), 2011 WL 2207513, at *3 (S.D.N.Y. June 6, 2011).

13. *See* Stewart, *supra* note 2.

14. In *Textron*, the *en banc* panel's rationale for its new standard was its avowed interest in helping the I.R.S. "in revenue collection." *Textron*, 577 F.3d at 31.

15. G.M. Harston Const. Co., Inc. v. City of Chicago, 2001 WL 817855, at *2 (N.D. Ill. 2001).

16. It should be noted that, later in the same litigation, Judge Baer returned to the fold and properly applied *Adlman*. *See* GenOn Mid-Atl., LLC v. Stone & Webster, Inc., No. 11 CV 1299 HB, 2012 WL 1849101 (S.D.N.Y. May 21, 2012).

17. As she transitioned to that part of the opinion, the Magistrate Judge wrote that she did not feel the need to determine whether Kyocera's consent to the 2008 audit was conditioned upon an understanding that it would be the same or different than the 2005 audit. One material problem with that observation is that neither Kodak nor its outside counsel sought Kyocera's consent for the 2008 audit. *See supra* text accompanying note 10.

18. With the Magistrate Judge so determined to rule against Kodak, perhaps it would not have mattered. However, Kodak could have improved its litigation posture by providing its 2005 retention arrangement with Deloitte, which presumably would have not included the important components set forth in the 2008 Deloitte letter (*e.g.*, anticipation of litigation, confidentiality, etc.).

19. Rock and Roll aficionados know that Mitch Ryder and the Detroit Wheels covered Little Richard's 1958 hit (#4) "Good Golly Miss Molly" (Specialty Records) in a 1966 medley with "Devil with a Blue Dress On" (New Voice), which also was a #4 hit. MITCH RYDER AND THE DETROIT WHEELS, GOOD GOLLY MISS MOLLY (Breakout! 1966); MITCH RYDER AND THE DETROIT WHEELS, DEVIL WITH A BLUE DRESS ON (Breakout! 1966).

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New SEC Rules for Resource Extraction Issuers to Disclose Payments to Governments

By Guy P. Lander, Steven J. Glusband, Bruce A. Rich and Gideon Even-Or

The SEC recently adopted rules requiring resource extraction issuers to disclose the type and the amount of certain payments to governments relating to their commercial development of oil, natural gas or minerals. All issuers engaged in oil, gas or mineral development activities that are subject to filing annual reports with the SEC under the Securities Exchange Act of 1934 (the "Exchange Act"), including foreign private issuers with their resource extraction activities outside of the U.S., are subject to these rules.[1]

Affected issuers must comply with these rules beginning with their first fiscal year ending after September 30, 2013 by filing a Form SD within 150 days after the end of that fiscal year. While companies now have plenty of time before filing their first Form SD, which would be May 2014 at the earliest, nevertheless they and their subsidiaries and controlled entities should now become aware of possible future disclosures when negotiating contracts with governments or otherwise committing to cash and non-cash payment arrangements that might be covered by these rules.

These rules, together with companion rules for disclosures also on Form SD by issuers that use "conflicts minerals" in their products, were adopted by the SEC to implement Sections 13(p) and 13(q) of the Exchange Act, which are part of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The concept for these rules stems from the commitment of the U.S. government to international efforts to promote transparency in the commercial development of oil, natural gas and minerals, rather than enhancing any financial markets reform. The rules intend to be consistent with what are deemed payments under the Extractive Industries Transparency Initiative ("EITI"). However, currently, neither the U.S. nor Canada is an EITI implementing country.

General Rule Covering Payments to Governments

The general rule is that a "resource extraction issuer" must disclose "payments" made by it, its subsidiaries, or its controlled entities to a "foreign government or the U.S. government" for each "project" undertaken for the purpose of commercial development of oil, natural gas or minerals. The disclosure would be on the new Form SD. No exemptions from filing are available even if a foreign law prohibits the disclosure or if the issuer is subject to a confidentiality agreement. This Form is to be filed as a stand-alone document, and not part of the issuer's annual report on Form10-K, 20-F or 40-F.

The following analyzes the terms comprising the general rule that would trigger its application.

Resource Extraction Issuer is any U.S. or foreign issuer (i) required to file an annual report with the SEC and (ii) engaged in the commercial development of oil, natural gas or minerals, regardless of the issuer's size or the extent of its business operations in developing oil, natural gas or minerals. Although the SEC acknowledged in its adopting release that filing a Form SD could cause foreign private issuers to face competitive disadvantages and risk concerns in their home countries, it concluded that the transparency objectives of Dodd-Frank required these disclosures by all SEC reporting companies.

Payments means amounts paid by the issuer, its subsidiaries or its controlled entities that:

- further their commercial development of oil, natural gas or minerals,
- constitute taxes (such as taxes on corporate profits, corporate income or production, but excluding sales tax, VAT and other taxes levied on consumption), royalties, fees (including license fees), production entitlements, bonuses (including signature, discovery and production bonuses), dividends (other than those paid pro rata to all shareholders) and infrastructure improvements, and
- are "not de minimis" in amount.

Within each of these categories of expense in clause (ii) above is an overall concept of "other material benefits," which is intended to include payments that are part of any "commonly recognized revenue stream" for such commercial development.

"**Not de minimis**" means any payment, whether a single payment or a series of related payments, that equals or exceeds U.S. $100,000 during the fiscal year. An instruction to Form SD mentions that in determining whether arrangements for periodic payments or installments come within the "not de minimis" exception, the issuer must consider the aggregate amount of the related payments or installments.

"**Infrastructure improvements**" is explained by the SEC as possibly the cost of building a road or railway, whether by contract or voluntarily, needed for the development of the area where the minerals are located. For example, if an issuer is obligated to build a road rather than paying the host country government to build the road, the issuer would be required to disclose the cost of building the road as a payment to a government if the payment is not de minimis. However, the issuer need not disclose social or community payments, such as payments to build a hospital or a school, as the SEC stated it was not clear that these payments are part of the commonly recognized revenue stream. The SEC release does not provide specific guidance whether payments such as to First Nations groups under Canadian law would be considered "social or community payments." One must seek clarification from the SEC Staff about those types of payments.

Foreign government or U.S. government. "Foreign government" means a foreign national or a foreign subnational government. A "foreign national government" includes the departments, agencies, instrumentalities under and companies majority-owned by a foreign government. A "foreign subnational government" means governments of a state, province, county, district, municipality or territory under a foreign government.

In contrast, the U.S. government is just the federal government of the United States, and its agencies, excluding state or local governments or their subnational governments. For example, payments by a resource extraction issuer to the U.S. Bureau of Land Management would be payments to the U.S. government that could be subject to being disclosed on Form SD, while payments to the State of Nevada or a local county or agency in Nevada would not be payments to the U.S. government for purposes of disclosure on Form SD.

Project. Although issuers must disclose the type and amount of payments for each project, the SEC expressly omitted a definition of "project" because of the difficulty in choosing a single industry-acceptable definition. It felt that by leaving "project" undefined, an issuer should have some flexibility in applying the term to its different business contexts depending on factors in the industry in which the issuer operates or the issuer's size. The SEC expressed that what is or is not a project for purposes of Form SD could be based upon the same concepts an issuer uses to disclose "projects" in its other Exchange Act reports and public statements.

Commercial development of oil, natural gas or minerals includes exploration, extraction, processing, export and other significant actions relating to those activities or the acquisition of a license for any of those activities. While the SEC definition of commercial development is broader than that of the EITI, the SEC release acknowledges that ancillary or preparatory activities, such as refining, smelting, transportation and marketing, are outside of the definition.

Reporting on Form SD

Form SD is filed with the SEC through EDGAR and electronically formatted using the XBRL interactive data standard. The filing due date is no later than 150 days after the end of the issuer's fiscal year. The first filing is for fiscal years ending after September 30, 2013 and with disclosures from that date. Therefore, the first Form SD of a calendar year company would be due on May 30, 2014 and cover the period from October 1, 2013 through December 31, 2013. Thereafter, Form SD would cover the company's entire fiscal year.

Form SD requires the data to be shown by electronic tag that identifies the following payment information:

- the total amounts of payments, by category;
- the currency used to make the payments;
- the financial period in which the payments were made;
- the business segment of the issuer that made the payments;
- the government that received the payments, and the country in which the government is located; and
- the project of the issuer to which the payments relate.

The payment information in the Form SD need not be audited or provided on an accrual basis. The amounts can be presented in U.S. dollars or the issuer's reporting currency. When the payment made to a government is in currencies other than that of the U.S. or the issuer's reporting currency, the company may convert the payment into U.S. or its reporting currency by one of the following methods: (i) by translating the amount at the exchange rate existing at the time the payment is made, (ii) using a weighted average of the exchange rates during the reporting period or (iii) basing it on the exchange rate as of the company's fiscal year end. The method chosen for the currency conversion must be disclosed.

The SEC anticipates that appropriate XBRL taxonomy will be available before the first filing date. Foreign private issuers that prepare their financial statements under International Financial Reporting Standards do not have experience with XBRL. They will incur some start-up costs associated with XBRL in preparing the Form SD. The SEC speculated that these costs would not be much greater than if these companies filed the data in XML.

Some additional points about the Form SD:

- issuers will not be able to obtain confidential treatment for any specific information presented in the Form,
- the Sarbanes-Oxley officers' certification rules covering Forms 10-K, 20-F and 40-F and other SEC filings do not apply,
- for information in their Form SD, issuers will be subject to the same liability that applies to them for their other reports deemed filed under the Exchange Act, and
- information in and documents filed with this Form will not be automatically incorporated by reference into an issuer's filings under the Securities Act of 1933 or the Exchange Act unless the issuer expressly incorporates them by reference in its registration statements or other reports.

As previously noted, reporting companies have substantial time until the spring of 2014 to prepare and file their initial Form SD. However, these companies should establish collection and monitoring procedures for themselves now, and especially their foreign divisions and subsidiaries and controlled entities, for payments or payment arrangements that could be deemed to be made to a government in connection with their oil, natural gas or minerals activities that could require disclosure in a Form SD.

Over the next few months, the SEC staff should be releasing interpretative guidance concerning disclosures and procedures by resource extraction issuers for preparing and filing their Form SD. The reader should be prepared to consult future SEC guidance or any amendments to these payment disclosure rules as they are released.

Endnote

1. Exchange Act Release No. 34-67717 (Aug. 22, 2012).

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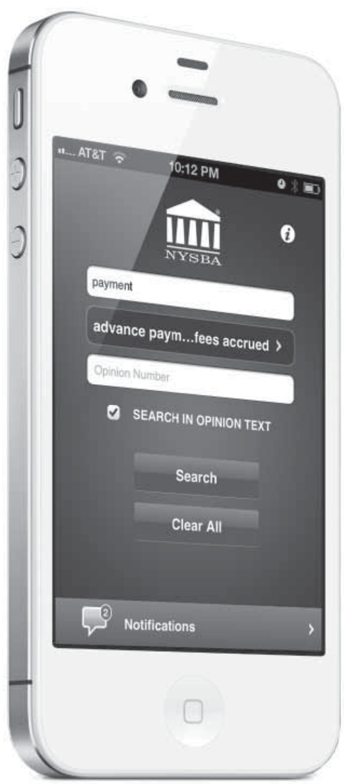

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New FINRA Know Your Customer and Suitability Rules Require Brokerage Changes

By Morris N. Simkin

Introduction

The Financial Industry Regulatory Authority ("FINRA") has adopted a new Know Your Customer Rule (FINRA Rule 2090) replacing NYSE Rule 405 and a new Suitability Rule (FINRA Rule 2111) replacing NASD Rule 2310 (Recommendations to Customers), IM-2310-1 (penny stocks) and IM-2310-2 (Fair Dealing with Customers). These new rules, effective July 9, 2012, are quite complex. In fact, FINRA has issued three (3) Regulatory Notices to explain them—Regulatory Notices 11-02, 11-25 and 12-25.

These new rules are discussed below, together with take-aways for brokerage firms.

Know Your Customer (FINRA Rule 2090)

On its face, the rule appears quite simple. It requires a firm to use reasonable diligence in regard to opening and maintaining every account. This includes knowing and retaining the essential facts about a customer and the authority of the persons acting on behalf of that customer. Supplementary material identifies the essential facts as those required to service the account, acting in accordance with any special handling instructions, knowing the authority of each person acting on behalf of the customer, and having sufficient information to assure that the account will comply with all applicable laws, rules and regulations. However, when this rule is read together with the new Suitability Rule, the information required of a customer is materially expanded, even in the case of institutional investors.

This is in addition to the information about customers that SEC Rule 17a-(3)(a)(17) requires for natural persons—name, tax identification number, address, telephone number, date of birth, employment status—and that Financial Crimes Enforcement Network Rule 1023.220 (Customer Identification Program for Broker-Dealers) requires for all customers.

The Regulatory Notices considerably expand upon this. They require the brokerage firm to know who is authorized to act for a customer. In the case of institutional accounts (accounts of persons or entities with over $50 million in assets), and accounts managed by a third party, e.g., investment adviser managed accounts, the rule requires knowing who has the authority to act for the customer and the scope of that authority. Many financial institutions have a trading desk that places orders for its various components—e.g., hedge funds, investment advisor accounts, mutual funds and custodial accounts. This suggests that information as to the authority of each trader to place orders and for whom that trader may place orders is required, as well as the scope of that person's authority to place orders.

The rule requires maintaining this basic information. But things change. In other words, a brokerage firm needs to have in place a procedure to update on a reasonable basis the accuracy of the information it has about a customer. No standard for updating is contained in the rule or in the Regulatory Notices. However, some commentators have referred to SEC Rule 17a-3(a)(17)'s requirement to update natural person customer information every three (3) years.

Take-away:

1. Consider procedures to deal with the situation where a customer fails to give all the information required by Rule 2090.
2. Develop procedures to confirm the authority of a person to trade where a third party manages an account or where an institutional investor has a trading desk that the traders are in fact authorized to trade for the institution and to what extent.
3. Develop procedures for where a trader or a third party manager has limited authority over the account.
4. Develop procedures to assure that an account is not effecting trades that raise legal or regulatory questions.
5. Develop procedures to verify account information on a periodic basis—e.g., negative confirmation letters.

Suitability (FINRA Rule 2111)

This rule requires a member firm or registered representative to have a reasonable basis to believe when it recommends a transaction or an investment strategy that it is suitable for the customer, based on information obtained through reasonable diligence according to the customer's investment profile. FINRA has not defined what a recommendation is. However, it has set forth a number of guidelines.

Recommend/Recommendation

A recommendation has to be made to a customer. A customer is someone who places an order or has an account with a broker-dealer. It may also include anyone with whom the broker has an informal business relationship relating to brokerage services. FINRA has stated that the distribution of marketing or offering materials by itself would not constitute a recommendation. However, based on other statements in FINRA guidelines and interpretations, such a distribution, including research reports that rate securities, could be part of a chain of actions that would constitute a recommendation.

To determine whether a communication is a recommendation, FINRA applies a three factor facts-and-circumstances test that evaluates the communication's content, context and presentation. In viewing the communication or series of communications' content, context and presentation, one must ask whether there is a call to action. Is there an implicit or explicit suggestion that the recipient take action or refrain from taking action with respect to a security or investment strategy?

The rule applies to an investment strategy. FINRA interprets investment strategy broadly. The SEC's anti-fraud rule (Rule 10b-5) applies only where there is a purchase or sale. The suitability rule's investment strategy applies to a recommendation to buy or sell and to an explicit recommendation to hold a security. Investment strategy also includes trading on margin or engaging in day trading.

Rule 2111.03 excludes the following from a recommendation subject to the rule's requirements, as long as there is not a recommendation of a particular security or securities:

a) General financial and investment information. This includes: (i) basic investment concepts, such as risk and return, diversification, dollar cost averaging, compounded return and tax deferred investments; (ii) historic differences in the return of asset classes—e.g, bonds, cash or equities, based on standard market indices; (iii) the effects of inflation; (iv) estimates of future retirement income needs; and (v) assessment of a customer's investment profile;

b) Descriptive information about an employer sponsored retirement or benefit plan, participation in the plan, the benefits of plan participation, and investment options available under the plan; and

c) Asset allocation models that are (i) based on generally accepted investment theory, (ii) accompanied by disclosures of material facts and assumptions that may affect a reasonable investor's assessment of the asset allocation model or any report generated by such model, and (iii) if the investment analysis is in compliance with NASD Rule IM-2210-6 (Investment Analysis Tools). But if an asset allocation model becomes too narrow or specific, it may cross over the line and be a recommendation.

Generally, the more individually tailored the communication is to a particular customer or customers about a specific security or investment strategy, the more likely the communication will be viewed as a recommendation.

Required Information

To make a recommendation a broker / salesperson must use reasonable diligence to have an investment profile of the customer. An investment profile includes the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance and any other information the customer may disclose. Other investments includes investments held elsewhere, such as accounts at other brokerage firms. A customer's financial ability means: Does the customer have the financial ability to meet the commitment of a transaction or investment strategy? Liquidity needs have been interpreted to mean the extent to which a customer desires the ability or has financial obligations that dictate the need to quickly and easily convert to cash all or a portion of an investment without experiencing significant loss in value. Time horizon means the expected number of months, years or decades a customer plans to invest to achieve a particular financial goal. Risk tolerance means a customer's ability and willingness to lose some or all of the investment in exchange for greater potential returns. Generally, absent "red flags" indicating inaccuracy, or if the customer is unclear about the information, a broker may rely on the customer's responses.

The rule does not require that all of the information be in hand before a firm / salesperson can make a recommendation. If some information is not material under the circumstances, the firm would still be able to make a recommendation. However, the firm must obtain and analyze enough information to have a reasonable basis to believe the recommendation is suitable. If the firm does not have or seek all of the information listed above, it should have a reasonable basis to believe, documented with specificity, that one or more of the factors are not components of a customer's investment profile in light of the facts and circumstances of the particular case.

The Rule does not explicitly require the firm to update the information it has obtained. However, to the extent the customer tells the firm / salesperson updated information that should be reflected in the customer's investment profile, the profile should be updated accordingly.

Suitability Standards

Rule 2111 sets forth three (3) suitability standards:

> Reasonable basis. The firm or salesperson must have a reasonable basis to believe, based upon reasonable diligence, that the recommendation is suitable for at least some investors. Reasonable diligence includes, among other things, the complexity of and risks associated with a security or investment strategy and the firm's or salesperson's familiarity with the security or investment strategy. If a salesperson lacks familiarity with or an understanding of a recommended security or investment strategy, there is a lack of suitability, even if the firm has determined that such security or strategy is a reasonable one, e.g., placed it on a recommended or approved list.
>
> Customer specific. The firm or salesperson must have a reasonable basis to believe that the recommendation is suitable for the particular customer based on that customer's investment profile.
>
> Quantitative suitability. The firm or salesperson who has actual or de facto control over a customer account must have a reasonable basis to believe that a series of rec-

> ommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile. Factors included in making such a determination include turnover rate, cost-equity ratio and the use of in and out trading.

In applying these three standards, FINRA has said that the suitability rule requires a broker-dealer to make only those recommendations that are consistent with the customer's best interest and prohibits a broker from placing his or her interests ahead of the customer's interests. In addition to applying the customer's investment profile, additional factors are to be considered. These include the product or strategy's investment objectives, characteristics, liquidity risks and potential benefits, volatility and likely performance in a variety of market and economic conditions.

Compliance

How should a firm evidence its compliance with the suitability rule? The rule does not impose explicit documentation requirements. FINRA has suggested using a risk-based approach to evidence compliance. This means that based upon an assessment of the customer's investment profile and the complexity of the recommended security or investment strategy involving a security or securities (including both its structure and potential performance) and / or the risks involved, is it more prudent to document than not to document? FINRA stated that a recommendation of a large-cap, value-oriented equity security usually would not require documentation. However, the recommendation of a complex and / or potentially risky security or investment strategy usually would require documentation.

Institutional Investor Exception

The ability to rely on an exception to the suitability rule for institutional investors has been materially limited. An institutional investor is an individual or entity with at least $50 million in assets. The requirements are that (i) the firm or salesperson reasonably believes that the institutional customer is capable of evaluating investment risks independently, both in general and with regard to each particular transaction and each investment strategy involving a security or securities, and (ii) the institutional customer affirmatively indicates that it is exercising independent judgment in evaluating the recommendations being made. Where a third party is delegated investment decision authority, these tests must be applied to that third party.

Some have suggested that obtaining a form of certificate from institutional investors would be sufficient for this exception. However, that does not appear to be wholly correct. This is a factual test—(i) can the customer independently evaluate recommendations in general, the specific recommendation and the investment strategy involved, (ii) does the broker or salesperson have a reasonable basis to believe that is the case, and (iii) has the customer affirmatively acknowledged that it is exercising independent judgment?

A certificate from the customer may meet the third test, but not the first two tests. The exception is only from the specific customer suitability requirement. It is not available for the reasonable basis and quantitative suitability requirements. The institutional investor exception from the suitability rule raises a question—who is the customer to whom it applies? Is it the institutional investor—e.g., the major money management firms? Is it each of the money managers or team employed by the institution to manage accounts? But the broker may not know who they are. Is it the traders on the trading desk with whom the broker regularly deals?

Take Away

1. If a firm distributes research, whether to customers or in general, it must review the research to determine if the research in general or specifically constitutes a call to action by a present or prospective recipient of such research. If so, suitability obligations may be incurred.
2. Each salesperson who recommends a security to buy, sell or hold, or who recommends an investment strategy, should be sufficiently familiar with that security or strategy to be able to make the required suitability determinations. Firms may have to expand their training programs and go beyond a general recommended or acceptable list of investments and strategies.
3. Firms and salespersons should make a concerted effort to obtain and record all the required information for a suitability determination. To the extent any information is unavailable or cannot be obtained, the firm and salesperson should make an informed decision as to the materiality of such missing information in making a recommendation. While not specifically required to do so, it would be more prudent to record on a timely basis the reasons for such determinations.
4. The more complex or involved a recommendation of a security or investment strategy, the more prudent it would be to record the basis for the suitability determination.

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Why FIO Matters

By Ethan T. James and Amanda Greenwold Wise

Introduction and Background

The Federal Insurance Office stands at the center of a new national and international insurance regulatory world. Created by Title V of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. 111-203), the Federal Insurance Office ("FIO") is not the most powerful presence at the Financial Stability Oversight Council ("FSOC"), nor at the International Association of Insurance Supervisors, nor does it hold a lofty perch within the walls of the Department of the Treasury. Despite lacking a true regulatory mandate, despite efforts by many to dilute the functions of the office, and despite the statutory limits of the Office's power, the FIO is in an unparalleled position among insurance-related entities to participate in the unfolding of this new post-crisis world.

The FIO did not begin auspiciously. As early as 2008, in the Blueprint for Modernizing Financial Regulatory Structure produced under Secretary Paulson, Treasury advocated for more extensive federal participation in insurance regulation by proposing an optional federal charter for insurance companies as an alternative to the system of state insurance regulation. The optional federal charter would have created a system similar to the dual state/federal banking system that developed in the nineteenth century. By late 2009, however, the Obama Administration and its allies in Congress found themselves pushing for a more comprehensive set of financial regulatory reforms. Supporters of financial reform believed that a proposal for an optional federal insurance charter would jeopardize the chance for passage of broader reform. The optional federal charter was never proposed, either by the Administration or by members of Congress, as part of this package of reform legislation. Instead, these reforms, which became Dodd-Frank, opened a new window for federal participation in insurance, creating FIO as a limited-purpose office, to monitor all aspects of the insurance industry; to recommend to FSOC that it designate certain insurers as systemically important; and to coordinate federal efforts and develop federal policy on international insurance issues.[1]

Although there was consensus from the outset that FIO would be housed in Treasury, there was some debate as to the stature of the office within the Department. Initially, some in the Department and in Congress proposed that the office be headed by a Deputy Assistant Secretary, a political position. In the end, however, the Act directed that the FIO Director be a member of the Senior Executive Service, a high-ranking senior civil servant reporting to the political ranks within the Department.[2] As a result, today the FIO Director reports to the Deputy Assistant Director for Financial Institutions, on up to the Assistant Secretary for Financial Institutions, the Undersecretary for Domestic Finance, the Deputy Secretary, and, finally, to the Secretary. Insulating the position from politics also had the effect of moving it down the chain of Departmental reporting.

FSOC Responsibilities

Among his other responsibilities, the Director serves as a non-voting member of the FSOC. Thus far, this position has given the Director access to FSOC deliberations in their entirety, as the voting members of the FSOC have never excluded the non-voting members from FSOC proceedings (as is their right under certain circumstances).[3] The Director and his staff also participate in staff-level discussions and workstreams with other FSOC member agencies. With the other two "insurance members" of the FSOC—the independent member with insurance expertise and the member selected by the state insurance commissioners—FIO is leading efforts to determine which insurers will move from "Stage 2" to "Stage 3" in the designation process.[4] So far, AIG is the only insurer to confirm it has been moved to Stage 3, but it may have company when the FSOC meets again. To varying degrees, the FIO and the other FSOC insurance members continue to work to distinguish the insurance industry from other types of non-bank financial institutions for FSOC purposes. While FIO and its Director can work within the Treasury to influence the Secretary and other Treasury FSOC personnel, the FSOC vote ultimately belongs to the Secretary. FIO has to fight to be heard over the din of the Secretary's other advisors, many of whom came from the world of banking, or from other types of non-bank financial institutions, like hedge funds and asset managers.

The Federal Reserve Board's recent Basel III implementation proposals highlight the difficulties insurers have in complying with bank standards. Although several insurers are organized as bank holding companies or as savings and loan holding companies, their risk-based capital requirements differ from those of banks. An insurer's investment horizons and risk allocations differ from a bank's. Many insurers prepare financial statements using statutory accounting principles, and may not even prepare GAAP financial statements.

FIO is currently understaffed, reducing its ability to provide views to balance generally bank-centric thinking within some other FSOC agencies. And, while FSOC appears open to some limited tailoring for insurance providers, as of yet the FSOC has not chosen to create a distinct analytical process for insurance institutions.

Compounding the problem for the insurance industry is the exclusive authority of the Federal Reserve Board to determine how to implement heightened supervision for companies designated as systemically important financial institutions, or SIFIs, by the FSOC (although the FSOC can make recommendations to the Board). The Federal Reserve Board's proposed rule for enhanced supervision of non-banks published for comment on January 5, 2012 made no distinction between insurance institutions and other types of non-banks, despite permission in the statute for different prudential standards for different types of financial institutions.[5] The Federal Reserve Board's proposal disappointed the insurance industry, which had argued before the Board and other FSOC members that a single-application supervisory standard would not fit with insurers' investment and risk profiles, accounting standards, and state regulatory requirements. In any case, it is largely out of the hands of FIO, and of Treasury, how the Federal Reserve Board chooses to implement its heightened supervision of designated institutions.

International Responsibilities

Despite the importance of the FSOC and its work, FIO's immediate challenges will arise in the international arena. Congress authorized FIO to "coordinate Federal efforts and develop Federal policy on prudential aspects of international insurance matters, including representing the United States in the International Association of Insurance Supervisors…and assisting the Secretary in negotiating covered agreements." Dodd-Frank defines "covered agreements" as written bi- or multi-lateral agreements between the United States and foreign entities on prudential matters relating to the business of insurance.[6]

Currently, FIO is part of the international effort to develop several proposals that have the potential to result in covered agreements. FIO joined the International Association of Insurance Supervisors ("IAIS") in late 2011, and took a seat on the Executive Committee in early 2012. This is noteworthy because it is the first time that the United States has been represented by a federal government actor at the IAIS. Historically, the U.S. delegation has been confined to the National Association of Insurance Commissioners staff, joined by a limited number of state insurance regulators working closely with the NAIC. Indeed, to take its place on the Executive Committee, FIO displaced a state insurance commissioner (Christina Urias of Arizona) in order to hold the official U.S. delegation at three members. In October 2012, FIO became chair of the IAIS Technical Committee, the group charged with developing IAIS standards.

FIO has been a part of IAIS efforts to identify global systemically important insurers, or GSIIs. As charged by the G-20, the Bank of International Settlements has undertaken a number of different projects designed to promote global financial stability. Through the Financial Stability Board, it tasked the IAIS with developing a system to identify insurers whose failure or financial difficulty could result in harm to the financial systems of multiple nations. In contrast to the U.S. domestic process for identifying SIFIs, the IAIS has determined that it will collect data from several large insurers, and derive a system for identifying GSIIs based upon the data received. However, both industry and regulators in the United States are concerned about the confidentiality of this data.

To date, IAIS has sent two data calls to approximately fourteen U.S. institutions, most recently in August 2012. The information responding to the first data call was collected and forwarded to the IAIS by the State of Connecticut, which relied on state data privacy and other laws in performing this function. In the second data call, FIO is serving as the U.S. point of contact. Relying on its authority to collect and analyze data, as well as its charge to represent the U.S. at the IAIS, this data call will test FIO's ability to protect any confidential information gathered. The GSII process is particularly critical, as it will be one of the first demonstrations of how FIO interprets its charge to "represent" the U.S. in the international body: FIO will have to balance its stewardship of international financial stability and its advocacy of the United States and its insurance industry.

The IAIS designation and supervision project could ultimately be memorialized in a covered agreement. This may give FIO the opportunity to employ one of the most controversial provisions of Dodd-Frank—the power to preempt state law under certain conditions. If a state does not bring its law into compliance with the terms of the agreement, and if that results in discriminatory treatment of a non-resident insurer, FIO may preempt the laws of the state and enforce the terms of the covered agreement.[7] In granting FIO this preemptive power, Congress took a step towards solving one of the problems that has vexed many, particularly abroad, by guaranteeing that each insurance-regulating jurisdiction at least minimally adheres to internationally agreed prudential norms.

FIO is also working with the IAIS and others to create a common framework for supervision of internationally active insurers, a project known as "ComFrame." ComFrame would have supervisors around the globe work together to supervise internationally active insurance groups and close regulatory gaps. While the details of ComFrame have yet to be articulated, FIO has expressed its support for the concept of international regulatory convergence.

Another major international project for the FIO is Solvency II, although the immediacy of this project has diminished recently. Solvency II is a review of the capital adequacy regime for the European insurance industry. It aims to establish a revised set of European Union-wide capital requirements and risk management standards that will replace the current solvency requirements. The European Commission will then study non-European insurance regimes to determine their "equivalence" with the EU standard.

FIO and the EU agreed in early 2012 to create bilateral working groups to discuss a few major areas of insurance regulation, including data privacy and reserving. FIO and the EU have recently produced these reports for public comment. These reports discuss the differences and similarities in the U.S. and European approaches to insurance regulation. FIO believes that the reports will form the basis for the EU to determine that the U.S. system is equivalent to the EU standards, allowing the United States to avoid a unilateral EU conclusion about the nature and adequacy of the U.S. regulatory system. This belief is based largely on the conviction that the EU, as a matter of practical economics, cannot help but determine that the U.S. system is equivalent. A decision based on a dialogue between Europe and the United States will help both parties—it allows the EU to say that it explored the issues raised by the American systems, and allows the U.S. to claim that it did not submit its system to the judgment of foreign governments.

Treatment of Data

As a result of its international work, as well as its FSOC duties, FIO is at the center of federal efforts to obtain and analyze insurance-sector information. The financial crisis, and in particular the situation at AIG, highlighted to the federal government how little information it had about the insurance sector. As a result, Dodd-Frank gave FIO authority to require insurers to submit any data the FIO may "reasonably require" to carry out its duties (although FIO must first ascertain that it cannot get the information it needs from a public source or from a functional regulator).[8] FIO may enter into information-sharing agreements, analyze and disseminate data, and issue reports on all lines of insurance except health insurance. FIO may even, after coordinating with insurance regulatory agencies and upon a finding by the Director, compel information by subpoena.

Dodd-Frank established the Office of Financial Research to lead efforts to collect and analyze data for FSOC use.[9] Because of political and bureaucratic obstacles, however, the Office of Financial Research has not yet been able to provide these services on any comprehensive basis. The various other FSOC member agencies have therefore done much of their own data collection and analysis, mostly using regulatory data already at hand. But since the federal government has almost no regulatory data for insurance companies, FIO has been forced to do more work on collection, data sharing, and data analysis than its FSOC counterparts, and more than contemplated by the drafters of Dodd-Frank.

However, without the explicit confidentiality provisions Dodd-Frank gives the Office of Financial Research, FIO may not be able to protect the data it collects from disclosure under the Freedom of Information Act ("FOIA").[10] FOIA requires federal agencies, upon request, to disclose information in their possession, although agencies may withhold documents falling into a few protected categories. FIO data reasonably could be expected to fall into one FOIA exemption—the confidential business information exception—and might possibly fall under the supervisory exemption.[11] If documents or data requested by the public contain commercially or financially confidential information (as is likely in the case of any FIO data call relating to its monitoring of the health of the insurance sector), FIO can withhold from disclosure at least that portion of the submission which contains the business-sensitive information.

Applying the supervisory exemption may be more difficult. As Dodd-Frank makes clear, FIO does not have general supervisory or regulatory authority over the business of insurance.[12] If FSOC designates any insurers as systemically important, those companies will be subject to heightened supervision by the Federal Reserve Board. If FIO prepares reports for the Federal Reserve Board as the regulator of those entities, those reports and the information underlying them may be exempted from public release as examination, operating or condition reports for the use of a supervisory agency.

Another application of the supervisory exemption could arise if FIO ever preempts state law, as permitted under the limited circumstances discussed above. In that case, documents relating to that law and that process may be considered supervisory documents since FIO would be enforcing prudential standards. Finally, Dodd-Frank is explicit that disclosure of information to FIO does not constitute a waiver of a legal privilege or by a confidentiality agreement.[13]

Conclusion

Federal involvement in the insurance industry is here to stay, and it is likely to increase. Although thus far AIG is the only insurer to move to Stage 3 of the SIFI designation process, it is generally assumed that at least a small handful of insurers will ultimately be designated by the FSOC. It only takes one to cause the Federal Reserve Board to apply capital standards and other prudential regulation to an insurance company. Similarly, although the number of savings and loan holding companies in the insurance industry is dwindling, when Basel III standards become effective they will provide another entrée to the insurance industry for federal regulators. When MetLife, a bank holding company by virtue of its ownership of a bank (which it is in the process of divesting), participated in the Federal Reserve Board's stress test exercise earlier this year, it experienced first-hand the challenges facing an insurance company when it is measured using banking standards.

In each of those circumstances FIO has a unique and somewhat undefined position. That, along with the statutory authority to represent the U.S. insurance industry on international matters, strongly demonstrates that the industry would be well-served to help guide the evolution of FIO's role, and to help FIO play that role as effectively as possible. Industry participants, whether individual companies or associations, should actively look for ways to engage and assist FIO. In addition, the NAIC has an important role to play in this process. Expanded federal regulation of insurers is on its way, and it is in everyone's interest to help ensure that the related policy decisions have a solid underpinning of practical input.

Endnotes

1. Also, FIO has authority to monitor consumer access to insurance products; to assist the Secretary in administering the Terrorism Risk Insurance Program; to consult with the states on insurance matters of national and international importance; and to carry out such other duties as the Secretary may assign it. *See* 31 U.S.C. § 313(a) (2012).
2. 31 U.S.C. § 313(b).
3. Dodd-Frank Wall Street Reform and Consumer Protection Act [hereinafter Dodd-Frank Act], Pub. L. No. 111-203, § 111(b)(3).
4. As described in its rule of April 11, 2012, Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21,637 (Apr. 11, 2012), non-bank financial institutions meeting certain statistical thresholds automatically move from Stage 1 to Stage 2 in the designation process (other nonbanks can be moved from Stage 1 to Stage 2, but not automatically). In Stage 2, the FSOC gathers and considers information about specific financial institutions. If the FSOC believes after a Stage 2 analysis that the institution may be systemically important, that institution will be moved to Stage 3, and the institution itself will be asked to provide data for FSOC analysis.
5. Self-Regulatory Organizations; The National Securities Clearing Corporation; Order Granting Approval of a Proposed Rule Change To Amend Rules Relating To the Creation of a Service To Provide Post-Trade Information, 77 Fed. Reg. 528, 529 (Jan. 5, 2012); Dodd-Frank Act § 115(a)(2)(A).
6. 31 U.S.C. § 313(r)(2).
7. For example, the U.S. might agree to risk-based collateral requirements for all reinsurers without regard to domicile. State laws requiring 100% collateral for non-domiciliary reinsurers would not comply with the terms of such a covered agreement, which would result in harm to a non-domiciliary reinsurer.
8. 31 U.S.C. § 313(e).
9. Dodd-Frank Act §§ 152 et. seq.
10. 5 U.S.C. § 552.
11. 5 U.S.C. §§ 552(b)(4), (b)(8).
12. 31 U.S.C. § 313(k).
13. 31 U.S.C. 313(e)(5).

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Inside the Courts

Prepared by Attorneys at Skadden Arps

U.S. SUPREME COURT

Supreme Court Grants *Cert.* to Review Securities Fraud Class Action Circuit Split

Amgen Inc. v. Connecticut Ret. Plans & Trust Funds, 132 S. Ct. 2742 (2012)

The U.S. Supreme Court granted defendant Amgen Inc.'s petition for a writ of *certiorari* to review whether a securities fraud plaintiff alleging fraud on the market must establish materiality in order to obtain class certification. The Ninth Circuit, in *Connecticut Retirement Plans & Trust Funds v. Amgen Inc.*, 660 F.3d 1170 (9th Cir. 2011), had held that such a plaintiff need not establish the materiality of an alleged fraudulent statement in order to obtain class certification. Rather, according to the Ninth Circuit's ruling, it is enough to show that the security in question was traded in an efficient market and that the alleged fraudulent statement became public. Having made that showing, the plaintiff could represent a class of shareholders, notwithstanding the defendant's objection that issues pertaining to individual reliance would predominate in the action. The Ninth Circuit joined the Third and Seventh Circuits, but deepened a split with three other Courts of Appeal on the issue.

Amgen's successful petition posed two questions: "(1) [w]hether, in a misrepresentation case under SEC Rule 10b-5, the district court must require proof of materiality before certifying a plaintiff class based on the fraud-on-the-market theory"; and "(2) [w]hether, in such a case, the district court must allow the defendant to present evidence rebutting the applicability of the fraud-on-the-market theory before certifying a plaintiff class based on that theory." The case will be heard during the October Term 2012, and a decision is anticipated by the end of June 2013.

AUCTION RATE SECURITIES

SDNY Dismisses Claims That Merrill Lynch Made Misrepresentations and Omissions About the ARS Market

In re *Merrill Lynch Auction Rate Sec. Litig.*, No. 10 CIV. 0124 LAP, 2012 WL 1994707 (S.D.N.Y. June 4, 2012)

Chief Judge Loretta A. Preska of the U.S. District Court for the Southern District of New York dismissed claims that Merrill Lynch violated Section 12(a)(1) of the Securities Act and Section 10(b) of the Securities Exchange Act by allegedly making misrepresentations and omissions about the market for auction rate securities. Consistent with the U.S. Court of Appeals for the Second Circuit's ruling in *Wilson v. Merrill Lynch & Co., Inc.*, 671 F.3d 120 (2d Cir. 2011), the court dismissed the Section 10(b) claims because, taking judicial notice of articles demonstrating the information available to the market, the ARS purchases at issue occurred after Merrill Lynch disclosed to the market and on its website that it periodically intervened to support ARS auctions to prevent auction failure. As to the Section 12(a)(1) claim, that claim was time-barred by both the one-year limitations period and the three-year statute of repose because the action was filed more than one year after the ARS purchases occurred and more than three years after the ARS were first offered to the public. In addition, the complaint did not state a claim for violation of Section 12(a)(1) because Merrill Lynch could have reasonably concluded that the purchaser was a qualified institutional buyer and therefore, under SEC Rule 144A, the ARS offering was exempted from the Securities Act registration requirements, including Section 12(a)(1).

CLASS ACTIONS

Certification

SDNY Certifies Class of Investors; Plaintiffs' Only Claim Was That Underwriter Failed to Make a Reasonable Inspection of Offering Documents

Tsereteli v. Residential Asset Securitization Trust 2006-A8, 283 F.R.D. 199 (S.D.N.Y. 2012)

Judge Lewis A. Kaplan of the U.S. District Court for the Southern District of New York certified a class of investors alleging that an underwriter of a residential mortgage-backed securities (MBS) offering violated Sections 11 and 12(a)(2) of the Securities Act. Because the court had previously dismissed all other claims, the plaintiffs' only claim was that the underwriter failed to make a reasonable inspection of the offering documents, which did not disclose the offerer's alleged abandonment of its underwriting standards. The court initially determined that Rule 23(a)'s numerosity requirement must be met on an "offering-by-offering" basis, rather than "tranche-by-tranche" as the underwriter argued. Rule 23(a)'s commonality and typicality requirements were satisfied because all proposed members purchased securities in the same offering and allegedly relied on the same offering documents that contained the same purported misstatements or omissions. And although the lead plaintiff did not show that it had not received principal or interest payments, it adequately alleged that its claims arose from the "same course of events" as other class members' claims, and so it met the typicality requirement. Further, Rule 23(a)'s adequacy requirement was satisfied, even though the lead plaintiff lacked knowledge about the claims, because lead plaintiffs may rely heavily on their counsel's knowledge. In addition, the underwriter did not show that the various investors had acquired individualized knowledge of the securities at issue, and the general information about MBS markets that might have put the investors on inquiry notice of a potential fraud were subject to generalized proof, satisfying Rule 23(b)(3)'s predominance requirement. The court also determined that the foreign identity of certain proposed class members, including the proposed lead plaintiff, did not make other forms of litigation superior to a class action because any unique issues of foreign law were minor or nonexistent.

SDNY Certifies Investor Class in Case Against Drugmaker

In re *Pfizer Inc. Sec. Litig.*, 282 F.R.D. 38 (S.D.N.Y. 2012)

Judge Laura Taylor Swain of the U.S. District Court for the Southern District of New York certified a class of investors claiming that Pfizer violated Section 10(b) of the Securities Exchange Act by allegedly making material misstatements and omissions concerning the safety of two drugs. Although the proposed institutional lead plaintiff's investments had been made by sophisticated investment advisers, it satisfied Rule 23(a)'s typicality requirement because those advisers presumably relied on market information, and Pfizer presented no evidence that the advisers relied on nonpublic information. In addition, the proposed institutional lead plaintiff's failure to establish a litigation hold on electronic communications did not render it inadequate because Pfizer did not show that relevant e-mails ever existed. Further, because the plaintiffs adequately alleged that Pfizer's statements regarding the drugs' safety were material and that its stock traded in an efficient market, the plaintiffs were entitled to the fraud-on-the-market presumption, and did not need to establish individual reliance.

Settlements

SDNY Declines to Approve Settlement With Former Lehman Directors and Officers

***In re Lehman Bros. Sec. & ERISA Litig.*, No. 09 MD 2017 (LAK) (S.D.N.Y. May 3, 2012)**

In a securities fraud class action, Judge Lewis A. Kaplan of the U.S. District Court for the Southern District of New York declined to approve a proposed class settlement with certain former directors and officers of Lehman because the lead plaintiff did not provide sufficient information about the defendants' ability to pay a judgment higher than the proposed settlement amount. Under the proposed settlement, the plaintiffs would receive $90 million, all paid from the defendants' D&O insurance. In support of the settlement, the plaintiffs commissioned an independent study performed by a former S.D.N.Y. judge, which obtained information on the defendants' liquid and illiquid assets, and concluded that the liquid net worth of the defendants was "substantially less than $100 million." The court determined that restricting this information to only "liquid" assets was insufficient to determine the defendants' ability to pay, a factor in determining the reasonableness of a class settlement, and required the defendants to turn over all materials provided to the independent investigator for *in camera* review, including information regarding the defendants' illiquid assets.

SDNY Subsequently Rules Class Action Settlement Is Fair Despite Lack of Any Contribution by Former Lehman Directors and Officers

***In re Lehman Bros. Sec. & ERISA Litig.*, No. 08 CIV. 5523 (LAK), 2012 WL 1920543 (S.D.N.Y. May 24, 2012)**

Judge Lewis A. Kaplan of the U.S. District Court for the Southern District of New York subsequently ruled that a class action settlement with the former directors and officers of Lehman Brothers was fair, reasonable and adequate. Under that settlement, certain insurers would pay $90 million without contributions from Lehman's former officers and directors. Following an *in camera* review of the value of the personal assets of the former directors and officers, the court concluded that a guaranteed $90 million from insurance policies was reasonable when compared to the risk of an unsuccessful outcome at trial, even though some investors may have been concerned at the lack of any contribution by the former directors and officers.

Waivers

Northern California Federal Court Refuses to Reach Broker-Dealer's Argument That FINRA's Ban on Class Action Waivers Is Preempted by the Federal Arbitration Act

***Charles Schwab & Co. Inc. v. Fin. Indus. Regulatory Auth. Inc.*, 861 F. Supp. 2d 1063 (N.D. Cal. 2012)**

Magistrate Judge Elizabeth LaPorte of the U.S. District Court for the Northern District of California dismissed with prejudice Charles Schwab & Co.'s (Schwab) action for a declaratory judgment against the Financial Industry Regulatory Authority, Inc. (FINRA). The dispute concerned whether Schwab had to exhaust administrative remedies before it could argue that FINRA's rule forbidding class action waivers is preempted by the Federal Arbitration Act under the U.S. Supreme Court's recent holding in *AT&T Mobility LLC v. Concepcion*, 131 S. Ct. 1740 (2011). Schwab argued that under *AT&T* the Federal Arbitration Act preempts even federal laws that interfere with interpreting arbitration agreements according to their terms.

The district court explained that, under the Securities Exchange Act, FINRA has the power, under the SEC's supervision, to regulate broker-dealers. Pursuant to its regulatory authority as "a key part of the interrelated and comprehensive mechanism for regulating securities markets, including market participants such as [Schwab]," the court said, FINRA issued Rule 2268(d), which purports to prevent broker-dealers from making arbitration agreements with class action waivers. Because Schwab's customer agreement contained a class action waiver, FINRA began enforcement actions against it. Schwab had not, however, elevated its preemption argument through the five-layered administrative process for challenging FINRA enforcement actions. The court ruled that the failure to exhaust remedies was jurisdictional and dismissed Schwab's request for declaratory relief. The question of whether broker-dealers can agree with their customers to waive the right to proceed as a class remains undecided.

Consent Orders

D.C. Federal Court Grants Third Party's Motion to Unseal Reports Related to SEC-AIG Settlement Agreement

***Sec. & Exch. Comm'n v. Am. Int'l Grp., Inc.*, No. 04-2070 (GK) (D.D.C. Apr. 16, 2012)**

Judge Gladys Kessler of the U.S. District Court for the District of Columbia granted a third party's motion to unseal the reports of an independent consultant appointed pursuant to an SEC-AIG settlement agreement. The court determined that the reports were judicial records subject to the common law right of access because the court might rely on the reports in enforcing the consent order, and the reports played a central role in the operation of the consent order. The court then ruled that the public's interest in viewing the documents outweighed the SEC's and AIG's interests in maintaining confidentiality. Although the SEC and AIG had jointly sought an order sealing the report, they did so 18 months after filing the initial consent order, which according to the court indicated that confidentiality was not a significant consideration in the initial agreement. In addition, AIG's concerns that the reports contained competitive information could be addressed by redacting the reports.

DEMAND FUTILITY

Eleventh Circuit Rejects a Proposed "Majority Ownership" Exception to a Contractual Demand Requirement

***Akanthos Capital Mgmt., LLC v. CompuCredit Holdings Corp.*, 677 F.3d 1286 (11th Cir. 2012)**

A unanimous panel of the U.S. Court of Appeals for the Eleventh Circuit upheld a contractual "no-action clause" against a challenge brought by bondholder plaintiffs who failed to make a pre-suit demand. The defendant corporation issued the bonds using a standard "no-action clause" barring bondholders from suing for any remedy with respect to the securities. Rather, the sole remedies belonged to the trustee. There was an exception to the no-action clause for bondholders who first made an appropriate pre-suit demand on the trustee, but it was undisputed that no such demand had been made.

The district court had denied the issuing corporation's motion to dismiss because, among other reasons, the plaintiffs comprised a majority of the bondholders. The lower court had reasoned that no-action clauses are intended to prevent the poor judgment of a minority interest from overwhelming the best collective interests of the bondholders.

The Eleventh Circuit rejected what it called the "novel proposition" that the no-action clause could be avoided by a majority of bondholders. "Although one purpose of the no-action clause is to deter suits brought by the minority, other purposes of the clause are to 'prevent rash, precipitate, or harassing suits by bondholders who disrupt corporate affairs,' and to protect the issuer from a multiplicity of lawsuits. Majority ownership offers no guarantee that those purposes are fulfilled," the court said. The panel reversed and remanded with instructions to dismiss the bondholders' suit.

DIRECTORS AND DIRECTORS' DUTIES

Court of Chancery Dismisses Complaint Accusing HP Directors of Committing Waste in Connection With Termination Severance Payments to CEO

***Zucker v. Andreessen*, CIV.A. 6014-VCP, 2012 WL 2366448 (Del. Ch. June 21, 2012)**

Vice Chancellor Donald F. Parsons Jr. of the Delaware Court of Chancery dismissed a derivative complaint for failure to adequately allege demand futility. The derivative complaint, brought on behalf of Hewlett-Packard, accused certain HP directors of committing waste in connection with the termination severance payments to then-CEO Mark Hurd and of breaching their duty of care by failing to implement a long-term succession plan. The court found that the plaintiff had not pleaded demand futility as to his waste claim because the plaintiff had failed to allege adequately that the severance agreement was so one-sided as to constitute waste. The court remarked that matters of executive compensation and severance are within the "essence of business judgment." The court found that, in exchange for the severance agreement, "at least some consideration runs to HP," including Hurd's agreement to extend certain confidentiality agreements, not to disparage the company, to cooperate with respect to transition and succession, and to release all claims he had against the company. Moreover, the court found that at least some portion of the severance could represent reasonable compensation for Hurd's past performance. While the "amount of Hurd's severance may appear extremely rich or altogether distasteful for some," the court held that the value of such benefits "is a matter best determined by the good faith judgments of disinterested and independent directors, men and women with business acumen appointed by shareholders precisely for their skill at making such evaluations," and not by the courts.

In dismissing the plaintiff's claim that the HP board's decision not to have a succession plan was a breach of the duty of care, the court applied the *Rales* test for evaluating demand futility because the claim challenged board inaction, rather than board action. The court explained that because HP's charter contained an exculpatory provision, for the HP directors to suffer a disabling likelihood of personal liability to satisfy the *Rales* test "the alleged breach of care for failing to implement a succession plan must rise to the level of bad faith, such as a conscious disregard of a known duty to act." The court stated that it was not aware of any Delaware precedent finding that failure to adopt a long-term succession plan amounts to a breach of duty, and that there was "no basis on which to find demand futility, regardless of whether Delaware, as a normative matter, should adopt an express requirement that corporate fiduciaries must implement long term succession plans."

Court of Chancery Denies Motion to Dismiss Derivative Claims, Refusing to Give Collateral Estoppel Effect to a California Court's Dismissal of Related Claims

Louisiana Mun. Police Emps.' Ret. Sys. v. Pyott, 46 A.3d 313 (Del. Ch. 2012)

Vice Chancellor J. Travis Laster of the Delaware Court of Chancery denied a motion to dismiss derivative claims asserted on behalf of Allergan, Inc. In so doing, the court refused to give collateral estoppel effect to a California court's dismissal of related claims.

Derivative actions were filed in the Delaware Court of Chancery and in the U.S. District Court for the Central District of California. The federal court dismissed claims in the California action pursuant to Rule 23.1 with prejudice. In the Court of Chancery action, the defendants moved to dismiss claims arguing that, among other grounds, the district court's dismissal operated as collateral estoppel, requiring dismissal. The Court of Chancery disagreed, and denied the defendants' motion to dismiss.

As an initial matter, the Court of Chancery determined that "whether successive stockholders are sufficiently in privity with the corporation and each other is a matter of substantive Delaware law governed by the internal affairs doctrine." Thus, whether the California judgment acted as collateral estoppel in the Delaware action would be evaluated under Delaware law. The Court of Chancery found that while a growing body of precedent holds that a Rule 23.1 dismissal has preclusive effect on other derivative complaints, controlling Delaware Supreme Court precedent makes clear that until a Rule 23.1 motion has been denied, a derivative plaintiff whose litigation efforts are opposed by the corporation does not have the authority to sue in the name of the corporation. Consequently, at the time of the first Rule 23.1 dismissal, other stockholders are not in privity with the stockholder plaintiff in the first derivative action, and the decision granting a Rule 23.1 dismissal cannot have preclusive effect. According to the Court of Chancery, while the first dismissal would constitute persuasive authority, it does not preclude the second action.

Moreover, the court found that the plaintiffs in the district court action did not adequately represent Allergan, a finding that provided an independent basis for refusing to give collateral estoppel effect to dismissal of the federal court action. The Court of Chancery explained that it presumes that "a fast-filing stockholder with a nominal stake, who sues derivatively after the public announcement of a corporate trauma in an effort to shift the still-developing losses to the corporation's fiduciaries, but without first conducting a meaningful investigation, has not provided adequate representation." Thus, the court concluded that "[b]y leaping to litigate without first conducting a meaningful investigation, the California plaintiffs' firms failed to fulfill the fiduciary duties they voluntarily assumed as derivative action plaintiffs. Rather than seeking to benefit Allergan, they sought to benefit themselves by rushing to gain control of a case that could be harvested for legal fees. In doing so, the fast-filing plaintiffs failed to provide adequate representation." Thus, on those bases, the court found that the California judgment did not have preclusive effect on the Delaware litigation, and proceeded to deny the defendants' motions to dismiss under Rules 23.1 and 12(b)(6). The court held that, read as a whole, the particularized allegations supported a reasonable inference that the board consciously approved a business plan predicated on violating the federal statutory prohibition against off-label marketing, and that one cannot loyally act as a corporate director by causing the corporation to violate the positive laws it is obliged to obey. The Delaware Supreme Court has accepted an interlocutory appeal of the decision.

DUTY TO DISCLOSE

Eighth Circuit Reinstates Investors' Claims That KV Pharmaceutical Failed to Disclose FDA Problems

Pub. Pension Fund Grp. v. KV Pharm. Co., No. 10-3402 (8th Cir. June 4, 2012)

The U.S. Court of Appeals for the Eighth Circuit reversed in part, and affirmed in part, the dismissal of an action against KV Pharmaceutical relating to statements made about the company's compliance with FDA regulations between 2003 and 2009. The plaintiffs alleged that KV failed to disclose numerous warnings received from the FDA that its facilities were not in compliance with FDA regulations, including by ignoring manufacturing deficiencies that produced defective products and packaging. These deficiencies eventually led KV to shut down its manufacturing activities altogether. The plaintiffs also alleged that KV made false and misleading statements about its earnings from sales of these defective products. Shortly after the district court dismissed the initial complaint for failure to plead claims with enough specificity, a KV business unit pled guilty to two felony counts and paid more than $27 million in penalties. The district court thereafter denied the plaintiffs' motion to vacate dismissal and for leave to file an amended complaint.

On appeal, the Eighth Circuit reversed in part, holding that the plaintiffs adequately set forth the reasons that KV's statements about its material compliance with FDA regulations were false and misleading. The court determined that receipt of warnings from the FDA indicated that the company was not in material compliance with FDA regulations and that this information would be material to a reasonable investor. The court found KV's argument that investors could have obtained these FDA warnings by filing a FOIA request unpersuasive, noting that, once KV chose to represent that it was in compliance with FDA regulations, it was obligated to make full disclosure of all material facts. By contrast, the court affirmed the dismissal of the plaintiffs' claim that KV made false and misleading statements about its earnings, noting that the company did not undertake a duty to speak about its manufacturing problems solely by reporting historical financial results. In addition, the court affirmed the dismissal of claims against two executives under a theory of scheme liability, adopting new precedent that requires more than mere misrepresentations or omissions for liability in a scheme. Finally, the court determined that the district court abused its discretion in denying the plaintiffs' motion to amend the complaint, as the new allegations related to the guilty plea provided further support for the allegations in the plaintiffs' initial complaint.

SDNY Dismisses Claims Against Goldman Sachs Relating to Disclosure of Wells Notices

***Richman v. Goldman Sachs Grp., Inc.*, No. 10 Civ. 3461 (PAC) (S.D.N.Y. June 21, 2012)**

Judge Paul A. Crotty of the U.S. District Court for the Southern District of New York dismissed claims that Goldman Sachs violated Section 10(b) of the Securities Exchange Act by failing to disclose its receipt of Wells notices from the SEC regarding its role in a collateralized debt obligation (CDO) offering. Although Goldman Sachs had previously disclosed that it was being investigated, it did not have a duty to specifically disclose the Wells notices, because those notices merely confirmed that investigations were ongoing. Goldman Sachs' press release following a *New York Times* article on CDOs also did not trigger a duty to disclose because it did not address the issue of governmental investigations. The court also determined that Item 103 of Regulation S-K does not create a duty to disclose a Wells notice, because litigation is not substantially certain to occur at that point. Goldman's failure to disclose the Wells notices received by two of its employees under FINRA Rule 2010 and NASD Conduct Rule 3010 was insufficient to support the plaintiffs' claims because such rules do not confer private rights of action.

INTERLOCUTORY APPEALS

SDNY Grants Motion to Permit Expedited Appeal of Ruling Denying Dismissal of Claims Brought by the FHFA on Behalf of Fannie Mae and Freddie Mac

***Fed. Hous. Fin. Agency v. UBS Ams., Inc.*, No. 11 Civ. 5201 (DLC) (S.D.N.Y. June 19, 2012)**

Judge Denise Cote of the U.S. District Court for the Southern District of New York granted UBS's motion to permit expedited appeal of the court's earlier ruling denying dismissal of claims brought by the Federal Housing Finance Agency on behalf of Fannie Mae and Freddie Mac as untimely under Sections 11 and 12(a)(2) of the Securities Act. The court had concluded that the Housing and Economic Recovery Act of 2008 (HERA) displaced the three-year statute of repose on Securities Act claims brought by the Federal Housing Finance Authority, even though the express language of that act addressed only the one-year statute of limitations on Securities Act claims. Although a reversal of the court's decision might not fully end the litigation, it would significantly narrow the classes of securities at issue and limit discovery, and so constituted a "controlling question[] of law." Appellate review would also materially advance the litigation's termination, because a reversal would end or significantly restrict the litigation's scope, and an affirmance would clarify the parties' bargaining positions, facilitating settlement. In addition, resolution of the timeliness issue would facilitate the resolution of 17 similar actions filed by the Federal Housing Finance Agency against various defendants. Finally, UBS's citation to two previous district court decisions interpreting statutes with substantially similar language to that at issue, both of which reached conclusions contrary to the court's decision, suggested that there were grounds for a difference of opinion on the question to be appealed. Thus, the court certified for review by the U.S. Court of Appeals for the Second Circuit the question whether it was an error to conclude that HERA displaces the statute of repose that generally governs claims under the Securities Act.

INVESTMENT COMPANY ACT

Third Circuit Affirms Dismissal Because Plaintiffs Did Not Maintain Continuous Ownership of Fund

***Santomenno v. John Hancock Life Ins. Co. (U.S.A.)*, No. 11-2520 (3d Cir. Apr. 16, 2012)**

The U.S. Court of Appeals for the Third Circuit affirmed the dismissal of claims that John Hancock violated Sections 36(b) and 47(b) of the Investment Company Act by allegedly charging excessive fees on annuity contracts held by an employees' retirement fund because the plaintiffs did not maintain continuous ownership in the fund.

The court held that, because Section 36(b) is derivative in nature, plaintiffs must own shares in the fund when they file suit and must hold the fund's securities throughout the entire litigation in order to maintain standing. Because all of the plaintiffs had sold their securities before filing their amended complaint, which was the operative pleading, the plaintiffs did not have standing to sue under Section 36(b). The plaintiffs' Section 47(b) claims also failed because that section creates a remedy rather than a separate cause of action, and the plaintiffs could not rely on John Hancock's alleged violations of Section 26(f) to create a claim because Section 26(f) does not provide for a private right of action.

LOSS CAUSATION

Sixth Circuit Upholds Decisions on Securities Fraud Claims, Award of Rescissory Damages and Imposition of Discovery Sanctions

***Fencorp, Co. v. Ohio Ky. Oil Corp.*, Nos. 09-4317/4320/4321/4322 (6th Cir. Apr. 4, 2012)**

***Nolfi v. Ohio Ky. Oil Corp.*, Nos. 09-4315/4316/4323 (6th Cir. Apr. 4, 2012)**

The U.S. Court of Appeals for the Sixth Circuit affirmed the district court's judgment and directed the reinstatement of the verdict in two companion cases involving federal securities claims brought against Ohio Kentucky Oil Corporation (OKO). The dispute arose from various investments made by Frederick E. Nonneman and Fencorp, the family investment corporation he formed, in oil drilling ventures with OKO. In personal letters to Nonneman, OKO touted the virtues of a drilling joint venture and included grandiose promises of rich rewards but did not temper those promises with any cautions or warning that the exploratory drilling had a low chance of success. Further, the investment terms provided that if no oil was found, OKO would keep any excess funds invested. Ostensibly for this reason, OKO did not drill in areas where it was likely to strike oil, thereby allowing OKO to avoid the costs of completing the well and keep the remainder of any investments. After learning of these facts, the plaintiffs filed suit against OKO alleging violations of Section 10(b) of the Securities Exchange Act, Section 12(a)(1) of the Securities Act, Ohio Blue Sky laws, common law fraud, breach of fiduciary duties and breach of contract. After the jury found that OKO had violated various federal securities laws and awarded rescissory damages, OKO appealed.

On appeal, the Sixth Circuit rejected OKO's argument that the plaintiffs' loss causation theory was not actionable under Section 10(b) because an inflated purchase price is not an actionable economic loss. The Sixth Circuit distinguished the purchase of stock in a company traded on the open market, as occurred in *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005), from a partnership with an oil company that has no intention of actually finding oil. As the Sixth Circuit explained, the stockholder in *Dura* received stock at a price that may have been inflated but retained real value. The investors in OKO, however, purchased interests in oil drilling ventures from a company that was not actually interested in drilling for oil and whose interests are now completely worthless. The Sixth Circuit also affirmed the district court's ruling that the OKO investments—fractional undivided interests created by OKO for the purpose of sale—are securities as a matter of law.

The Sixth Circuit also rejected OKO's various challenges to the jury instructions. OKO argued, among other things, that the jury instructions incorrectly stated that the measure of damages for Section 10(b) claims is the purchase price, *i.e.*, rescission. In considering this argument, the Sixth Circuit once again distinguished this case from *Dura*, where the pleadings did not let the defendants know what the causal connection might be between the loss and the misrepresentation. In this case, there was no question that the misrepresentation caused the complete loss of the plaintiffs' entire investment because the wells were worthless and the investments were fraudulent. As the Sixth Circuit explained, a private sale of worthless investments by a company intending to keep the profits by drilling dry wells is in no way analogous to the public sale of stock by a major corporation. Since the misrepresentations caused the plaintiffs to lose their entire investment, rescissory damages were appropriate. The Sixth Circuit emphasized, however, that rescission is a fact-dependent remedy for a Section 10(b) claim and likely only appropriate in rare or unusual circumstances.

The Sixth Circuit also upheld the dismissal of the Section 12(a)(1) claims as barred by the statute of limitations, even though the plaintiffs contended that equitable tolling should extend the statute of limitations period. The Sixth Circuit, however, concluded that Congress intended to negate equitable tolling in this context because Congress expressly mentioned a discovery rule for Section 12(a)(2) claims but not for Section 12(a)(1) claims.

The Sixth Circuit also affirmed the district court's decision to impose discovery sanctions and grant summary judgment against OKO on its federal preemption defense to state securities claims. Although OKO argued that these were "drastic" discovery sanctions, the Sixth Circuit noted that the facts demonstrated the reasonableness of the district court's action. The district court found that the defendants had disobeyed three separate discovery requests for documents related to OKO's general solicitation and refused to produce material that the court deemed discoverable. Moreover, at a later hearing, an OKO official testified that although the material requested still existed, there had been a companywide order to destroy the documents and no official had ordered that the documents be made available to the plaintiffs. Based on these facts, the Sixth Circuit upheld the district court's decision to impose discovery sanctions and found that OKO had engaged in general solicitation, rendering OKO's federal preemption defense void.

MATERIALITY

Eleventh Circuit Rules That a Misstatement by an Individual Broker to an Individual Investor Can Be Included in "Total Mix" of Information Available to Reasonable Investor

***Sec. & Exch. Comm'n v. Morgan Keegan & Co., Inc.*, No. 11-13992 (11th Cir. May 2, 2012)**

The U.S. Court of Appeals for the Eleventh Circuit held *per curiam* that, in an enforcement action brought by the SEC, misstatements made by an individual broker to an individual investor can be considered in a court's materiality analysis. The SEC brought suit against Morgan Keegan & Co., alleging that the company falsely stated that auction rate securities were "cash equivalents," and that the securities were liquid investments despite auction failures and other trouble in the relevant markets. The SEC proffered testimony from individual customers who said they had *not* read the publicly available materials, but had received misstatements from their brokers directly. The district court had granted Morgan Keegan summary judgment on the basis of a lack of materiality, holding that "the SEC must do more than show a few isolated instances of alleged broker misconduct to obtain the relief it seeks."

The Eleventh Circuit reversed, noting that under U.S. Supreme Court case law, a misstatement or omission is material if there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having altered the "total mix" of information available. Applying this test to the one-on-one alleged misrepresentations at issue, the appellate court ruled that the lower court erred in finding no materiality as a matter of law. The private communications were part of the total mix: "In other words, the materiality test requires the court to consider *all* the information available to the hypothetical reasonable investor, which necessarily includes private communications," the court said.

MISREPRESENTATIONS

Delaware Federal Court Dismisses Claims Against Bank for Failure to Plead Any Misrepresentations

***In re Wilmington Trust Sec. Litig.*, No. 10-990 (D. Del. Mar. 29, 2012)**

Judge Sue L. Robinson of the U.S. District Court for the District of Delaware dismissed claims that a bank violated Section 10(b) of the Securities Exchange Act and Sections 11 and 12(a)(2) of the Securities Act, because the plaintiffs did not adequately plead any misrepresentations. The plaintiffs' complaint listed numerous alleged misstatements and purported misconduct, but it failed to tie the statements and conduct together. In addition, the alleged misstatements consisted only of a series of quotes, without any documentation or context. Because the plaintiffs did not explain why each statement was false or misleading, they did not satisfy either the PSLRA's heightened pleading standards or state claims under the Securities Act.

MORTGAGE-BACKED SECURITIES

Seventh Circuit Affirms Dismissal of MBS Securities Fraud Action

***Fulton Cnty. Emps. Ret. Sys. v. MGIC Inv. Corp.*, No. 11-1080 (7th Cir. Apr. 12, 2012)**

The U.S. Court of Appeals for the Seventh Circuit upheld the dismissal of a putative securities class action against mortgage insurer MGIC Investment Corp., holding that the plaintiffs failed to plead fraud in connection with statements made about the financial health of an MGIC affiliate prior to the subprime mortgage crisis. The plaintiffs filed four class action suits under the Securities Exchange Act related to the steep fall in the price of MGIC securities after it announced that its investment in affiliate C-BASS (Credit-Based Asset Servicing and Securitization LLC) was materially impaired. These suits were consolidated in Wisconsin federal court, where the judge concluded that the consolidated complaint failed to meet the requirements of the PSLRA and subsequently denied leave to amend the complaint. One plaintiff appealed a claim related to alleged fraud that occurred in connection with an MGIC earnings call in which MGIC stated that C-BASS had "substantial liquidity" to meet margin calls. The plaintiff argued that certain statements made by C-BASS's executives during this call were fraudulent and that MGIC was either vicariously or directly liable for these statements.

On appeal, the Seventh Circuit affirmed dismissal of the action, holding that "the 'substantial liquidity' statement was true, both absolutely," because C-BASS at the time held cash reserves of $150 million, "and relative to the needs of C-BASS's business." As a result, the plaintiff "flunked the PSLRA's requirement for pleading *scienter*" because MGIC could plausibly argue that its reserves were adequate without raising an inference of fraud. The court further noted that MGIC made this statement in the context of warning that C-BASS's reserves might be insufficient, and that "MGIC had no duty to foresee the future" collapse of the subprime mortgage market. The Seventh Circuit also rejected the plaintiff's claim that MGIC was vicariously liable for statements made by C-BASS executives under Section 20(a) of the Securities Exchange Act. Although MGIC owned 46 percent of C-BASS shares, another 46 percent was owned by a separate entity, with the remaining 8 percent owned by C-BASS managers. Thus, MGIC could not control C-BASS without the assent of a third party. Finally, the court rejected the plaintiff's attempt to hold MGIC managers directly liable for the statements of C-BASS under Section 10(b) and Rule 10b-5. The plaintiff's argument that MGIC had a "duty to correct" erroneous statements made by C-BASS executives conflicted with the central holding of *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011), in which the U.S. Supreme Court determined that only the person with ultimate authority over the language is the "maker" of a statement under Section 10(b).

SDNY Partially Grants Summary Judgment in Favor of CDO Insurer

Syncora Guarantee Inc. v. EMC Mortg. Corp., No. 09 Civ. 3106 (PAC) (S.D.N.Y. June 19, 2012)

Judge Paul A. Crotty of the U.S. District Court for the Southern District of New York partially granted summary judgment in favor of a collateralized debt obligation (CDO) insurer and against the mortgage servicer EMC Mortgage on claims that the mortgage servicer allegedly breached the representations and warranties in the mortgage loan purchase agreement. Those representations and warranties covered both transaction-level warranties (including about EMC Mortgage's operations) and loan-level warranties (*e.g.*, about the mortgage underwriting and servicing process). The court reasoned that the agreement did not require that the insurer be injured by any breaches of the representations or warranties, and therefore that the insurer was not required to prove that any of the alleged breaches actually injured it. In addition, looking to New York Insurance Law Section 3106(b), the court concluded that the insurer only needed to prove that the alleged breaches of the representations and warranties increased the insurer's risk of loss.

PSLRA DISCOVERY STAY

Pennsylvania Federal Court Denies Motion to Lift PSLRA Automatic Discovery Stay for Failure to Show Undue Prejudice

Dipple v. Odell, No. 12-1415 (E.D. Pa. May 2, 2012)

Judge William H. Yohn Jr. of the U.S. District Court for the Eastern District of Pennsylvania denied a motion to lift the PSLRA automatic discovery stay because the plaintiffs did not show it was necessary to avoid undue prejudice. The plaintiffs alleged that an automotive repair company had made false and misleading statements in its proxy statement in connection with a proposed transaction that would take the company private. The court determined that the PSLRA automatic stay applied to individual actions as well as proposed class actions, and that the plaintiffs were required to show both particularized discovery specific to the claims asserted and undue prejudice before the court could lift the stay. The court ruled that some of the plaintiffs' discovery requests were particularized, but the plaintiffs failed to show undue prejudice. The plaintiffs' inability to review documents prior to a shareholder vote on the transaction was not undue prejudice because it was inherent in the effects of the stay, and the plaintiffs could still receive damages as a remedy. In addition, although the stay might put the plaintiffs at a disadvantage compared to parallel state court litigation (which the plaintiffs withdrew from in order to press similar claims in federal court), where discovery was ongoing, that did not amount to "undue prejudice" because it was a result of the plaintiffs' own strategic choice of forum and of Congress' decision that actions subject to the PSLRA should be treated differently than other actions.

SCIENTER

First Circuit Affirms Dismissal of Claims Related to Alleged Misrepresentation of the Significance of an Order Backlog

Auto. Indus. Pension Trust Fund v. Textron Inc., No. 11-2106 (1st Cir. June 7, 2012)

The U.S. Court of Appeals for the First Circuit (with retired Associate Justice David Souter on the three-judge panel) affirmed the dismissal of claims that Textron violated Section 10(b) of the Securities Exchange Act by allegedly misrepresenting the significance of a backlog of orders for planes sold by a Textron subsidiary. Although the district court dismissed the complaint on materiality grounds, the First Circuit affirmed on the ground that the plaintiff did not plead facts justifying a reasonable inference of scienter. Specifically, the complaint failed to plead a compelling inference that Textron's officers believed or were recklessly unaware that the backlog's significance had been undermined. Further, although the individual defendants sold some stock during the putative class period, the complaint did not explain that those sales were unusual (*e.g.*, by comparison to sales outside of the putative class period) and therefore the fact of the sales did not contribute to a finding that the plaintiffs had pled a compelling inference of scienter.

Seventh Circuit Affirms Dismissal of Zimmer Hip Implant Securities Suit

Plumbers & Pipefitters Local Union 719 Pension Fund v. Zimmer Holdings, Inc., No. 11-1471 (7th Cir. May 21, 2012)

The U.S. Court of Appeals for the Seventh Circuit upheld the dismissal of a putative class action regarding statements made by Zimmer Holdings Inc. about an allegedly faulty hip implant, holding that the plaintiffs failed to adequately plead fraud. The plaintiffs filed suit claiming that, in 2008, Zimmer and its top executives made false statements about the high failure rate one surgeon experienced with a hip implant product called the Durom Cup. The plaintiffs further claimed that Zimmer downplayed the significance of quality control problems at one of its plants. The district court dismissed the complaint, finding that it failed to meet the heightened pleading requirements of the PSLRA. On appeal, the Seventh

Circuit affirmed the dismissal of the action. The court held that scienter could not be inferred under the circumstances, because the plaintiffs could not prove that Zimmer's explanation—that the surgeon's high rate of failure was due to improper surgical technique—was false, let alone knowingly false. The court further determined that Zimmer did not mislead the market when it failed to disclose certain quality control problems at one of its plants, as it had no duty to disclose every problem. Moreover, the plaintiffs' contention that one could infer scienter because Zimmer managers had financial incentives to make the company appear profitable was too generic an allegation, since a similar assertion could be made about any company.

SEC ENFORCEMENT

District of Columbia Circuit Vacates SEC Default Order for Failure to Apply Rule Consistently

***Rapoport v. Sec. & Exch. Comm'n,* No. 11-1082 (D.C. Cir. June 19, 2012)**

The U.S. Court of Appeals for the District of Columbia Circuit vacated an SEC default order and remanded because the SEC failed in this instance to apply a rule allowing it to set aside default orders for good cause consistently with prior SEC precedent. The SEC had denied the petitioner's motion under Rule 155(b) to set aside a default judgment because the petitioner did not make his motion within a reasonable amount of time and his reasons for failing to defend against the claims lacked merit. The court determined that the SEC's refusal to consider the petitioner's proposed defenses (a third requirement of Rule 155(b)) was not consistent with the SEC's previous application of the rule, and so was arbitrary. The SEC also made a "vague and indecisive" interpretation of what constituted a "reasonable" amount of time to move to vacate a default order. It stated multiple different dates from which to begin calculating what constitutes a "reasonable" time, and it did not state with clarity what amount of time would be considered unreasonable. In addition, the court held that the SEC had not supported its imposition of second-tier penalties on the petitioner because it did not parse the alleged violations committed by the petitioner and his company, and its allegations that the petitioner "willfully" violated Section 15(a) of the Securities Exchange Act were too conclusory to justify imposing second-tier penalties.

Eleventh Circuit Overturns Injunction Ordering Defendant to Comply With Certain Sections of the Exchange Act

***Sec. & Exch. Comm'n v. Goble*, No. 11-12059 (11th Cir. May 29, 2012)**

The U.S. Court of Appeals for the Eleventh Circuit overturned an injunction ordering defendant Richard Goble not to violate the terms of Sections 15(c)(3) and 17(a) of the Securities Exchange Act. The SEC had successfully brought an enforcement action against Goble based on his alleged orchestration of a scheme to manipulate the amount of reserves his company was required to keep to protect customer assets. Goble appealed. The SEC's claim against Goble for aiding and abetting withstood review, but he also challenged the injunctive remedy issued by the district court as constituting an impermissible "obey-the-law" injunction, *i.e.*, an injunctive order that does nothing but tell the defendant to follow the dictates of a statute.

The injunction against Goble merely cross-referenced the language of the applicable statutes and regulations and ordered him not to disobey. The appellate court explained that under the Federal Rules of Civil Procedure an injunction must contain enough specificity that the subject can understand what he must do to avoid contempt by looking at the four corners of the injunction. Although other courts had given the SEC leeway in crafting relatively broad injunctions, in this instance, the bare language of the relevant securities laws could not deliver the requisite specificity, given the complexity of those laws and interpreting precedent from the courts. The court said, "[A] defendant reading the injunction would have little guidance on how to conform his conduct to the terms of the injunction. Indeed, that defendant would need to review hundreds of pages of the Federal Reporters, law reviews, and treatises before he could begin to grasp the conduct proscribed[.]" The court remanded with instructions to draft an injunction that specified what Goble must not do.

SECURITIES ACT CLAIMS

Second Circuit Vacates Denial of Leave to Amend Complaint Relating to Manufacturer's Alleged Failure to Disclose Known Defects in Its Semiconductor Chip

***Panther Partners Inc. v. Ikanos Commc'ns, Inc.*, No. 11-63-cv (2d Cir. May 25, 2012)**

The U.S. Court of Appeals for the Second Circuit vacated a denial of a putative lead plaintiff's leave to amend its complaint alleging violations of Sections 11 and 12(a)(2) of the Securities Act. The proposed amended complaint alleged that a manufacturer and various of its officers, directors and underwriters violated Sections 11 and 12(a)(2) by allegedly failing to disclose known defects in the manufacturer's semiconductor chip. The complaint plausibly pleaded facts suggesting that the defendants knew that a large quantity of the manufacturer's semiconductor chips sold to its largest customers were defective. If true, the manufacturer had an affirmative duty to disclose these facts under Item 303 of SEC Regulation S-K, which requires the disclosure of "known uncertainties" that could materially impact revenues. Although the manufacturer did not know the actual defect rate at the time of its offering and had not yet issued a product recall, the court held that, like the materiality standard articulated in *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011), Item 303's disclosure obligations regarding "uncertainty" do not turn on purely quantitative inquiries. Rather, the court held that a plausible inference arose from the allegations that, "at a time when it was receiving an increasing number of calls from these customers and its Board of Directors was discussing the issue, Ikanos was aware of the 'uncertainty' that it might have to accept returns of a substantial volume, if not all, of the chips it had delivered to its major customers. It goes without saying that such 'known uncertainties' could materially impact revenues."

On Motion to Reconsider, SDNY Dismisses Claims Against GE

In re Gen. Elec. Co. Sec. Litig., No. 09 Civ. 1951 (DLC) (S.D.N.Y. Apr. 18, 2012)

On a motion to reconsider, Judge Denise Cote of the U.S. District Court for the Southern District of New York dismissed claims that GE and its underwriters violated Sections 11 and 12(a)(2) of the Securities Act in GE's offering documents for a public stock offering because the plaintiffs did not allege any actionable misstatements or omissions. The court's earlier opinion had erroneously relied on statements in a GE Form 8-K that had not been incorporated into offering documents. In addition, GE's statements in its Form 10-Ks, although incorporated into the offering documents, were superseded by subsequent statements included in the offering's prospectus. Statements by GE's CEO that GE could continue to meet its commercial paper needs were not actionable because the complaint did not allege that the CEO knew the statements were false when made. Although the plaintiffs adequately alleged that GE overvalued its assets in violation of GAAP, these alleged misstatements were not actionable because the plaintiffs did not allege how much the valuation was inflated, and so they did not adequately allege materiality. But the court upheld claims that GE violated Section 10(b) of the Securities Exchange Act because, although the alleged misstatements were opinions, the plaintiffs adequately alleged that GE's CFO knew the alleged misstatements were false when he made them.

SECURITIES FRAUD PLEADING STANDARDS

Second Circuit Affirms Dismissal of Claims That CBS Improperly Delayed Impairment Testing of Its Intangible Assets

City of Omaha, Neb. Civilian Emps.' Ret. Sys. v. CBS Corp., No. 11-2575-cv (2d Cir. May 10, 2012)

The U.S. Court of Appeals for the Second Circuit affirmed the dismissal of claims that CBS allegedly violated Section 10(b) of the Securities Exchange Act by improperly delaying impairment testing of CBS's intangible assets (such as goodwill). The court had previously held, in *Fait v. Regions Financial Corp.*, 655 F.3d 105 (2d Cir. 2011), that statements regarding estimates of goodwill are statements of opinion. Although *Fait* involved claims under Sections 11 and 12 of the Securities Act, the court extended that holding to Section 10(b) claims, because all such claims shared a material misstatement or omission element. Under *Fait*, plaintiffs must allege that defendants were aware of facts that should have resulted in earlier impairment testing *and* that defendants did not believe the statements regarding goodwill at the time those statements were made. These plaintiffs did not adequately allege that CBS knew that conducting impairment testing would reveal that it had overvalued its goodwill. The plaintiffs also failed to allege that CBS did not believe that its goodwill valuations, which are statements of opinion, were overvalued. Finally, the plaintiffs failed to allege that CBS's price was inflated, because all of the purported "red flags" the plaintiffs pointed to were public knowledge, and it was publicly known that CBS had not conducted an impairment test since before the appearance of those red flags.

Massachusetts Federal Court Dismisses Claims Relating to Allegedly Misleading Statements About Cancer Treatment Drug

Urman v. Novelos Therapeutics, Inc., No. 10-10394-NMG (D. Mass. June 11, 2012)

Judge Nathaniel M. Gorton of the U.S. District Court for the District of Massachusetts dismissed claims that Novelos violated Section 10(b) of the Securities Exchange Act by allegedly making overly optimistic statements during the clinical trial of its cancer treatment drug. The plaintiffs alleged that Novelos had no basis for making the statements, which relied on the drug's success in previous phases of the trial, because Novelos had allegedly made material changes to the drug between phases. The court determined that the plaintiffs failed to show scienter because it was implausible that Novelos would knowingly make fundamental changes to the drug when it had been successful in previous trial phases. Also, on 16 occasions in its prior SEC filings, Novelos had made statements similar to those now alleged to be misleading, making it doubtful that the alleged misstatement caused its stock to be artificially inflated only due to the latest disclosure.

STATUTES OF REPOSE

SDNY Determines Claims Brought by the FHFA on Behalf of Fannie Mae and Freddie Mac Were Not Barred by Section 13's Statute of Repose

Fed. Hous. Fin. Agency v. UBS Ams., Inc., No. 11 Civ. 5201 (DLC) (S.D.N.Y. June 26, 2012)

Judge Denise Cote of the U.S. District Court for the Southern District of New York determined that claims brought by the Federal Housing Finance Agency on behalf of Fannie Mae and Freddie Mac were not barred by the three-year statute of repose in Section 13 of the Securities Act. Section 13's statute of repose is triggered when there is a bona fide public offering of the securities in question. Although the securities were marketed pursuant to shelf registrations that became effective more than three years before the agency took Fannie Mae and Freddie Mac into receivership, this was not a bona fide public offering, because later updates to the shelf registration resulted in a fundamental change to the registration statement.

Texas Federal Court Limits Equitable Tolling From Order Vacating Class Certification

***Hall v. Variable Annuity Life Ins. Co.*, No. H-11-3639 (S.D. Tex. May 31, 2012)**

Judge Sim Lake of the U.S. District Court for the Southern District of Texas concluded that equitable tolling ceased on the date a court vacated a class certification order. The plaintiffs contended that claims were tolled past the court order vacating certification because the order did not amount to a denial of certification. According to the plaintiffs, the court never issued a final judgment on class certification.

The court concluded that equitable tolling did not apply past the order vacating class certification and dismissed the purported class action. Because the plaintiffs' claim would be barred even if the repose period were tolled, the court assumed, without deciding, that the statute of repose was subject to tolling under *American Pipe & Construction Co. v. Utah*, 414 U.S. 538 (1974). Under *American Pipe*, the initiation of the class action suspended the statute of repose. The tolling ended, however, when class certification was denied. Thus, the issue before the district court was whether the order vacating certification amounted to a denial of certification. In reaching the decision, the court noted that the court used the label "vacated" but made it clear that the case would not proceed as a class action. The plaintiffs could not prove a classwide measure of damages because their witnesses had been struck. In short, the court determined that class certification was no longer appropriate. Accordingly, the court concluded that the order vacating class certification functioned as a denial of certification and any tolling ceased on the date of that order.

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Lender Beware: Eleventh Circuit Court of Appeals Allows TOUSA Decision to Stand

By Alan R. Lepene, William H. Schrag, John F. Isbell, and Andrew L. Turscak, Jr.

On July 23, 2012, the Eleventh Circuit Court of Appeals slammed the door shut on the controversial TOUSA decision, when it denied a petition for *en banc* review by the full appellate court. With that denial, the Court of Appeals closed one chapter in the TOUSA litigation, but another one may be about to be opened.

TOUSA Background

In October 2009, the court overseeing the TOUSA, Inc. bankruptcy cases in the Southern District of Florida (the "Bankruptcy Court") set off considerable alarm bells throughout the lending community when it unraveled a refinancing transaction as a fraudulent conveyance based upon, in primary part, the fact that certain subsidiaries of TOUSA, Inc. pledged their assets as collateral for a new loan that was used to repay prior debt on which the subsidiaries were not liable and that was not secured by those subsidiaries' assets. The Bankruptcy Court's pronouncement required the disgorgement of more than $403 million in payments received by the prior lenders, and the avoidance of liens encumbering the subsidiaries' assets that were given to the take-out lenders. On February 11, 2011, the lending community obtained short-term relief from this decision when the District Court for the Southern District of Florida (the "District Court") reversed the Bankruptcy Court's holdings that (a) the TOUSA subsidiaries had not received reasonably equivalent value when they pledged their assets to the new lenders and (b) the prior lenders were entities "for whose benefit" the liens were conveyed. As of May 15, 2012, however, lenders could no longer rest easy, as the Eleventh Circuit Court of Appeals (the "Court of Appeals") reversed the District Court and reinstated the Bankruptcy Court's holdings on reasonably equivalent value and on the liability of the prior lenders, while remanding to the District Court for further proceedings regarding the propriety of the remedies and damages awarded by the Bankruptcy Court. On July 23, 2012, the Court of Appeals denied a petition for another review by the full appellate court, introducing the prospect of a potential further appeal to the United States Supreme Court.

The TOUSA Bankruptcy Cases

TOUSA, Inc., together with its numerous affiliates and subsidiaries (collectively, "Tousa"), was a large regional residential developer and builder. In July 2007, Tousa entered into a financing arrangement with a group of lenders (the "New Lenders") for the purpose of funding a litigation settlement with another group of lenders (the "Transeastern Lenders") that had previously provided separate financing for a failed joint venture involving certain Tousa entities.

Under the new financing, a number of Tousa subsidiaries (the "Conveying Subsidiaries"), which were not parties to the loans with the Transeastern Lenders, were named as borrowers on the New Lenders' loans. The Conveying Subsidiaries granted security interests and liens on certain of their assets as security for the new financing, and the settlement payment to the Transeastern Lenders was funded.

Not long after entering into the new lending arrangement with the New Lenders, the housing market in Florida (and elsewhere) took a decided turn for the worse (an "economic Pearl Harbor," according to one media report cited in the District Court opinion), freezing credit markets and drying up the pool of home buyers, which, in turn, doomed Tousa.

Tousa filed for bankruptcy protection in January 2008. Shortly thereafter, an official committee of unsecured creditors (the "Committee") was appointed, and in July 2008, the Committee brought a lawsuit on behalf of Tousa's bankruptcy estate against a number of prepetition secured creditors of Tousa, seeking, among other things, avoidance and recovery of substantial prepetition payments and lien interests under preference and fraudulent transfer theories. Included in the action were claims brought on behalf of the Conveying Subsidiaries against the Transeastern Lenders and the New Lenders for avoidance of alleged fraudulent transfers under 11 U.S.C. § 548 (the "Bankruptcy Code"), as a result of the 2007 financing and settlement payments.

"Tousa 1"[1]

In its complaint, the Committee alleged that the July 2007 transaction, including the settlement payment to the Transeastern Lenders, was an avoidable fraudulent transfer because the Conveying Subsidiaries were rendered insolvent as a result of the transaction and they did not receive "reasonably equivalent value" in return.

After a 13-day bench trial involving nearly two dozen witnesses and thousands of trial exhibits, the Bankruptcy Court issued a 182-page opinion, in which it held in favor of the Committee on all claims. Specifically, the Bankruptcy Court, among other things, avoided the obligations incurred by the Conveying Subsidiaries to the New Lenders (and the liens securing those obligations) as a fraudulent transfer, ordered the Transeastern Lenders to disgorge the majority of the settlement payment (approximately $403 million) received by the Transeastern Lenders, and ordered that damages, including the transaction costs for securing the new financing, the attorneys' fees and costs in seeking to unwind the transaction, and an amount equal to the decrease in value of the liens that were granted to the New Lenders (*i.e.*, the decrease in value of the assets), be paid from the disgorged funds prior to any of those funds being returned to the New Lenders.

"Tousa 2"[2]

In a harshly critical opinion, the District Court reversed the Bankruptcy Court's decision as to the Transeastern Lenders, holding that the transfers to the Transeastern Lenders were not avoidable under Bankruptcy Code section 548 and related provisions. First, the District Court held that the payment sought to be avoided was not a transfer of property of the Conveying Subsidiaries; thus, an essential element of Bankruptcy Code section 548 could not be met. Instead, the proceeds of the new loans were property of the parent. Moreover, with respect to the alleged fraudulent transfers arising from the granting of liens in the Conveying Subsidiaries' assets, the District Court held that the Conveying Subsidiaries received reasonably equivalent value in return by way of corresponding direct and indirect benefits in the form of averting defaults under other obligations[3] and a likely bankruptcy, as well as substantial tax benefits and an opportunity to rehabilitate their businesses. The District Court neither accepted nor rejected the Bankruptcy Court's finding that the Conveying Subsidiaries were insolvent at the time of the transaction.

"Tousa 3"[4]

After losing at the District Court, the Committee appealed to the Court of Appeals. In its decision, the Court of Appeals reversed the District Court and affirmed the Bankruptcy Court's finding that the Conveying Subsidiaries received less than reasonably equivalent value when they granted liens in their assets. Further, the Court of Appeals found that the Transeastern Lenders were entities "for whose benefit" the liens were transferred in affirming the liability of the Transeastern Lenders.

In arguing that they were not the entity "for whose benefit" the transfers were made, the Transeastern Lenders maintained that such a ruling would impose "extraordinary" duties of due diligence on the part of all creditors accepting repayments, as any funds could conceivably be received by the debtor in the first instance as a result of a fraudulent conveyance. In addressing this concern, and using language that will undoubtedly be quoted in future lender liability litigation, the Eleventh Circuit stated: "But every creditor must exercise some diligence when receiving payment from a struggling debtor. It is far from a drastic obligation to expect some diligence from a creditor when it is being repaid hundreds of millions of dollars by someone other than its debtor."[5]

The Court of Appeals remanded to the District Court for further proceedings regarding the propriety of the remedies and damages awarded by the Bankruptcy Court. The liability of the New Lenders was not decided in this appeal. As mentioned, the Court of Appeals thereafter denied a petition for *en banc* review by the full Eleventh Circuit Court of Appeals.

The Broader Implications of Tousa 3: What Does the Future Hold?

Tousa 3 involved one subset of appeals arising out of multi-faceted transactions involving numerous borrower, guarantor and lender parties, and the case was replete with factual and legal intricacies and complexities. As such, its holding is, for now, limited to the precise transaction and factual findings as upheld by one circuit court of appeals. Nonetheless, the reverberations of *Tousa 3* may be substantial and the implications far-reaching.

For starters, the *Tousa 3* opinion directly undermines the common practice of subsidiaries incurring obligations for the benefit of their parents, which practice is premised, in part, on the theory that the total enterprise benefits from the obligations incurred by the individual members of the enterprise. Ultimately, it is likely that counsel for borrowers and guarantors will seek to exploit this holding further, by attempting to use this decision to limit the liability of other affiliated corporate borrowers (*i.e.*, parent and sister companies) and guarantors that do not directly receive benefits from financings.

Further, it is likely that *Tousa 3* will be used to expand the scope of fraudulent conveyance litigation to include additional creditors as entities "for whose benefit" a transfer is made, as "every creditor must exercise some diligence when receiving payment from a struggling debtor."[6]

Further ramifications will be felt if the Bankruptcy Court is ultimately affirmed by the District Court on the broad range of remedies that it ordered, including, among other things, the disgorgement of the funds paid to the Transeastern Lenders, the award of damages that allowed the Committee to retain from the disgorged funds the transaction costs of entering into the financing, the costs and attorneys' fees incurred in pursuing the fraudulent conveyance claim, and the diminution in the value of the liens for the period between the transaction closing date of July 31, 2007, and October 13, 2009. Under the Bankruptcy Court's ruling, all of these costs and damages would be paid prior to the return of the remaining disgorged funds to the New Lenders.

Given the broad and far reaching implications of *Tousa 3*, it is possible the Transeastern Lenders will file a petition for a writ of *certiorari* with the United States Supreme Court. While only a small percentage of such petitions are typically granted, *Tousa 3* involves issues that could set it apart from other cases—among them the fact that *Tousa 3* arguably represents a departure from fraudulent transfer doctrine established in a number of other circuits—potentially making it an attractive candidate for high court review.[7]

The Transeastern Lenders still have time to consider whether to appeal to the nation's highest court. Whether they will do so and whether the important issues highlighted by *Tousa 3* will gain traction in further proceedings in the Supreme Court remains to be seen.

Until there is further clarity on all these issues, lenders will need to be guarded with respect to transactions that involve facts similar to those present in the Tousa case.

Endnotes

1. Official Committee of Unsecured Creditors of Tousa, Inc. v. Citicorp North America, Inc. (*In re* Tousa, Inc.), 422 B.R. 783 (Bankr. S.D. Fla. 2009).
2. 3V Capital Master Fund Ltd. v. Official Committee of Unsecured Creditors of Tousa, Inc. (*In re* Tousa, Inc.), 444 B.R. 613 (S.D. Fla. 2011).
3. Tousa's operations were financed in large part by issuances of unsecured bond indebtedness and a revolving credit facility, under which most of the numerous Tousa entities were jointly and severally liable as borrowers, pledgors and / or guarantors. According to testimony at trial, had TOUSA, Inc. not settled with the Transeastern Lenders, defaults might have been triggered under the bonds and / or credit facility.
4. Senior Transeastern Lenders v. Official Committee of Unsecured Creditors (*In re* Tousa, Inc.), 680 F.3d 1298 (11th Cir. 2012).
5. *Id.* at 39.
6. *Id.*
7. Another interesting issue not addressed by the Eleventh Circuit is the propriety of the standard of review applied by the Court of Appeals panel in light of the Supreme Court's recent decision in *Stern v. Marshall*, which, like *Tousa 3*, has generated a considerable amount of controversy in its own right. *Stern v. Marshall* concerns limits on the constitutional power of bankruptcy judges to enter final orders in non-core proceedings (*i.e.*, proceedings not integrally related to the restructuring of debtor-creditor relationships). Stern v. Marshall, 131 S. Ct. 2594 (2011). The standard of review employed by the Eleventh Circuit panel in *Tousa 3* was whether the Bankruptcy Court's findings of fact were clearly erroneous; applying this deferential standard, the Court of Appeals concluded that the Bankruptcy Court's findings of fact were not clearly erroneous and thus affirmed the Bankruptcy Court's holding that the lenders were liable. In their petition for rehearing *en banc*, the Transeastern Lenders argued that under *Stern*, fraudulent transfer claims are non-core proceedings for which bankruptcy courts lack constitutional authority to enter final orders (*i.e.*, they only may issue proposed findings of fact and conclusions of law, subject to *de novo* review by the district court); consequently, in light of *Stern*, it was the District Court's opinion that was entitled to deference, not the Bankruptcy Court's. If, under *Stern*, the action should have been treated as a non-core proceeding, as asserted by the Transeastern Lenders, the appropriate standard of review would have been for the Court of Appeals to have determined if the District Court's findings of fact in favor of the lenders were clearly erroneous (or to remand to the District Court to make such findings of fact). Had that standard of review been employed in *Tousa 3*, the outcome of the case might have been altogether different.

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COMMITTEE REPORTS

From the Section Chair

I am now several months into my term as Chair of the Business Law Section, and I would like to take the opportunity to share some of the many things the Section has been doing, and mention our upcoming events.

This summer, the Business Law Section conducted a unique telephone survey to learn ways in which we might better serve the business law community. Using two paid law school students, we surveyed business lawyers who are members of the State Bar Association, but not members of the Business Law Section. The results provided valuable insight into what members and potential members are looking for in the Section. The survey also resulted in a number of much-welcomed new Section members.

In July, the Section formally introduced the "Business Law Section Blog," which provides up-to-date articles on a broad range of business topics, primarily contributed by the Section's Committees.

The Section's Fall Meeting was held at the Statler Hotel at Cornell University in Ithaca from September 14-16. Our program chair, Jay Hack, put together an excellent program featuring a range of topics, including crisis management, counsel opinion letters, liability for fraudulent electronic fund transfers, consumer financial protection and "the myth of shareholder value." In addition to a great program, we enjoyed private tours of the Johnson Museum of Art, wine tasting in the beautiful Finger Lakes and the wonderful meals and hospitality provided at the Statler. Scholarships and discounts were available to newly admitted lawyers and lawyers who had not attended in recent years. We are now in the process of planning our next major CLE program which will be held on January 23, 2013 during the NYSBA Annual Meeting at the New York Hilton.

The diversity initiative begun last year continues to be a priority for the Association and for the Section. The Section was recognized as a leader in 2011 and we hope this year to continue our successful efforts.

I am honored to chair such an important and active Section and look forward to continuing to work with all of the Section's members and committees for a successful remainder of the year.

Deborah Doxey, Esq., NYSBA BLS Chair

Banking Law Committee

At the Section's Spring Meeting in New York City, the Banking Law Committee held a well-attended meeting, featuring Jonathan Rushdoony, regional counsel of the Office of the Comptroller of the Currency ("OCC") and his colleague, James Porreca, who was formerly counsel to the Office of Thrift Supervision ("OTS"). The OTS was abolished under the Dodd-Frank reform law and its functions merged into other bank regulatory agencies, paralleling their existing responsibilities for commercial banks. Thus, the OCC, which charters and regulates national banks, took on responsibility for federally chartered thrift institutions; the FDIC, which supervises state banks, for state-chartered thrifts; and the Federal Reserve, which supervises bank holding companies, for savings and loan holding companies. Messrs. Rushdoony and Porreca discussed the progress made in transitioning the supervisory authority for federal thrift institutions to the OCC. The meeting also featured a presentation by Mark Zingale, Esq., Senior Vice President and Deputy General Counsel to The Clearing House. Mr. Zingale described the functions of The Clearing House, which represents its twenty largest bank members, and discussed the outstanding exposure draft on corporate governance practices for banking organizations. Attendees received two CLE credits.

At the Section's annual Fall Meeting at Cornell University in Ithaca, the Committee assisted in putting together a panel discussion on the role of the Consumer Financial Protection Bureau ("CFPB") created by Congress under the Dodd-Frank Wall Street Reform and Consumer Protection Act to establish uniform rules for an array of consumer financial products, such as credit cards and mortgage loans, without regard to the type of institution that issues them. Cornell Law Professor Charles Whitehead, formerly an international attorney with Citibank and other financial institutions, offered a probing and insightful analysis of how consumer financial product regulation was likely to evolve under the CFPB. Section Vice Chair Jay Hack discussed the new agency from the perspective of community banks. Of particular interest was the discussion of the CFPB's first enforcement action, against Capital One Bank, for alleged deceptive practices in marketing add-on products, such as credit insurance and credit monitoring, in conjunction with marketing its credit cards to consumers. The Bank was required to pay $140 million in restitution to customers, and an additional

$60 million in fines to the CFPB and the Bank's primary regulator, the Office of the Comptroller of the Currency.

The Committee was also addressed by Janet Nadile, Esq., of Cravath Swaine & Moore, who is coordinating the efforts of the New York City Bar Association to introduce and enact an Omnibus UCC reform bill in the New York State Legislature. Ms. Nadile explained that New York State is the only state that has failed to enact the reforms, which date back to the early 1990s. One of the principal objections to the proposal in the State legislature had related to check truncation (i.e., banks not returning the physical checks drawn on customers' accounts); this concern was effectively mooted in the early 2000s with the enactment of the federal Check 21 law. The City Bar is seeking the NYSBA's support for the legislation. At this writing, the proposal is being vetted by the NYSBA's Executive Committee (see the report of the Legislative Affairs Committee, below).

David L. Glass, Esq., Chair

Bankruptcy Law Committee

The Bankruptcy Law Committee of the Business Law Section and the NYSBA's Committee on Continuing Legal Education co-sponsored a program on Advising Distressed Businesses and Business Bankruptcy Cases, which was held in Albany on November 14, 2012 and New York City on December 13, 2012. As the new Chair of the Bankruptcy Law Committee, Kevin Newman of Syracuse co-chaired the program and moderated and spoke at the Albany site.

Kevin Newman, Esq., Chair

Corporations Law Committee

The Corporations Law Committee held its Fall Meeting in connection with the Fall Meeting of the Business Law Section. Committee chair Jeffrey Bagner of Fried, Frank, Harris, Shriver and Jacobson LLP gave a presentation on legal opinions in corporate transactions. The Committee is looking for volunteers to make presentations at future committee meetings. The next meeting of the Committee will be held in conjunction with the Annual Meeting of the NYSBA. Please contact Jeffrey Bagner (212-859-8136 or jeffrey.bagner@friedfrank.com) to volunteer to make a presentation, to provide suggestions about future topics to discuss at committee meetings, or for other information concerning committee activities.

Jeffrey Bagner, Esq., Chair

Franchise, Distribution and Licensing Law Committee

The Franchise, Distribution and Licensing Law Committee has been very active this year. The Committee continues to pursue changes to the New York Franchise Sales Act and its accompanying Regulations in order to make the Act more business friendly and consistent with the Federal Franchise Rule, which was amended in 2008. Recently, the Committee invited Joseph Punturo, the Franchise Section Chief for the New York Department of Law, to attend and present at its Committee meeting. Mr. Punturo discussed the recently promulgated Trade Show Exemption under Section 684(1) of the New York Franchise Act; procedures for applying for exemptions under the New York Franchise Act, including discretionary exemptions; and the Committee's proposed amendments to the New York Franchise Act and its accompanying Regulations in order to make the Act more business friendly and consistent with the FTC Franchise Rule. The Committee's most recent meeting included a lively presentation led by Stan Friedman, a Certified Franchise Expert and a principal with an Atlanta-based franchise consulting firm. Mr. Friedman discussed the role that outside counsel can and should play in helping its start-up and emerging franchisor clients achieve sustainable growth. Mr. Friedman shared real world experiences about the challenges that emerging franchisors encounter when taking the leap from "start-up" to "stay-up." The Committee's next meeting is scheduled for January 23, 2013 in conjunction with the NYSBA's Annual Meeting.

David W. Oppenheim, Esq., Chair

Legislative Affairs Committee

The Legislative Affairs Committee follows bills in the New York State legislature that are of particular interest to business lawyers. Its activities include meetings with legislators and other interested groups, and the submission of memoranda opposing or supporting bills. The Committee is most active during the legislative session from April to June each year. The Committee is currently reviewing a proposed Omnibus UCC Bill intended to bring the State of New York's UCC law up to date and considering whether to recommend that the Association support its passage.

Peter W. LaVigne, Esq., Chair

Public Utility Law Committee

With the publication of Gregg Sayre's January 2012 report (see Committee Reports <http://www.nysba.org/PULreports), an era has come to an end. Gregg, who had undertaken the heroic task of assembling and presenting a comprehensive report on cases affecting the utility industry in New York for as long as anyone can remember, has moved on to become a commissioner of the Public Service Commission. Although we will miss Gregg and his work for the Committee very much, we look forward to inviting him to address the Committee as Commissioner Sayre in the near future.

The Public Utility Law Committee is in the process of transitioning to a new Board and exploring topics of interest for a 14th Annual Institute on Public Utility Law likely to take place in May 2013. We anticipate that it will include a full-day continuing legal education course, with faculty from in-house corporate counsel, government agencies and leading law firms. Curricula being explored involve the latest developments in the areas of energy and telecommunication regulation and practice, perhaps with an emphasis on ethical standards expected of practitioners before the Commission.

Bruce V. Miller, Esq., Chair

Securities Regulation Committee

The Securities Regulation Committee has continued its monthly meeting programs addressing a wide range of matters of importance to securities law practitioners. Our dinner meetings tend to foster lively discussions, and afford Committee members an opportunity to discuss "hot topics" with persons closely associated with them. Since our last Committee report in the Summer 2012 journal, among the topics presented at meetings were:

1. Social Media and the Securities Lawyer: A User's Guide
2. Recent SEC Enforcement Activities and Current Initiatives
3. JOBS Act: Changes to the Capital Raising Process
4. Securities Enforcement: Insights from a Recent Former Prosecutor
5. FINRA Rules Update
6. Financial Regulatory Reform Update
7. Securities Arbitration
8. Effects of the JOBS Act on Marketing Activities of Private Investment Funds
9. Conflicts of Interest and Other Ethics Issues in Private Equity Funds
10. Capital Raising or Hair Raising: The Trials of JOBS (including an analysis of the proposed rule to eliminate general solicitation)
11. Rational Boundaries for SEC Cost-Benefit Analysis
12. CFTC & SEC Update: Clarifications to the End-User Exception to Mandatory Clearing Requirements and New Rules for Swap Participants

In addition, our Private Investment Funds Subcommittee held a meeting in April 2012, titled "Unpacking New Form PF: What You Need to Know, Now." In June 2012, we had a meeting on "SEC Adviser Examinations: Are You Ready?" At this meeting our speakers included a former Director of the SEC's Division of Investment Management and an SEC Associate Director who currently heads the National Investment Adviser / Investment Company Examination Program. The Subcommittee closely tracks developments and emerging trends in the private investment funds industry.

Furthermore, in October, the Committee submitted a comment letter to the SEC on proposed rules Eliminating the Prohibition Against General Solicitation / Advertising in Rule 506 and Rule 144A. Finally, two of our members gave a presentation called "Capital Raising or Hair Raising: The Trials of JOBS" at the Business Law Section Fall Meeting held in Ithaca, NY.

For more information about, and how to join, the Securities Regulation Committee and Private Investment Funds Subcommittee, go to the website www.nysba.org/SecuritiesRegulation or www.nysba.org/PIF. We are also on LinkedIn at www.nysba.org/SecuritiesRegulationLinkedIn or www.nysba.org/PIFLinkedIn.

Howard Dicker, Esq., Chair

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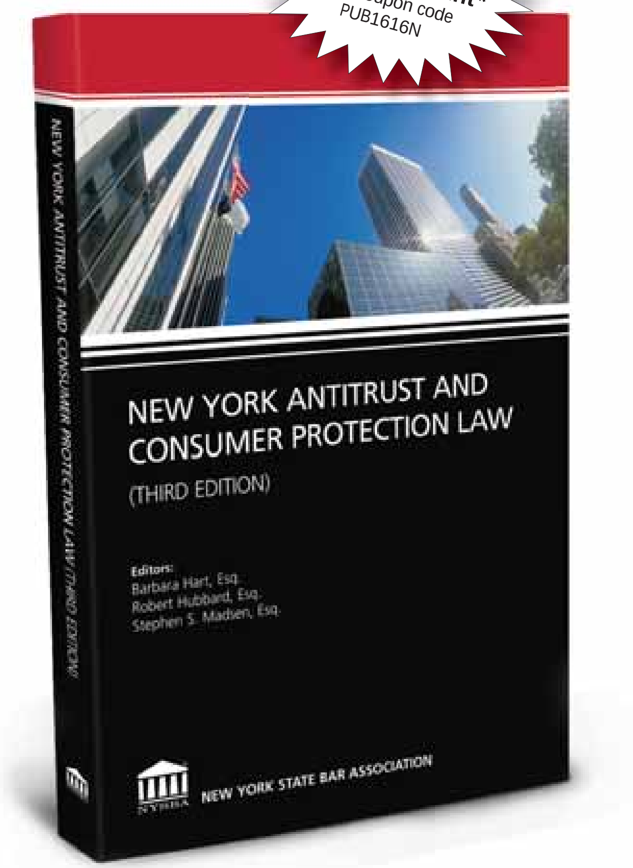

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