NYSBA SUMMER 2011 | VOL. 15 | NO. 1

NY Business Law Journal

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

Inside

NYSBA

NY BUSINESS LAW JOURNAL

Summer 2011

Vol. 15, No. 1

THE BUSINESS LAW SECTION
NEW YORK STATE BAR ASSOCIATION

in cooperation with

NEW YORK LAW SCHOOL

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

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For a significant number of business law practitioners in New York, Governor Cuomo's budget, enacted into law on March 31, is something of a game-changer. As part of the Governor's broader initiative to streamline and reduce the cost of State government by, among other things, combining eleven existing agencies into four, the budget bill included a new Financial Services Law, Chapter 18-A of the New York Consolidated Laws ("FSL"), which consolidates the New York State Banking Department and the New York State Insurance Department into a single, new Department of Financial Services ("DFS"). The DFS will be headed by a Superintendent of Financial Services appointed by the Governor with the consent of the State Senate for an indefinite term. In turn, the Superintendent will appoint deputies to head the DFS' banking division and insurance division. The financial frauds investigative units of the two existing departments will be combined into a single unit within the DFS. The effective date of the combination is October 3, 2011. In general, the substantive provisions of the existing Banking and Insurance Laws remain unchanged, and at least initially the policies, procedures and existing staffs of the two Departments will remain in place. However, the DFS's authority to investigate fraud is wider than the authority of the existing Departments.

Shortly after the Governor first announced his intention to merge the two Departments in January, at the request of NYSBA President Stephen Younger, affected Committees of the Business Law Section considered whether the Section wanted to take a position on the proposed merger. Within the Banking Committee the proposal was thoroughly debated; while some concerns were expressed, there was no strong consensus to take a stand opposing the merger (see Committee Reports, herein). Indeed, many of the initial concerns were addressed in various revisions of the first draft of the budget bill. In any event, the consolidation of these and other agencies, and the Governor's success in effecting significant changes in spending priorities through his budget, will present new challenges to business practitioners and their clients in the coming year.

As we noted in a recent issue of the *Journal*, the Federal Trade Commission ("FTC") has again been up to its usual mischief of trying to bring practicing lawyers under its jurisdiction. Following the consumer privacy provisions of the Gramm-Leach-Bliley Act of 1999, the FTC had sought to compel attorneys to provide "privacy notices" to their clients by treating them as "financial institutions." As discussed by the editor in a pair of articles in earlier issues of the *NY Business Law Journal*, a successful lawsuit brought by the NYSBA aborted that effort, with the court agreeing that the FTC's action was arbitrary, capricious and not in accordance with law (see "Are You a Dolphin? Or a Financial Institution?" NY Business Law J. Fall 2002, at 16, and "NYSBA v. FTC: The Dolphins Escape! (Or Do They?)," NY Business Law J. Fall 2004, at 25). But with the enactment of the "Red Flags Rule" under the Fair and Accurate Credit Transactions Act ("FACT Act"), which requires creditors and others to take measures to prevent identity theft of their customers, the FTC was up to its old tricks, this time attempting to define lawyers as "creditors." The agency was undeterred by an initial defeat in court, which imposed a preliminary injunction; but, as discussed in the Banking Law Committee writeup in this issue's Committee Reports, the Red Flag Program Clarification Act ("RFPCA") has redefined the term "creditor" to exclude lawyers and other professionals.

Leading off this issue is a cogent analysis of the application of Delaware law to a purported breach of fiduciary duty by the controlling shareholders of a closed corporation against a minority shareholder by Michael Martuscello, a recent graduate of New York Law School. In *eBay Domestic Holdings, Inc. v. Newmark*, a case arising from the contentious minority position held by eBay in the popular website craigslist (the defendant is Craig Newmark, founder of craigslist), eBay as the minority stockholder brought a claim for breach of fiduciary duty by Newmark and the other controlling shareholder of craigslist. The case arose after the controlling stockholders took several actions to counter competitive activity by eBay: 1) adopting a rights plan (commonly referred to as a "poison pill"); 2) implementing a staggered board; and 3) issuing stock in exchange for granting a right of first refusal to craigslist. The author argues that the Delaware Chancery Court reached the right result despite applying the wrong standard of review. In the process, he clearly elucidates the three basic tests under Delaware corporate law: the "business judgment" rule, which applies to most actions, and basically insulates directors from liability if they acted in good faith; the "intrinsic fairness" test, applied when the directors are self-interested; and the *Unocal* test, which requires a showing of compelling justification for the directors' actions under certain circumstances.

Next up is the Section's Ethics guru, Evan Stewart of Zuckerman Spaeder. In this issue, Mr. Stewart addresses "the potholes that lie in the legal highway for New York lawyers going forward, as we practice law beyond the geographic boundaries of New York State." In "Lawyers and the Border Patrol: The Challenges of Multi-Jurisdictional Practice," Mr. Stewart analyzes the approach of New York's new legal ethics rules, introduced in 2009, to the potential for the unauthorized practice of law when working on transactions that cross state or national borders. He first reviews the American Bar Association's ("ABA") Model Rules 5.5 and 8.5, which respectively provide certain temporary safe harbors for out-of-state lawyers working on a transaction and give jurisdiction to the "host" state for the out-of-state lawyer's conduct. He notes that the New York approach was basically to ignore Model Rule 5.5, while adopting a more common sense approach to the jurisdictional issue of Model Rule 8.5. Noting that Yogi Berra's dictum that "when you come to a fork in the road, take it" will not provide much useful guidance to lawyers, Mr. Stewart provides a useful and workable roadmap for practitioners to follow in multi-jurisdiction transactions.

One of the *Journal*'s ongoing features that has proved invaluable to business practitioners is the comprehensive and thorough review of pending securities-related litigation by the attorneys of Skadden Arps in New York. This issue's review covers matters ranging from auction rate and mortgage-backed securities through auditors' liability and directors' duties, insider trading, securities act enforcement, and litigation practice issues including class certification, pleading standards, statute of limitations and tolling.

While the immediacy of the financial crisis is behind us, practitioners are only beginning to deal with many aspects of its fallout. Given the role of commercial real estate ("CRE") and mortgage-backed securities ("MBS") in the financial meltdown of 2007-9, one of the perhaps predictable outcomes has been a rethinking of the financial accounting and capital rules for these transactions by the Financial Accounting Standards Board ("FASB"). In "Preferred Creditor Support for Regulated Institutions in CRE and MBS Transactions," Charles Wallshein and Craig Knutson discuss the 2010 revision of FASB Statement 166. FASB issued Statement 166 generally to clarify that a transfer of financial assets, as in a securitization, must be a true transfer in order to be recognized as such. Thus, the statement requires that a transferor recognize and initially measure at fair value all assets obtained (including a transferor's beneficial interest) and liabilities incurred as a result of a transfer of financial assets accounted for as a sale. Its intent was to prevent transfers to "qualifying special purpose entities" ("QSPEs") where the transferor actually retains significant risk. But the authors note that, as is often the case in the increasingly complex financial world, the Law of Unanticipated Consequences has reared its head—this time in the form of invalidating certain participation agreements used by smaller banks to raise capital and spread the risk of their loan portfolios. They propose a novel and innovative solution, in the form of what they call a "Preferred Creditor Transaction." Community banks and their lawyers may want to take note of the potential benefits of this approach.

The "ten ton gorilla" of the post-crisis world is, of course, the Dodd-Frank reform act enacted last year which, among other things, calls for more than 140 new rulemakings by regulatory agencies. The first wave of these rulemakings has begun. Former Section Chair Guy Lander of Carter, Ledyard & Milburn, a frequent contributor to the Journal, discusses one such rulemaking by the Securities and Exchange Commission ("SEC"). In "SEC Adopts New Rules For 'Say-On-Pay'," Mr. Lander reviews the rules made final earlier this year to implement Dodd-Frank's requirement that U.S. public companies conduct separate shareholder advisory votes on executive pay ("say on pay"), the frequency of votes on executive pay ("say on frequency"), and executive compensation in connection with merger and acquisition transactions submitted for shareholder approval (so-called "golden parachutes"). Mr. Lander's summary clearly delineates the requirements of and exceptions to each of the three rules.

Another regular *Journal* feature that benefits all business practitioners is the very useful update on federal and state employment law issues provided by James Grasso of Phillips Lytle in Buffalo. In this issue, on the federal side Mr. Grasso discusses the Equal Employment Opportunity Commission's ("EEOC") final regulations under the Genetic Information and Nondiscrimination Act ("GINA"), which define what constitutes genetic information, the restrictions on its use, and the exceptions allowing it to be obtained lawfully. On the State side, he reviews four significant developments. First, as of April 2011, New York employers must comply with the recently enacted Wage Theft Prevention Act, which requires New York employers to provide employees with notices of certain wage information, increases payroll recordkeeping requirements, increases penalties for violations, expands the Commissioner of Labor's enforcement authority and increases employee whistleblower protections. Second, he reviews the 2010 amendments to the Labor Law, Executive Law, and Workers' Compensation Law, which significantly expand the rights of domestic workers. The amendments prohibit sexual harassment or harassment based on race, gender, religion or national origin, and guarantee rest time and overtime pay. Third, he reviews the amendment to the Civil Rights Law providing bereavement leave to same-sex partners. And finally, he reviews the New York State Construction Industry Fair Play Act, which amends the Labor Law with respect to the classification of construction workers as employees or independent contractors.

Concluding this issue is a fascinating article regarding the "flash crash" of May 2010, in which computerized trading apparently caused a 1,000 point decline in the Dow Jones average in a matter of minutes. In "An Analysis of High Frequency Trading," Manny Alicandro, a candidate for the LLM degree in Financial Services Law at New York Law School, lays out a thorough and detailed explanation of how high frequency trading ("HFT") is conducted and what its implications are for the regulation of the financial markets. Noting that it is a trading technique, rather than a separate financial industry or activity, he explains that HFT constitutes extremely fast automated computer programs for creating, routing, canceling, modifying, and executing orders in electronic markets. These techniques exist to identify and exploit apparent inefficiencies in pricing financial assets. But because of their high degree of automation, they are extremely difficult to regulate effectively under the existing regulatory regime. Mr. Alicandro reviews current efforts by both the SEC and the Commodity Futures Trading Commission ("CFTC") to get a better handle on these techniques and apply regulatory tools to prevent future "flash crashes."

David L. Glass,
Editor-in-Chief

The Delaware Chancery's Harmless Application of the Wrong Standard of Review: *eBay Domestic Holdings, Inc. v. Newmark*

By Michael H. Martuscello, II

On September 9, 2010, the Delaware Chancery Court issued a decision in *eBay Domestic Holdings, Inc. v. Newmark*, a case involving a claim that the two controlling shareholders and directors of a closed corporation breached the fiduciary duties that they owed to the company's only minority stockholder. The case arose after craigslist's founder, Craig Newmark, and CEO, James Buckmaster, took three actions in their capacities as directors and controlling stockholders to counter competitive activity by eBay, which owns a minority stake in craigslist. These reactionary measures included: 1) adopting a rights plan (commonly referred to as a "poison pill"); 2) implementing a staggered board; and 3) issuing stock in exchange for granting a right of first refusal to craigslist. Chancellor Chandler found that the first and third measures constituted breaches of Buckmaster and Newmark's fiduciary duties, but the second one did not. Accordingly, the chancellor allowed the staggered board to remain in place while he rescinded both the rights plan and stock issuance deal.

Although Chancellor Chandler properly upheld the staggered board amendments while invalidating the rights plan and stock issuance scheme, his legal reasoning behind one of these decisions was flawed. When analyzing an alleged breach of fiduciary duty, the most important step for a Delaware Court is to decide which standard of judicial review to utilize: the business judgment rule, the *Unocal* test, the enhanced *Unocal* (or compelling justification) test, or the entire fairness test. Chandler correctly applied the *Unocal* standard to the rights plan because poison pills are defensive measures that recurrently receive such treatment. Since Buckmaster and Newmark stood on both sides of the transaction in the stock issuance deal and thus, were self-interested directors, Chandler rightly employed entire fairness review to judge that issue. However, the chancellor erred by analyzing the implementation of a staggered board under the business judgment rule. Because Buckmaster and Newmark interfered with eBay's ability to elect a third director by putting the staggered board in place, Chandler should have applied the compelling justification test instead. The implementation of the staggered board would still have been upheld under that test. Since preventing eBay from gaining a board member was the only way to ensure that eBay would not access sensitive inside information, which would be used to compete with craigslist for a larger share of the U.S. market in online classified ads, the defendant directors had a compelling justification. Thus, in the end, the effect of Chancellor Chandler's decision seems equitable though the reasoning behind it appears legally flawed.

I. Fiduciary Duties under Delaware Law

Under Delaware law, the board of directors "has the ultimate responsibility for managing the business and affairs of a corporation."[1] Accordingly, board members owe fiduciary duties of care and loyalty to both the corporation and its minority stockholders.[2] The duty of care requires directors "to inform [themselves] in preparation for a decision…and to proceed with a critical eye in assessing"[3] whether to take a particular action. The duty of loyalty "mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally."[4]

Controlling stockholders also have a fiduciary obligation of loyalty to the company and other stockholders.[5] Even when stockholders individually own less than a majority of shares, Delaware courts have considered them to be fiduciaries when they dominate corporate decision-making by forming a control group to work towards a common goal.[6] Because controlling stockholders and directors are fiduciaries, they must act in the best interests of the corporation and its stockholders, even when doing so would be against their own personal interests.[7]

Whenever a shareholder challenges an action that directors have taken, a court must decide which standard of review to use for analyzing the challenged behavior. Identifying the "correct analytical framework is essential to a proper judicial review of challenges to the decision-making process of a corporation's board of directors."[8] If a shareholder challenges defensive actions taken by directors in a takeover context, a court will "evaluate the board's overall response, including the justification for each contested defensive measure, and the results achieved thereby."[9] If the defensive measures are "inextricably related,"[10] a court will scrutinize such actions "collectively as a unitary response to the perceived threat."[11]

Normally, Delaware courts will presume that "in making a business decision the directors acted on an informed basis, in good faith, and in honest belief that the action taken was in the best interest of the company."[12] The party disputing the validity of the directors' action has the burden of rebutting the presumption.[13] Under this deferential standard, a court "will not substitute its judgment for that of the board if the latter's decision can be 'attributed to any rational business purpose.'"[14] But the business judgment rule only applies "when there is no evidence of 'fraud, bad faith, or self-dealing in the usual sense of personal profit or betterment' on the part of the directors."[15]

When board members are self-interested in a transaction, courts will instead apply the intrinsic fairness test.[16] Directors are considered self-interested when they stand on both sides of a transaction or receive a personal benefit that is not received by the stockholders generally.[17] Delaware courts have considered a director to be "independent only when the director's decision is based entirely on the corporate merits of the transaction and is not influenced by personal or extraneous considerations."[18] Under the entire fairness test, directors have the burden of demonstrating "to the *court's* satisfaction that the transaction was the product of both fair dealing *and* fair price."[19] While the concept of fair dealing involves "when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and stockholders were obtained," the concept of fair price "relates to the economic and financial considerations of the proposed [deal], including all relevant factors…that affect the intrinsic or inherent value of a company's stock."[20]

In addition, Delaware courts have applied a third standard—commonly known as the *Unocal* test—to actions taken by directors reacting to a hostile takeover bid because defensive measures often have the inherent effect of entrenching board members. Although directors must protect "the corporation and its owners from perceived harm whether a threat originates from third parties or other shareholders,"[21] they do not have "unbridled discretion to defeat any perceived threat by any Draconian means available."[22] When taking defensive action, board members must both "identify the proper corporate objectives served by their actions"[23] and "justify their actions as reasonable in relationship to those objectives."[24] The *Unocal* standard of review consists of two parts that must be passed before the protections of the business judgment rule can apply to a board's defensive measures: "first, a *reasonableness test,* which is satisfied by a demonstration that the board of directors had reasonable grounds for believing that a danger to corporate policy and effectiveness existed, and second, a *proportionality test,* which is satisfied by a demonstration that the board of directors' defensive response was reasonable in relation to the threat posed."[25] Directors can satisfy the reasonableness prong "by demonstrating good faith and reasonable investigation."[26] If directors show that "a defensive measure is not Draconian, because it is neither coercive nor preclusive, the proportionality review…requires the focus of enhanced judicial scrutiny to shift to the range of reasonableness."[27] To pass the proportionality prong, directors must show that the defensive actions are not "coercive in nature or force upon shareholders a management-sponsored alternative to a hostile offer."[28]

However, in cases where "the primary purpose of a board of directors' defensive measure is to interfere with or impede the effective exercise of the shareholder franchise in a contested election for directors, the board must first demonstrate a compelling justification for such action as a condition precedent to any judicial consideration of reasonableness and proportionality."[29] This means that directors must "show that their actions were reasonably necessary to advance a compelling corporate interest."[30] Delaware courts have referred to this last standard of judicial review as the compelling justification or enhanced *Unocal* test.

II. *eBay Domestic Holdings, Inc. v. Newmark*

The Delaware Chancery court held that the two directors and controlling stockholders of craigslist breached their fiduciary duties to eBay, as minority stockholder, twice: first, when they adopted a rights plan which restricted eBay's ability to purchase more shares or to sell already owned shares to a third party, and second, when they sought a right of first refusal over eBay's shares through a scheme which unreasonably diluted eBay's equity stake. The Chancery judge did not conclude, however, that craigslist's two controlling stockholders breached any duty by implementing a staggered board.

Facts and Procedural History

This case centers around a minority investment that eBay made in craigslist—a closed corporation that has never been owned by more than three stockholders. In August 2004, eBay purchased a 28.4% equity stake in craigslist from Phillip Knowlton, an early employee and stockholder who sold his shares after Newmark and Buckmaster, who both served as directors and who respectively owned 42.6% and 29% of the company's stock, adamantly refused to monetize more of their classified ads website.[31] Even though the reason that Knowlton cashed out of the company should have presaged the conflict that would eventually arise between the new and existing craigslist shareholders, Newmark and Buckmaster agreed to the sale. During the negotiations that led to the sale, eBay assured them that it would be content with only a minority interest and agreed to pay them each $8 million in exchange for certain rights to protect its investment.[32]

The parties specified the negotiated terms of eBay's investment in craigslist in two agreements: a stock purchase agreement and stockholders' agreement. The stock purchase agreement required eBay to help reincorporate craigslist, which was then domiciled in California, as a Delaware corporation by approving its new charter.[33] The new charter that eBay accepted instituted a three-person board of directors under a cumulative voting system that ensured its ability to elect one board member unilaterally.[34]

The shareholders' agreement contained many provisions that provided rights and protections to the three stockholders. First, the agreement set forth confidentiality obligations that allowed eBay to share confidential information only "for the purpose of evaluating [its] investment in [craigslist]."[35] Second, it gave eBay the right to consent to numerous corporate actions, including adverse charter amendments, changes in the amount of authorized stock, stock issuances to directors or officers, and dividend declarations.[36] Third, it provided to all stockholders both preemptive rights to "purchase enough shares in a new issuance of craigslist stock to maintain their respective ownership percentages"[37] and first-refusal rights before anyone could sell shares to a third party.[38] Lastly, the shareholders' agreement expressly reserved eBay's right to compete with craigslist in the online classified ads business, but stated consequences that would follow such competition, including the loss of all of its above-mentioned consent, preemptive, and first-refusal rights.[39] Following the triggering of these consequences, eBay would still have to maintain confidentiality but would no longer be bound to give a right of first refusal to Newmark or Buckmaster.[40] The shareholders' agreement stated that these bargained-for consequences were to be the "sole remedy for any action brought by [craigslist] against [eBay]…that may arise from or as a result of [eBay]…engaging in Competitive Activity."[41]

Besides the stock-purchase and shareholders' agreements, a third contract was also executed when eBay made its minority investment in craigslist. On the same day that eBay purchased its stake in craigslist, Newmark and Buckmaster entered into a voting agreement which required them to vote their shares "so as to elect one [] representative designated by [Buckmaster]…and one [] representative designated by [Newmark]"[42] to the board of directors. This voting agreement guaranteed that Buckmaster and Newmark would always be able to fill two out of the three board positions with their own designees—who have never been anyone but themselves.[43]

In his decision, Chancellor Chandler described the relationship between eBay and craigslist as being one of "oil and water."[44] From the start, the management of both companies clashed, as they pursued and expected different things from their relationship. Newmark and Buckmaster kept the same community-service approach to business that craigslist had followed since its founding. Believing that this strategy was key to craigslist's success, they sought not to maximize profits from the website but rather to provide a mostly free classified ad service to users that charged fees only for job and housing listings in certain cities.[45] However, the minority stockholder did not share the same altruism as the two controlling directors.[46] Concerned with "maximizing revenues, profits, and market share,"[47] eBay's management had invested in craigslist after realizing that huge potential profits could be reaped from online classified ads. Consequently, eBay found the modest income generated by the community-service approach to be unacceptable and expected the website to fully capitalize on its earning potential through a traditional wealth-maximizing business plan.[48]

Given their inherently different business models, it should have been obvious that full-blown conflict would eventually break out between the two controlling stockholders and eBay. Once eBay purchased its minority interest, its management team consistently tried to acquire complete ownership of craigslist and, along the way, sought to "combine the resources of the two companies to capitalize on international classified ad opportunities."[49] This severely irked Newmark and Buckmaster, who expected eBay to embrace their community-service corporate culture, remain content with a minority equity interest, and consider craigslist as its primary online-classified ads venture.[50] Thus, Newmark and Buckmaster refused to "go along with most of eBay's plans for craigslist, and ignored most of eBay's overtures and suggestions."[51] Since "they collectively owned the controlling block of craigslist shares and occupied two of the three board seats,"[52] craigslist continued "along its (primarily) free-listings trajectory,"[53] much to the dismay of eBay, whose only means of persuasion was one impotent board member and its contracted consent rights.[54]

As if the existing tensions were not enough, all hope of a partnership among the three shareholders was effectively eliminated when the New York Attorney General launched an investigation of craigslist in Spring 2005, due to antitrust concerns over the parts of the shareholders' agreement that penalized eBay if it competed with craigslist.[55] Although eBay responded to the investigation by explaining how the penalties were "not to dissuade eBay from competing but rather to protect craigslist's 'competitively sensitive information and its business in the event eBay becomes a competitor,'"[56] the Attorney General still issued a subpoena for craigslist's records. That subpoena dissuaded the two controlling stockholders even more from engaging eBay in the management of craigslist because they feared that such would only fuel further investigation.[57]

Since the shareholders' agreement narrowly defined competitive activity as "the business of providing an Internet posting board containing specific categories for the listing by employers and recruiters of available jobs and posting of resumes…anywhere in the United States,"[58] eBay could and did pursue international business opportunities in the online classified ad industry after acquiring its minority interest in craigslist without contractual consequence. eBay's main venture outside of craigslist was Kijiji, an online site that featured many categories, like craigslist, but displayed them in a different way.[59] The launch of Kijiji internationally in March of 2005 could not be considered competitive behavior under the shareholders' agreement because it did not enter U.S. markets. While eBay engaged in this non-consequential activity in international markets, eBay violated its confidentiality obligations under the shareholders' agreement by using non-public craigslist information, which it accessed through its minority investment and board seat, to both develop and expand Kijiji during 2005-2007.[60]

The final blow to the relationship between eBay and the two controlling stockholders came in June 2007, when Kijiji launched in the U.S. and began to compete with craigslist in the American market.[61] Soon afterwards, Buckmaster notified eBay's CEO, Meg Whitman, that "craigslist wished to 'gracefully unwind the relationship' between the two companies because craigslist was no longer comfortable with eBay's shareholding and board seat."[62] At this point, both Buckmaster and Newmark wanted eBay to divest from the company due to their discomfort with eBay being "privy to craigslist financials and other nonpublic information"[63] while it was engaging in competitive activity. Whitman responded by telling Newmark and Buckmaster that eBay was "so happy with [its] relationship with craigslist"[64] and wanted not to part ways, but rather to acquire full ownership of the company. She told them not to worry about eBay having access to craigslist's sensitive information because eBay "completely firewall[ed] off operations relating to [] Kijiji…from the corporate management of [its] investment in craigslist."[65] The controlling directors interpreted Whitman's response as not only telling them to "pound sand,"[66] but also indicating that eBay possibly misused inside information to develop Kijiji. So Newmark and Buckmaster took action to "keep eBay out of the craigslist boardroom and to limit eBay's ability to purchase additional craigslist shares."[67]

In January 2008, after previously refusing to seat eBay's choice to the third board seat that was left vacant by the resignation of its previously selected representative,[68] Buckmaster and Newmark "executed a unanimous written consent as craigslist directors and a written consent as majority stockholders"[69] that approved three actions designed supposedly to counter the threat posed by eBay. First, they adopted a rights plan that restricted eBay from not only purchasing more shares but also freely selling already owned shares to third parties.[70] Second, they instituted a staggered board that made it impossible for eBay to unilaterally elect a craigslist director.[71] Third, they issued one new share of craigslist stock in exchange for every five existing shares over which a right of first refusal was granted in the company's favor.[72] Because eBay did not grant a right of first refusal to craigslist while Newmark and Buckmaster did, the third action diluted its equity stake to 24.9%, a figure that made it (mathematically) impossible for eBay to unilaterally elect a director even if the board was not staggered.[73] In April 2008, eBay responded to the three actions by filing suit in Delaware against Newmark and Buckmaster for allegedly breaching their fiduciary duties as both directors and controlling stockholders.[74]

Chancellor Chandler's Decision

In his decision, Chancellor Chandler analyzed each of the three measures separately because he did not believe that Buckmaster and Newmark's actions constituted "an 'inextricably related' set of responses to a takeover threat"[75] by eBay. After reviewing each type of action, he determined that a different judicial standard of review should be applied to each of the board's decisions. Since poison pills "fundamentally are defensive devices that, if used correctly can enhance stockholder value but, if used incorrectly, can entrench management and deter value-maximizing bidders at the stockholders' expense,"[76] he evaluated the rights plan using the *Unocal* test. He applied the business judgment rule to the staggered board amendments because he did not consider them "in the unique circumstances of the case, as a defensive measure at all."[77] Finally, he employed the entire fairness test when determining whether the dilutive issuance of stock in exchange for the company's right of first refusal on outstanding craigslist shares violated the directors' fiduciary obligations, as Buckmaster and Newmark "st[ood] on both sides of that Action in the classic sense."[78]

Rights Plan

After noting that the *Unocal* test has "been applied universally when stockholders challenge a board's use of a rights plan as a defensive device,"[79] Chancellor Chandler chose to use enhanced scrutiny to decide whether Newmark and Buckmaster had violated their fiduciary duties to eBay by implementing their poison pill. Under that test, the chancellor addressed two issues: first, whether the directors "properly and reasonably perceive[d] a threat to craigslist's corporate policy and effectiveness"[80] and second, whether the rights plan was a "proportional response to that threat."[81]

With regards to the first issue, Chancellor Chandler concluded that Newmark and Buckmaster "did *not* adopt the Rights Plan in response to a reasonably perceived threat or for a proper corporate purpose."[82] He refused to recognize their use of a rights plan as reasonable even though the defendant directors claimed that they were using their poison pill to protect craigslist's so-called corporate culture from the threat that would come following their deaths when eBay could compel the company to depart from its "public-service mission in favor of increased monetization."[83] He explained that "promoting, protecting, or pursuing non-stockholder considerations must lead at some point to value for the stockholders."[84] Since the directors failed to show that "the craigslist culture, which rejects any attempt to further monetize its services, translates into increased profitability for stockholders,"[85] Chandler found that Buckmaster and Newmark had no need to protect it. Indeed, Chandler did not "accept as valid for the purposes of implementing the Rights Plan a corporate policy that specifically, clearly, and admittedly s[ought] *not* to maximize the economic value of a for-profit Delaware corporation for the benefit of its stockholders."[86] According to him, "directors of a for-profit Delaware corporation cannot deploy a rights plan to defend a business strategy that openly eschews stockholder wealth maximization."[87]

On the second issue, Chancellor Chandler found that the implementation of the rights plan was not a proportional response to the threat because it utterly could not serve Buckmaster and Newmark's professed goal of protecting the "the craigslist 'culture' at some point in the future unrelated to when eBay sells some or all of its shares."[88] Given that Newmark and Buckmaster already controlled craigslist and the rights plan did not affect when eBay could sell its shares, Chandler concluded that there was no reason to implement such a poison pill and therefore, it automatically failed the proportionality test.[89] After judging the directors' actions to fail both prongs of the *Unocal* test, Chancellor Chandler determined that the directors breached their fiduciary duties and, accordingly, he rescinded the entire rights plan.[90]

Staggered Board Amendments

Chancellor Chandler analyzed the staggered board amendments under the business judgment rule. Since the staggered board amendments "did not affect [Buckmaster] and [Newmark's] ability to control the board by filling two of the three director positions,"[91] Chandler concluded they "d[id] not function as a defensive device under the unique facts of this case"[92] and thus were not "subject to *Unocal* review."[93] According to him, the amendments could not be considered defensive because they did not affect the directors' control over the company. Indeed, both before and after the transaction, Buckmaster and Newmark comprised the majority of the board by occupying two of three seats and exercised complete control over craigslist.

The chancellor also considered entire fairness review to be an inappropriate standard to judge the staggered board amendments. He explained that "entire fairness review ordinarily applies in cases where a fiduciary either literally stands on both sides of the challenged transaction or where the fiduciary 'expects to derive personal financial benefit from the challenged transaction in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally.'"[94] According to the chancellor, this standard did not apply for two reasons. The first reason was that Buckmaster and Newmark "did not realize a financial benefit by approving the staggered board Amendments"[95] since they already controlled the board. The second reason was that although the staggered board amendments "had a disparate and, from eBay's point of view, unfavorable impact on eBay,"[96] their implementation could not "be classified as self-dealing because the law expressly allows majority stockholders to elect the entire board."[97] Since eBay lost its consent rights to charter amendments after it engaged in competitive activity,[98] nothing contractually precluded the directors from implementing a staggered board.

After finding that the directors "approved the staggered Board Amendments in good faith to prevent eBay, a business competitor, from having access to confidential craigslist board discussions,"[99] Chancellor Chandler applied the business judgment rule and concluded that they did not breach their fiduciary duties. In his decision, Chandler opined that "preventing a competitor that is also a minority stockholder from unilaterally placing a director on a board so that confidential corporate information w[ould] not be freely shared with that competitor [wa]s a legitimate and rational business purpose."[100] Since implementing a staggered board represented one way to accomplish this objective, Newmark and Buckmaster's behavior was "sufficiently rational to satisfy business judgment review."[101] Therefore, Chandler found no breach of a fiduciary obligation and refused to rescind the staggered board amendments.[102]

ROFR/Dilutive Issuance

Chancellor Chandler used the entire fairness test to review the directors' response that involved craigslist issuing one share of stock for every five existing shares over which a right of first refusal was granted. He did not apply the business judgment rule because its "protections only apply to transactions in which a majority of directors are disinterested and independent."[103] In this case, Newmark and Buckmaster used their positions as controlling stockholders and directors to enter into a direct deal with craigslist that would benefit them financially.[104] Therefore, the chancellor found the entire fairness test to be the appropriate standard, not the business judgment rule.

In applying the entire fairness test, Chancellor Chandler only examined whether the ROFR/Dilutive Issuance "was effectuated at a fair price."[105] The chancellor did not explore the other "fair dealing" prong of the test since the "disproportionate 'price' [wa]s sufficient, standing alone, to render the ROFR/Dilutive Issuance void."[106] The chancellor found that the transaction was not at a fair price because "it actually cost[] eBay more to grant a right of first refusal…than it cost[] [Buckmaster] or [Newmark] to do the same."[107] At the time of the transaction, eBay's shares were freely transferable while the directors' shares were encumbered with a right of first refusal that they granted to each other. Therefore, the chancellor reasoned that the price was "not fair because it require[d] eBay, the minority stockholder, to give up more value per share than either [Buckmaster] or [Newmark], the majority stockholders and directors."[108] This lost extra value came from the free transferability of eBay's shares.

Another reason that Chancellor Chandler believed the ROFR/Dilutive Issuance failed the "fair price" test is that it placed "eBay in a position where it had to make one of two choices, and either choice would harm eBay economically while benefiting [Buckmaster] and [Newmark]."[109] If eBay refrained from the deal, then its equity stake would be diluted while the directors' ownership interest would increase.[110] If eBay accepted the transaction, then it "would immediately suffer an illiquidity discount for their shares"[111] because third parties would be unwilling to bid against craigslist for shares, due to both the company's right of first refusal and the directors' inside knowledge about the company's condition.[112]

After finding that the ROFR/Dilutive Issuance was not at a fair price, Chancellor Chandler ruled that Buckmaster and Newmark "breached their fiduciary duty of loyalty by using their power as directors and controlling stockholders to implement an interested transaction that was not entirely fair to eBay, the minority stockholder."[113] Consequently, he rescinded the transaction.[114]

III. Discussion of the Chancery's Decision

Although Chancellor Chandler seemingly reached the correct conclusions regarding the validity of Buckmaster and Newmark's three actions, he arguably did not apply the right legal standard when analyzing all of them. While he soundly judged the rights plan using the *Unocal* test and the ROFR/Dilutive Issuance using the entire fairness test, he should not have applied the business judgment rule to the directors' implementation of the staggered board amendments. Instead, when deciding that issue, he should have invoked the enhanced *Unocal* standard that would require showing a compelling justification before reasonableness and proportionality could be assessed.

Rights Plan

Chancellor Chandler correctly applied the *Unocal* test to determine whether Buckmaster and Newmark violated their fiduciary duty to eBay by implementing a rights plan. The business judgment rule was not the appropriate standard by which to judge the rights plan because Newmark and Buckmaster not only had a personal interest in taking this action but also had the bad faith motivation to punish eBay for its competitive activity. Moreover, Delaware case law "is clear that *Unocal* is invoked as the result of any defensive measures taken in response to some threat to corporate policy and effectiveness which touch upon issues of control."[115] This standard seems duly appropriate given that Buckmaster and Newmark claimed that the purpose of their poison pill was to prevent eBay from gaining control of craigslist after their deaths and changing its corporate culture from one of community service to one of profit maximization.[116]

Additionally, the chancellor not only chose the right standard of review for the rights plan but also properly applied it to the facts. He correctly concluded that the implementation of the rights plan failed both the reasonableness and proportionality parts of the *Unocal* test. The adoption of the rights plan was unreasonable because it only advanced the personal interests of the directors and did not benefit eBay in any way. Although a "board may have regard for various constituencies in discharging its responsibilities,"[117] it can only do so if "there are rationally related benefits accruing to the stockholders."[118] The rights plan designed to protect craigslist's community-service culture after the death of its two controlling stockholders did not provide any benefit to eBay or any third party to whom it could sell its shares because there was no proof that the "craigslist culture, which rejects any attempt to further monetize its services, translate[d] into increased profitability for stockholders."[119] The rights plan was admittedly meant to protect primarily the interests of two current stockholders in the future, when they would be dead and no longer stockholders, and conferred no benefit whatsoever on eBay. Therefore, it was unreasonable.

The adoption of the rights plan also was not a proportional response because it did not serve the directors' professed goal of preserving the "cultural integrity of craigslist's business model."[120] Indeed, the rights plan had no effect on when eBay could sell its shares or craigslist's corporate culture could change. Even after its adoption, eBay could still sell its shares to a third party and craigslist's business model could still morph into a profit-oriented one; Chancellor Chandler properly concluded that the rights plan failed the proportionality test since the poison pill could not possibly fulfill its professed purpose.

Dilutive Issuance/ROFR

Chancellor Chandler correctly applied the entire fairness test when deciding whether Buckmaster and Newmark breached their fiduciary duty to eBay by having craigslist issue one new share of stock in exchange for every five shares of stock over which a right of first refusal was granted to the company. This was a classic example of self-interested board members standing on both sides of a transaction. Buckmaster and Newmark simultaneously authorized craigslist to enter into the deal, as directors, and accepted the offer, as shareholders. Accordingly, they had to show that the transaction met both the "fair price" and "fair dealing" prongs of the entire fairness test in order for the court to uphold their action.

By cleverly analyzing the terms of the deal, Chancellor Chandler invalidated the transaction for not being at a fair price. His determination of an unfair price seemed sound since eBay had to give up more than the controlling directors in order to receive the same benefit that they received. Requiring eBay to relinquish fully transferable shares, which were more valuable, while Newmark and Buckmaster had to give up their transfer-restricted shares, which were less valuable, did not carry the "earmarks of an arm's length bargain"[121] made for the general benefit of the shareholders. Instead, it openly appeared as a transaction to reward Newmark and Buckmaster while punishing eBay. Therefore, Chancellor Chandler correctly found that the directors breached their fiduciary duty to eBay when they forced craigslist to make a deal that disproportionately benefited their interests over those of the minority shareholder. Given that the value of their shares was not the same, it certainly was not a fair deal to offer the same exchange terms to all of the craigslist stockholders.

Staggered Board Amendments

By applying the business judgment rule to the staggered board amendments, Chancellor Chandler showed sympathy for the two controlling stockholders but exhibited faulty legal judgment. He justified his use of this deferential standard by claiming that the staggered board amendments could not be considered defensive measures. According to him, the amendments were not defensive because they did not ultimately have an effect on Buckmaster and Newmark's control over craigslist. Indeed, both before and after the amendments, the controlling stockholders possessed two board seats and complete dominion over the company. However, this deferential treatment of the amendments was peculiar given that they were implemented on the same day as the other defensive measures and thus seemed connected to them.

Chancellor Chandler should have applied the *Unocal* test. Delaware courts "must apply the *Unocal* standard of review whenever a board of directors adopts any defensive measure 'in response to some threat to corporate policy and effectiveness which touches upon issues of control.'"[122] Buckmaster and Newmark implemented a staggered board in "good faith to prevent eBay, a business competitor, from having access to confidential craigslist board discussion."[123] Such was a defensive action to counter a threat to corporate effectiveness. Indeed, craigslist could not effectively compete with a competitor that had access to its inside information. By blocking eBay's access to board meetings, the directors ensured that eBay could not reduce craigslist's U.S. market share by using its own sensitive information against it. Accordingly, the staggered board amendments should have been subject to the *Unocal* test.

Furthermore, before weighing reasonableness and proportionality under the *Unocal* test, Chancellor Chandler should have looked for a compelling justification for the implementation of the board amendments because "careful judicial scrutiny [should] be given a situation in which the right to vote for the election of successor directors has been *effectively frustrated* and denied."[124] Indeed, "a board's unilateral decision to adopt a defensive measure touching 'upon issues of control' that purposefully disenfranchises its shareholders is strongly suspect under *Unocal*, and cannot be sustained without a 'compelling justification.'"[125] Buckmaster and Newmark implemented the staggered board amendments after they refused to seat eBay's nominee to the third board seat. The amendments designated the election of a third director to occur in 2010. At that time, the controlling directors were able to select the third director because all stockholders would be voting on only one position and cumulative voting would mean nothing. Consequently, the practical effect of the controlling stockholders' action was that eBay not only lost hope of replacing the director who resigned, but also of electing a new one in future elections. Therefore, it would be hard to perceive this case as not touching on issues of control. Even though the expressed aim of the staggered board amendments may have been to prevent eBay from accessing sensitive craigslist information and not to keep eBay from gaining control of the company, their practical effect was to interfere with eBay's ability to choose a successor director to the third board seat. Since "the election contest need not involve a challenge for outright control of the board of directors"[126] for compelling justification review to apply, the chancellor should have used such standard.

Chancellor Chandler attempted to validate Buckmaster and Newmark's action by claiming that Delaware law allows companies to implement staggered boards and does not require minority stockholders to be able to elect a director. He also claimed that eBay lost its right to consent to charter amendments under the shareholders' agreement after it engaged in competitive activity and, therefore, had no right to challenge the amendments. While arguing that eBay was seeking a benefit that it bargained for and then lost as consequence of competing, Chancellor Chandler forgot that "one of the most venerable precepts of Delaware's common law corporate jurisprudence is the principle that 'inequitable action does not become permissible simple because it is legally possible.'"[127] The issue in this case was "not the validity generally of either a [charter amendment]…or board's power to appoint successor members to fill board vacancies."[128] Rather, the issue was whether the "incumbent Board timed its utilization of these otherwise valid powers… for the primary purpose of impeding and interfering with the efforts of the stockholders…to effectively exercise their voting rights in a contested election for directors."[129] Buckmaster and Newmark implemented the staggered board amendments when eBay did not have a representative on the board, even though at the time there was one open position and eBay had sought to seat a representative. Accordingly, it is hard to imagine that the implementation of a staggered board did not touch on issues of control or did not require a compelling justification.

Nevertheless, Buckmaster and Newmark still presented a compelling justification for their action. According to Chancellor Chandler, "preventing a competitor that is also a minority stockholder from unilaterally placing a director on the board so that confidential corporate information w[ould] not be freely shared with that competitor [wa]s a legitimate and rational business purpose."[130] Stopping a stockholder that openly competed with craigslist from accessing such sensitive information through a board seat was a compelling justification for the staggered board amendments because eBay's board members had historically been known to leak craigslist information and there was no other way to stop such leaks except by preventing the presence of an eBay representative in the board room. Buckmaster and Newmark needed to "show that their actions were reasonable in relation to their legitimate objective, and did not preclude the stockholders from exercising their right to vote or coerce them into voting a particular way."[131] The staggered board amendments were not preclusive because they stopped eBay from voting in the 2010 election. They may have prevented eBay from currently filling the third seat with a director of its choice. However, given that "Delaware law does not require that minority stockholders such as eBay have board representation,"[132] this should not matter. Since "Delaware corporations do not have to adopt cumulative voting for the benefit of minority stockholders, and…have the express power to implement staggered boards,"[133] the directors' actions should not be considered preclusive of any legal right possessed by eBay. Moreover, the implementation of a staggered board was not coercive because it did not force eBay into voting a certain way. Instead, the staggered board amendments only delayed when eBay would next vote for a director and restricted its ability to unilaterally fill a board seat. Lastly, the amendments passed the proportionality test because such measures were not excessive and fell within the range of reasonableness. The staggered board amendments were reasonably designed to make sure that eBay could not place someone on the craigslist board that could continue to provide it with sensitive information. The amendments served only that purpose and offered no other benefit to Newmark and Buckmaster because they already controlled the company, and thus, did not have to institute such measures in order to maintain their power and dominance.

Although Chancellor Chandler applied the wrong standard of review, he reached the right conclusion when he upheld the staggered board amendments. Indeed, the staggered board amendments would still be valid if the chancellor reviewed them using the enhanced *Unocal* test.

Conclusion

In *eBay Domestic Holdings, Inc. v. Newmark*, Chancellor Chandler rightly upheld one while rescinding two of the three actions that the controlling stockholders and directors of craigslist took in response to eBay's engaging in competitive behavior. Surprisingly and fortunately, the Chancellor did this while applying the wrong judicial standard of review to analyze one of the actions. Instead of using the business judgment rule to determine whether the staggered board amendments violated Buckmaster and Newmark's fiduciary obligations to the minority stockholder, Chancellor Chandler should have applied the compelling justification test. This standard is appropriate when directors adopt a defensive measure that interferes with the effectiveness of a shareholder vote in a contested election for directors.[134] In the case at hand, the staggered board amendments interfered with the effectiveness of a shareholder vote for the contested election for the vacant board seat. By interfering with eBay's ability to unilaterally elect a director to that vacant seat—through both refusing to seat eBay's replacement director and delaying voting on the empty position for two years—Newmark and Buckmaster's action implicated the compelling justification standard. Since they would not accept eBay's replacement to the board and then took subsequent action to prevent eBay from voting on a director for two years, the controlling stockholders needed to show that their actions had a compelling justification. The staggered board interfered with eBay's ability not only to unilaterally elect a director in the future but also to choose a representative for the board seat from which its previous designee resigned. Indeed, the contentious issue regarding the staggered board was not the directors' legal ability to implement such a board but rather the timing of such implementation. This suspect timing is what caused the staggered board amendments to interfere with eBay's voting franchise and what called for a compelling justification. In the end, however, the consequence of using the business judgment rule instead of the compelling justification test seemed limited. Indeed, Newmark and Buckmaster's implementation of the staggered board would pass the compelling justification test and the result would be the same. Consequently, Chancellor Chandler's application of the wrong standard of review to the staggered board amendments proved harmless.

Endnotes

1. *Mills Acquisition Co. v. Macmillan Inc.*, 559 A.2d 1261, 1280 (Del. 1989) (referencing 8 Del. C. § 141(a)).
2. *See Mills Acquisition Co. v. Macmillan Inc.*, 559 A.2d at 1280 ("In discharging [their management] function, directors owe fiduciary duties of care and loyalty to the corporation and its shareholders.").
3. *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).
4. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993).
5. *See Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1344 (Del. 1987) ("Under Delaware law a shareholder owes a fiduciary duty only if it owns a majority interest in or exercises control over the business affairs of the corporation."); *See also Singer v. Magnavox Co.*, 380 A.2d 969, 976 (Del. 1977) (overruled for other reasons by *Weinberger v. UOP Inc.*, 457 A.2d 701 (Del. 1983) ("It is settled Delaware law that…corporate officers and directors…and controlling shareholders…owe their corporation and its minority shareholders a fiduciary obligation of honesty, loyalty, good faith, and fairness.").

6. *See Dubroff v. Wren Holdings, LLC,* 2009 WL 1478697, 3 (Del. Ch. May 22, 2009) ("a number of shareholders, each of whom individually cannot exert control over [a] corporation (either through majority ownership or significant voting power coupled with formidable managerial power), can collectively form a control group where those shareholders are connected in some legally significant way—e.g., by contract, common ownership, agreement or other arrangement—to work together toward a shared goal"); *see also Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 70 (Del. 1989) ("[A] shareholder who owns less than 50% of a corporation's outstanding stocks does not, without more, become a controlling shareholder of that corporation, with a concomitant fiduciary status. For a dominating relationship to exist in the absence of controlling stock ownership, a plaintiff must allege domination by a minority shareholder through actual control of corporation conduct.")

7. *See Cede & Co. v. Technicolor, Inc.*, 634 A.2d at 361 ("Essentially, the duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally.").

8. *MM Companies, Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118, 1127 (Del. 2003).

9. *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361, 1386-7 (Del. 1995).

10. *Id*. *at* 1387.

11. *Id*.

12. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

13. *MM Companies, Inc. v. Liquid Audio, Inc.*, 813 A.2d at 1127-28 ("An application of the traditional business judgment rule places the burden on the 'party challenging the [board's] decision to establish facts rebutting the presumption.'") (citing *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d at 1373*).*

14. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d. 946, 954 (Del. 1985) (citing *Sinclair Oil Corp. v. Levien,* 280 A.2d 717, 720 (Del. 1971)).

15. *In re Walt Disney Co. Derivative Litigation*, 907 A.2d 693, 747 (Del. Ch. 2005).

16. *See Kahn v. Tremont Corp*., 694 A.2d 422, 428 (Del. 1997) ("When a controlling shareholder stands on both sides of the transaction the conduct of the parties will be viewed under the more exacting standard of entire fairness as opposed to the more deferential business judgment standard"; *see also Sterling v. Mayflower Hotel Corp.*, 93 A.2d 107, 110 (Del. 1952) ("Since [the majority shareholder and its appointed directors] stand on both sides of the transaction, they bear the burden of establishing [the deal's] entire fairness, and it must pass the test of careful scrutiny by the courts.").

17. *See Cede & Co. v. Technicolor, Inc*., 634 A.2d at 361 ("Classic examples of director self-interest in a business transaction involve either a director appearing on both sides of a transaction or a director receiving a personal benefit from a transaction not received by the shareholders generally.").

18. *Id*. at 362.

19. *Id*. at 361.

20. *Weinberger v. UOP, Inc.*, 457 A.2d at 711.

21. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d at 956.

22. *Id*.

23. *Mercier v. Inter-Tel (Delaware), Inc.*, 929 A.2d 786, 807 (Del. Ch. 2007).

24. *Id*.

25. *Unitrin, Inc. v. American General Corp.*, 651 A.2d at 1373 (Del. 1995); *see also Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d at 955 (Del. 1985) ("If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed.").

26. *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1152 (Del. 1989).

27. *MM Companies, Inc. v. Liquid Audio, Inc.*, 813 A.2d at 1131.

28. *Paramount Communications, Inc. v. Time Inc*., 571 A.2d at 1154 ("Even in light of a valid threat, management actions that are coercive in nature or force upon shareholders a management-sponsored alternative to a hostile offer may be struck down as unreasonable and nonproportionate responses.").

29. *MM Companies, Inc. v. Liquid Audio, Inc*., 813 A.2d at 1131.

30. *Mercier v. Inter-Tel (Delaware), Inc.*, 929 A.2d at 810.

31. *See eBay Domestic Holdings, Inc. v. Newmark*, 2010 WL 3516473 at 4 (Del. Ch. 2010).

32. *See id*.

33. *See id*. at 5

34. *See id*.

35. *Id*.

36. *See id*.

37. *Id*. at 6.

38. *See id*.

39. *See id*.

40. *See id*.

41. *Id*.

42. *Id*.

43. *See id*.

44. *Id*. at 2.

45. *See id*.

46. *See id.* at 3 ("it might be said that 'eBay' is a moniker for monetization, and that 'craigslist' is anything but").

47. *Id*.

48. *See id*. ("generating income from each of its products and services [] rather than from only a small subset of services").

49. *Id*. at 8.

50. *See id*.

51. *Id*.

52. *Id*. at 9.

53. *Id*.

54. *See id*.

55. *See id*.

56. *Id*.

57. *See id*.

58. *Id*. at 6.

59. *See id*. at 9.

60. *See id*. at 10.

61. *See id*. at 11.

62. *Id*. at 12.

63. *Id*.

64. *Id*.

65. *Id*. at 13.

66. *Id*.

67. *Id*.

68. *See id*. at 11.

69. *Id*. at 14.

70. *See id*. at 1.

71. *See id*.

72. *See id*.

73. *See id*. at 17.

74. See *id*.

75. *Id*. at 19.

76. *Id*.

77. *Id*.

78. *Id*.

79. *Id*.

80. *Id*. at 21.

81. *Id*.

82. *Id*.

83. *Id*.

84. *Id*.

85. *Id*.

86. *Id*. at 23.

87. *Id*.

88. *Id*. at 24.

89. *See id*.

90. *See id*. ("Because defendants failed to prove that they acted to protect or defend a legitimate corporate interest and because they failed to prove that the rights plan was a reasonable response to a perceived threat to corporate policy or effectiveness, [Chancellor Chandler] rescind[s] the Rights Plan in its entirety.").

91. *Id*.

92. *Id*.

93. *Id*.

94. *Id*. at 26.

95. *Id*.

96. *Id*.

97. *Id*.

98. *See id*. at 27 ("The negotiated consequence of [eBay's competitive activity], as expressly provided for in the Shareholders' Agreement, is that eBay lost the ability to block charter amendments such as the Staggered Board Amendments.").

99. *Id*.

100. *Id*. at 28.

101. *Id*.

102. *See id*. ("I conclude that Jim and Craig did not breach their fiduciary duties by approving the Staggered Board Amendments, and decline eBay's request that I rescind the Staggered Board Amendments.").

103. *Id*.

104. *See id*. at 29 (discussing how Newmark and Buckmaster stood on both sides of the transaction and therefore the ROFR/Dilutive Issuance is subject to the entire fairness test).

105. *Id*.

106. *Id*.

107. *Id*.

108. *Id*.

109. *Id*. at 30.

110. *See id*. (explaining how if eBay did not accept, then its ownership interest in craigslist would be diluted from 28.4% to 24.9%.).

111. *Id*.

112. *See id*.

113. *Id*. at 31.

114. *See id*.

115. *Gilbert v. El Paso Co.*, 575 A.2d 1131, 1144 (Del. 1990).

116. *See eBay Domestic Holdings, Inc. v. Newmark*, 2010 WL 3516473 at 21 ("Jim and Craig contend that they identified a threat to craigslist and its corporate policies that will materialize after they both die and their craigslist shares are distributed to their heirs. At that point, they say, 'eBay's acquisition of control [via the anticipated acquisition of their shares from some combination of their heirs] would fundamentally alter craigslist's values, culture, and business model…in favor of increased monetization of craigslist.' To prevent this unwanted potential future reality, Jim and Craig have adopted the Rights Plan.").

117. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986).

118. *Id*.

119. *eBay Domestic Holdings, Inc. v. Newmark*, 2010 WL 3516473 at 22.

120. *Id*. at 24.

121. *Pepper v. Litton*, 60 S.Ct. 238, 306-307 (U.S. 1939).

122. *MM Companies, Inc. v. Liquid Audio, Inc.*, 813 A.2d at 1129-1130.

123. *eBay Domestic Holdings, Inc. v. Newmark*, 2010 WL 3516473 at 27.

124. *MM Companies, Inc. v. Liquid Audio, Inc.*, 813 A.2d at 1127.

125. *Id*. at 1130.

126. *Id*. at 1132.

127. *Id*.

128. *Id*.

129. *Id*.

130. *eBay Domestic Holdings, Inc. v. Newmark*, 2010 WL 3516473 at 28.

131. *Mercier v. Inter-Tel (Delaware), Inc.*, 929 A.2d at 810-811.

132. *eBay Domestic Holdings, Inc. v. Newmark*, 2010 WL 3516473 at 26.

133. *Id*.

134. *See MM Companies, Inc. v. Liquid Audio, Inc.*, 813 A.2d at 1132.

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Lawyers and the Border Patrol: The Challenges of Multi-Jurisdictional Practice

By C. Evan Stewart

The interrelated topics of multi-jurisdictional practice and the unauthorized practice of law are not new.[1] Indeed, readers of the *NY Business Law Journal* were recently given a brief glimpse into these matters.[2] What this particular article is aimed at is the flagging of the potholes that lie in the legal highway for New York lawyers going forward, as we practice law beyond the geographic boundaries of New York State.

What Are the Rules?

To understand that legal highway, it is first necessary to identify the two relevant Model Rules promulgated by the American Bar Association. The first is Rule 5.5. Subsection (c) thereof identifies a number of "safe harbors" by which an out-of-state lawyer may provide legal services on a "temporary basis" in a state where she is not licensed.[3] And subsection (d)(1) of that same Model Rule permits another "safe harbor" for in-house lawyers to work at a corporation in a state where they are not licensed.[4]

The second Model Rule is 8.5. By subsection (a) of that rule, a "temporary" lawyer's host state is given jurisdiction co-equal to the jurisdiction of the state in which the lawyer has her license; under this provision a lawyer could be subject to disciplinary action by both jurisdictions for the same conduct. Subsection (b) of Model Rule 8.5 relates to choice of law principles and, frankly, it is pretty opaque. The easy part relates to conduct on a matter pending before a tribunal—the jurisdictional rules of where the tribunal sits govern. As to "any other" conduct:

- one looks to the jurisdiction in which the conduct occurred; or
- if the predominant effect of the conduct is in a different jurisdiction, one looks to that jurisdiction; but
- a lawyer is not to be disciplined if the conduct conforms to the rules of a jurisdiction where the lawyer *reasonably believes* the predominant effect of the lawyer's conduct will occur.

So when New York State ushered in its new legal ethics in 2009, how did these provisions fare? As for Rule 5.5, the powers that be simply ignored *all* the work done by the ABA—merely positing instead that lawyers should not engage in the unauthorized practice of law.[5] And as for Rule 8.5, the New York drafters agreed with the straightforward parts of the Model Rule (i.e., the dual jurisdiction approach, as well as the tribunal jurisdictional approach). As to the choice of law principles for "any other conduct," the drafters adopted a more common-sense (and understandable) protocol:

- if the lawyer is only licensed to practice in New York, then New York's rules are to be applied; or
- if the lawyer has dual licenses, the rules of the state where the lawyer principally practices are to be applied; unless, if the predominant effect of the conduct is in another jurisdiction in which the lawyer is licensed, then that second state's rules are to be applied to the conduct.[6]

So Where Does That Leave Us?

Yogi Berra once said: "When you come to a fork in the road, take it."[7] That advice, of course, is not terribly helpful on professional responsibility issues generally, and it is certainly not going to get the job done on the matters at issue here.

While out-of-state transactional lawyers have no "rule" guidance to help them, the New York courts over the years have provided a fair amount of jurisprudential direction from which non-New Yorkers can structure their professional behavior.[8] As for in-house lawyers working in New York-based companies, a number of bar association proposals had been advanced, but without success;[9] just recently, the New York Court of Appeals stepped into this space and approved a special registration process for out-of-state in-house lawyers.[10]

But enough about out-of-state lawyers; what about us New York-licensed lawyers—what do we face? First and foremost is the reality that many states have *very* different takes on how they implemented Rules 5.5 and 8.5.[11] And while this dissonance has led to calls for some type of uniform, across-the-board protocol to govern these issues, do not hold your breath.[12] As a result, every New York lawyer going outside New York State's boundaries needs to educate herself as to the rules of each state in which she hands out her business card.[13]

And it is not just me who is raising this flag of warning. Recently, an ABA group, called the Commission on Ethics 20/20, released a white paper to highlight a number of problems facing lawyers who practice in more than one jurisdiction.[14] Some of these problem areas will have particular resonance for New York lawyers.

- **Virtual Law Practices**. A solo lawyer advertises her will-writing services over the internet on her website. While she mostly drafts wills for clients from her home state, she occasionally works on estate documents for clients in state X where she is not licensed. Assuming the two states have different rules for advertising, conflicts of interest, and fee agreements, would state X have jurisdiction over her?; and, if so, what state's laws would state X apply?

- **Partnering and Sharing Fees with Non-Lawyers**. A law firm has offices in multiple states, the District of Columbia, and London, England. The District of Columbia allows for non-lawyer equity partners, and the firm has two economist non-lawyer equity partners in Washington who do work for various clients throughout the firm on antitrust matters. The firm's London office has three non-lawyer equity partners who are financial planners and work with firm clients world-wide on trusts and estates matters. Are there any constraints on distributing firm monies to the non-lawyers? Are there any constraints on distributing the proceeds of work generated by non-lawyer equity partners to lawyers not based in Washington and London?
- **Screening of Laterals in Multi-State Law Firms**. A lateral partner is being considered by a multi-state law firm. Bringing her into the firm, however, would create an imputed conflict of interest for a partner who works in another state. The state in which the lateral is admitted and will practice allows for screening to prevent an imputation of a conflict; but the state where the other partner is admitted and practices (e.g., New York) does not. Is the firm at risk? Is the New York-based partner at risk?[15]
- **Conflicts in International, Multi-Office Law Firms**. A partner in an international law firm's foreign office wants to take on a case adverse to a client that a partner in the New York office represents on an unrelated matter. Under the rules in the foreign office, such a representation is permitted; under New York's rules, such a representation is not permitted. Is the firm at risk? What obligations does the New York-based partner have vis-à-vis this issue?[16]
- **Choice of Law Provisions in Engagement Letters**. The law firms in the prior two examples hope to avoid any problems by specifying in engagement letters that the conflicts rules in jurisdictions which do not prohibit the activities in question will govern the attorney-client relationships. Will such drafting avoid the mandates of Rule 8.5 (the ABA's Model Rule, New York's rule, other states' rules)?
- **Client Fraud**. Various partners of a large, multi-state law firm are representing a client in a major transaction, and in the course of that representation they learn that the client has been engaging in a fraud vis-à-vis its counterparty. Partner A is licensed in New Jersey (which requires her to disclose the fraud); Partner B is licensed in Connecticut (which gives her discretion to disclose the fraud); Partner C is licensed in New York (which does not permit her to disclose the fraud). Is the firm at risk? What should Partners A, B & C do?

By identifying these problem areas, the ABA group clearly believes that the ABA's current formulation of Model Rule 8.5 is not sufficient. Indeed, beyond the white paper's specific emphasis, the group is also looking at, and seeking feedback about, a variety of possible amendments to Rule 8.5.[17] How that process (with all of its inevitable compromises) will end up is anyone's guess. In the interim, we must deal with the rules as they are, and recognize that for a number of multi-jurisdictional/cross-border practice issues there are no safe harbors or easy answers. Caveat counselor.

Endnotes

1. *See* C. E. Stewart, "Corporate Counsel and the Unauthorized Practice of Law: 'Special' Is Not Necessarily Better," *New York Law Journal* (August 28, 2001).
2. *See* C. E. Stewart, "New York's New Ethics Rules: What You Don't Know Can Hurt You!" *NY Business Law Journal* (Fall 2009).
3. Model Rule 5.5(c) reads as follows:

    (c) A lawyer admitted in another United States jurisdiction, and not disbarred or suspended from practice in any jurisdiction, may provide legal services on a temporary basis in this jurisdiction that:

    (1) are undertaken in association with a lawyer who is admitted to practice in this jurisdiction and who actively participates in this matter;

    (2) are in or reasonably related to a pending or potential proceeding before a tribunal in this or another jurisdiction, if the lawyer, or a person the lawyer is assisting, is authorized by law or order to appear in such a proceeding or reasonably expects to be so authorized;

    (3) are in or reasonably related to a pending or potential arbitration, mediation, or other alternative dispute resolution proceeding in this or another jurisdiction, if the services arise out of or are reasonably related to the lawyer's practice in a jurisdiction in which the lawyer is admitted to practice and are not services for which the forum requires pro hac vice admission; or

    (4) are not within paragraphs (c)(2) or (c)(3) and arise out of or are reasonably related to the lawyer's practice in a jurisdiction in which the lawyer is admitted to practice.

4. Six years after the adoption of Model Rule 5.5(d)(1), the ABA House of Delegates adopted, by voice vote, a Model Rule on Registration of In-House Counsel, which reads as follows:

    GENERAL PROVISIONS:

    A. A lawyer admitted to the practice of law in another United States jurisdiction who has a continuous presence in this jurisdiction and is employed as a lawyer by an organization as permitted pursuant to Rule 5.5(d)(1) of the Model Rules of Professional Conduct, the business of which is lawful and consists of activities other than the practice of law or the provision of legal services, shall register as in-house counsel within [180] days of the commencement of employment as a lawyer or if currently so employed then within [180] days of the effective date of this rule, by submitting to the [registration authority] the following:

1. A completed application in the form prescribed by the [registration authority];

2. A fee in the amount determined by the [registration authority];

3. Documents proving admission to practice law and current good standing in all jurisdictions in which the lawyer is admitted to practice law; and

4. An affidavit from an officer, director, or general counsel of the employing entity attesting to the lawyer's employment by the entity and the capacity in which the lawyer is so employed, and stating that the employment conforms to the requirements of this rule.

SCOPE OF AUTHORITY OF REGISTERED LAWYER:

B. A lawyer registered under this section shall have the rights and privileges otherwise applicable to members of the bar of this jurisdiction with the following restrictions:

1. The registered lawyer is authorized to provide legal services to the entity client or its organizational affiliates, including entities that control, are controlled by, or are under common control with the employer, and for employees, officers and directors of such entities, but only on matters directly related to their work for the entity and only to the extent consistent with Rule 1.7 of the Model Rules of Professional Conduct [or equivalent provision in the jurisdiction]; and

2. The registered lawyer shall not:

a. Except as otherwise permitted by the rules of this jurisdiction, appear before a court or any other tribunal as defined in Rule 1.0(m) of the Model Rules of Professional Conduct [or jurisdictional equivalent], or

b. Offer or provide legal services or advice to any person other than as described in paragraph B.1., or hold himself or herself out as being authorized to practice law in this jurisdiction other than as described in paragraph B.1.

PRO BONO PRACTICE:

C. Notwithstanding the provisions of paragraph B above, a lawyer registered under this section is authorized to provide pro bono legal services through an established not-for-profit bar association, pro bono program or legal services program or through such organization(s) specifically authorized in this jurisdiction;

OBLIGATIONS:

D. A lawyer registered under this section shall:

1. Pay an annual fee in the amount of $____________;

2. Fulfill the continuing legal education requirements that are required of active members of the bar in this jurisdiction;

3. Report within [____] days to the jurisdiction the following:

a. Termination of the lawyer's employment as described in paragraph A.4.;

b. Whether or not public, any change in the lawyer's license status in another jurisdiction, including by the lawyer's resignation;

c. Whether or not public, any disciplinary charge, finding, or sanction concerning the lawyer by any disciplinary authority, court, or other tribunal in any jurisdiction.

LOCAL DISCIPLINE:

E. A registered lawyer under this section shall be subject to the [jurisdiction's Rules of Professional Conduct] and all other laws and rules governing lawyers admitted to the active practice of law in this jurisdiction. The [jurisdiction's disciplinary counsel] has and shall retain jurisdiction over the registered lawyer with respect to the conduct of the lawyer in this or another jurisdiction to the same extent as it has over lawyers generally admitted in this jurisdiction.

AUTOMATIC TERMINATION:

F. A Registered lawyer's rights and privileges under this section automatically terminate when:

1. The lawyer's employment terminates;

2. The lawyer is suspended or disbarred from practice in any jurisdiction or any court or agency before which the lawyer is admitted; or

3. The lawyer fails to maintain active status in at least one jurisdiction.

REINSTATEMENT:

G. A registered lawyer whose registration is terminated under paragraph F.1 above, may be reinstated within [xx] months of termination upon submission to the [registration authority] of the following:

1. An application for reinstatement in a form prescribed by the [registration authority];

2. A reinstatement fee in the amount of $_____;

3. An affidavit from the current employing entity as prescribed in paragraph A.4.

SANCTIONS:

H. A lawyer under this rule who fails to register shall be:

1. Subject to professional discipline in this jurisdiction;

2. Ineligible for admission on motion in this jurisdiction;

3. Referred by [registration authority] to the disciplinary authority of the jurisdictions of licensure.

The report submitted in 2006 in support of the Model Rule on Registration of In-House Counsel provided, in part, as follows:

> The Council of the Section of Legal Education and Admissions to the Bar,…approved the Model Rule for Registration of House Counsel (Rule) for use by jurisdictions adopting or intending to adopt amended Model Rule 5.5(d) of the Model Rules of Professional Conduct. Rule 5.5(d) now excludes from the definition of unauthorized practice of law the provision of legal services by in-house counsel admitted in one jurisdiction and practicing in another jurisdiction, when the lawyer is providing legal services solely to the lawyer's employer. Rule 5.5(d) states:
>
> A lawyer admitted in another United States jurisdiction, and not disbarred or suspended from practice in any jurisdiction, may provide legal services in this jurisdiction that:

(1) are provided to the lawyer's employer or its organizational affiliates and are not services for which the forum requires pro hac vice admission.

Rule 5.5(d) applies to lawyers who are in-house corporate lawyers, government lawyers, and others who are employed to render legal services to the employer. The provision assumes that the in-house lawyer can establish an office or other "systematic presence" in the jurisdiction and forgo legal licensure without unreasonable risk to the client or others because the employer is able to assess the lawyer's qualifications and the quality of the lawyer's work.

Model Rule 5.5, Comment [17], states that lawyers who establish an office or continuous presence in the state "may be subject to registration or other requirements, including assessments for client protection funds and mandatory continuing legal education." In an effort to create a regulatory model useful to states that might wish to follow the registration approach, the Bar Admission Committee drafted, and the Council of the Section has approved for submission to the House, this Rule.

PURPOSE OF THE REGISTRATION RULE:

The Council recognizes that in addition to client security fund assessments and continuing legal education requirements, registration would make an in-house counsel's status known to the public.… Furthermore, a lawyer who practices pursuant to this rule is subject to the disciplinary authority of the local jurisdiction. (*See* Rules 5.5 and 8.5, ABA *Model Rules of Professional Conduct*.)

5. Instead of tackling anything done by the ABA, the New York State code reads as follows:

   Rule 5.5 Unauthorized Practice of Law

   (a) A lawyer shall not practice law in a jurisdiction in violation of the regulation of the legal profession in that jurisdiction.

   (b) A lawyer shall not aid a nonlawyer in the unauthorized practice of law.

6. For reasons that are not entirely clear, a committee of the New York City Bar Association has proposed that New York adopt the Model Rule's "reasonably believes" standard (*see* http://www.nycbar.org/pdf/report/uploads/20071895-ReportonConflictsofInterestinMulti-JurisdictionalPractice.pdf); to date, that proposal has gone nowhere. *See* J. C. Rogers, "Ethics 20/20 Commission Seeks Comments on Choice of Rules in Cross-Border Practice," *ABA/BNA Lawyers' Manual on Professional Conduct* (February 2, 2011).

7. *See* Y. Berra, *The Yogi Book*, p. 48 (Worman Publishing 1998).

8. *See, e.g.*, *Prudential Equity Group LLC v. Ajamie*, 538 F. Supp. 2d 605 (S.D.N.Y. 2008); *El Gemayel v. Seaman*, 72 N.Y.2d 701, 533 N.E.2d 245, 536 N.Y.S.3d 406 (1988). *See also* B. Temkin, "State Regulation of Unauthorized Practice of Law in Arbitration and Mediation: The Trend Toward Permitting Multijurisdictional Practice in ADR," *BNA Securities Regulation & Law Report* (August 16, 2010).

9. *See* L. Rogers, "New York Bar Proposes Rule Allowing In-House Counsel Licensed Outside State," *ABA/BNA Lawyers' Manual on Professional Conduct* (November 24, 2010).

10. *See* J. Stashenko, "Courts Offer Special Registration to Out-of-State In-House Counsel," *New York Law Journal* (April 12, 2011) (pursuant to 22 NYCRR Part 522, unregistered in-house counsel will be required to pay a bi-annual $375 fee, meet New York's C.L.E. requirements, and be subject to the state's disciplinary rules). For how courts previously dealt with this issue, *compare Gucci America Inc. v. Guess? Inc.*, No. 09 Civ. 4373 (SAS) (January 13, 2011) (S.D.N.Y.) (upholding corporate privilege claim notwithstanding in-house lawyer not being licensed) (reported in *ABA/BNA Lawyers' Manual on Professional Conduct* (January 19, 2011)) *with Financial Technologies International Inc. v. Smith*, No. 99 Civ. 9351 (GEL) (RLE) (December 19, 2000) (corporate privilege claim dependent upon corporation verifying in-house lawyers are properly licensed) (reported in *BNA's Corporate Counsel Weekly* (January 17, 2001)).

11. *See, e.g.*, S. Gillers, R. Simm, A. Perlman, "Regulation of Lawyers: Statutes and Standards" (Wolters Kluwer 2010). In their treatise, Professors Gillers, Simm and Perlman state that "[a]t least 42 jurisdictions have adopted multijurisdictional practice rules similar or identical to ABA Model Rule 5.5." *Id*. at 358. But they then go on to detail how many important commercial states diverge from this rule. *Id.* at 359-65. And as for Model Rule 8.5, the Professors do not even attempt to make a "similar or identical" representation, defaulting to describing the different states' approaches. *Id.* at 516-19.

12. The Association of Corporate Counsel has for many years advocated a "driver's license model" to apply to the professional licensing of lawyers. *See* "ABA Commission Hears Concerns Over Multijurisdictional Practice," *BNA Antitrust & Trade Regulation Report* (March 2, 2001). That proposal, however, has been a controversial one, with many bar authorities labeling it as "disastrous." *See* "Final Multijurisdictional Practice Hearing Reveals Much Support, But Also Bar's Concerns, About Permitting Multistate Practice," *BNA's Corporate Counsel Weekly* (September 19, 2001); *see also supra* n.1.

13. Two excellent internet sources to help lawyers are (i) ACC's MJP homepage: http://www.acc.com/advocacy/keyissues/mjp.cfm; and (ii) the ABA's Center for Professional Responsibility MJP home: http://www.abanet.org/cpr/mjp/home.html. The need to understand each state's different approach to these issues is underscored by the fact that states give different priorities to (and commit disparate resources to) the enforcement of out-of-state lawyers' unauthorized practice of law. *See* "Latest ABA Review of UPL Enforcement Finds More Regulation, More Prosecution," *ABA/BNA Lawyers' Manual on Professional Conduct* (May 27, 2009). One area, outside of Rules 5.5 and 8.5, where state laws vary greatly is whether an insurance company's in-house counsel may represent insureds. *See* "In-House Counsel for Insurance Carrier Cannot Be Assigned to Defend Insureds," *ABA/BNA Lawyers' Manual on Professional Conduct* (March 16, 2011).

14. *See* http://www.abanet.org/ethics2020/20111801.pdf.

15. A committee of the New York City Bar Association has proposed that New York amend Rule 1.10 (which addresses the imputation of conflicts) to exempt out any imputations where another jurisdiction's rules permit such representations; to date, that proposal has gone nowhere. *See supra* n.6. For a review of New York's decision not to permit screening, see *supra* n.2.

16. Another international/cross-border issue about which lawyers need to be aware is that many communications with lawyers abroad may not be privileged. *See, e.g.*, *AM&S v. EC Commission*, Case 155/79 [1982] 2 CMLR 264 (Court of Justice of the European Communities limited the attorney-client privilege to cover only "independent" lawyers "who are not bound to the client by a relationship of employment."); *Azko Nobel Chemicals Ltd. v. Comm'n of the European Communities*, Euro. Ct. First Inst., Case T-253/03 (September 17, 2007) (*same*).

17. *See supra* n.14.

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Inside the Courts: An Update on Securities Litigation

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

AUCTION RATE SECURITIES

S.D.N.Y. Dismisses Claims Relating to Alleged Misrepresentations Regarding Student Loan Pools Securitization

***In re MRU Holdings Sec. Litig.*, No. 09 Civ. 3807 (RMB) (S.D.N.Y. Feb. 17, 2011)**

Judge Richard M. Berman of the U.S. District Court for the Southern District of New York dismissed claims that MRU's officers, its banker and its auditor violated Section 10(b) of the Securities Exchange Act by allegedly misrepresenting MRU's ability to securitize student loan pools into auction rate securities (ARS), which generally represented MRU's business model. As MRU had filed for Chapter 7 bankruptcy, it was not named as a defendant. The plaintiffs did not allege a misrepresentation because MRU had in fact disclosed in detail the assumptions and risks its use of ARS created, and MRU also had clearly disclosed its reliance on securitization of its student loan pools and the risks associated with ARS. Further, as to MRU's banker, the plaintiffs did not plead that the banker owed them any fiduciary duty, and therefore the banker could not be liable for alleged omissions; even if it had, the plaintiffs did not allege with particularity any specific alleged misrepresentations or omissions. As to scienter, the court concluded that the plaintiffs did not plead a specific motive as to MRU's officers (instead alleging only generalized motives such as preventing losses) and that the banker's alleged motive—to obtain repayment of a loan to MRU—also was insufficient, as it did not explain why the banker would continue to underwrite MRU's ARS after the loan was repaid. Finally, the complaint did not allege specific red flags that MRU's auditor purportedly ignored, and the plaintiffs could not allege simply that the auditor committed the alleged fraud to increase its fees.

S.D.N.Y. Dismisses Claims Involving Auction Intervention Disclosure

***Anschutz Corp. v. Merrill Lynch & Co., Inc.*, No. 09 MD 2030 (LAP) (S.D.N.Y. Feb. 9, 2011)**

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 10(b) of the Securities Exchange Act in connection with ARS that Merrill Lynch had underwritten. The court determined that the plaintiffs failed to plead a material omission or misrepresentation by Merrill Lynch because the alleged omissions—that Merrill Lynch would intervene in auctions to prevent failure—were disclosed in a website disclosure on Merrill Lynch's website that it would routinely intervene in auctions (a disclosure that was made as a result of an SEC order that highlighted auction interventions). Further, the plaintiffs failed to plead scienter because Merrill Lynch's desire to maintain a profit was insufficient, and the plaintiffs did not plead that the conduct was highly unreasonable—Merrill Lynch sufficiently disclosed the challenged practices, and therefore could not be found to have acted recklessly. In addition, the court concluded that sanctions were not warranted under the PSLRA, and that the ratings agencies did not commit common-law negligent misrepresentation by rating the ARS and not downgrading those ratings quickly enough.

S.D.N.Y. Upholds Claims Involving Write Down of Lehman-Issued ARS

***CLAL Fin. Batucha Inv. Mgmt., Ltd. v. Perrigo Co.*, No. 09 Civ. 2255 (TPG) (S.D.N.Y. Sept. 30, 2010)**

Judge Thomas P. Griesa of the U.S. District Court for the Southern District of New York upheld claims that Perrigo, its CEO and its CFO violated Section 10(b) of the Securities Exchange Act by failing to write down Perrigo's ARS, which it had acquired from Lehman Brothers, in the immediate aftermath of Lehman's September 2008 bankruptcy. Instead, Perrigo continued listing its Lehman-issued ARS at the value it assigned those ARS at the end of the first quarter of 2008 (in which Lehman declared bankruptcy) and only wrote down the value of those ARS at the end of the following quarter. The complaint pled an alleged material misrepresentation because (i) the basis for maintaining the March 2008 value for the ARS was that the market for those ARS might be revived, which was no longer possible following Lehman's bankruptcy, and (ii) Perrigo's net income would have declined from the prior quarter, if it had written down the ARS in March 2008. Further, scienter was pled adequately because the defendants were aware of the "severe danger" to the ARS's value in November 2008 when they announced the results of the quarter ending in September 2008. Among other things, other companies that held Lehman-issued ARS had immediately written them down for the quarter that covered Lehman's bankruptcy. Finally, the complaint pled loss causation because the purported corrective disclosure—the write-down of Perrigo's ARS in the following quarter—was pled to be a substantial cause of the decline in Perrigo's stock price (which happened the same day that two indexes that Perrigo's stock was part of registered a gain). The court also upheld in part, and dismissed in part, the associated Section 20(a) control-person liability claim, reasoning that a Section 20(a) claim must allege particularized facts of the controlling person's culpable behavior; the complaint did so for Perrigo's CEO and CFO, but not for the other defendants.

AUDITOR LIABILITY CLAIMS

Second Circuit Affirms Dismissal of Claims Involving Audit Opinion

***Amorosa v. Ernst & Young LLP*, No. 09-5270-cv (L) (2d Cir. Feb. 2, 2011)**

The U.S. Court of Appeals for the Second Circuit affirmed the dismissal of claims that AOL's auditor, Ernst & Young, violated Section 11 of the Securities Act and Sections 10(b) and 14(a) of the Securities Exchange Act by making alleged misrepresentations in a "clean" audit opinion on AOL. The court, agreeing with the trial court, concluded that the plaintiff did not plead loss causation in connection with his Sections 10(b) and 14(a) claims and that the Section 11 claim was barred by the one-year limitations period. As to the Section 10(b) and 14(a) claims, the plaintiff did not identify any purported corrective disclosures that implicated Ernst & Young's challenged audit opinions and, further, did not connect AOL's alleged fraud to Ernst & Young itself. As to the Section 11 claim, the complaint alleged that the first disclosures relating to Ernst & Young's alleged misrepresentations, which started running the statute of limitations, were more than a year before the plaintiff filed suit. Further, although the plaintiff claimed that true corrective disclosure occurred less than one year before he filed suit, AOL's stock price had actually increased after that purported true corrective disclosure, making his Section 11 claim fail for lack of loss causation.

D.C. Circuit Affirms Denial of Proposed Amended Complaint for Failure to Plead Reliance

***In re Interbank Funding Corp. Sec. Litig.*, No. 09-7167 (D.C. Cir. Dec. 28, 2010)**

The U.S. Court of Appeals for the D.C. Circuit affirmed the denial of a proposed amended complaint alleging that Interbank's auditor (Radin Glass & Co., LLP) violated Section 10(b) of the Securities Exchange Act, because the proposed amended complaint did not adequately plead reliance. The plaintiff alleged that Interbank was a Ponzi scheme, and that the auditor violated Section 10(b) by stating that Interbank's financial statements were prepared in accordance with GAAP. The proposed amended complaint did not directly plead reliance, and, because it alleged that the auditor made an affirmative misrepresentation (*i.e.*, that Interbank's financial statements were prepared in conformity with GAAP), the plaintiff was not entitled to a presumption of reliance under *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972).

S.D.N.Y. Grants Summary Judgment in Case Involving Bankrupt Limited Partnership

***Lewin v. Lipper Convertibles, L.P.*, No. 03 Civ. 1117 (RMB) (S.D.N.Y. Nov. 17, 2010)**

Judge Richard M. Berman of the U.S. District Court for the Southern District of New York granted summary judgment on claims by investors in a bankrupt limited partnership that the limited partnership's auditor, PricewaterhouseCoopers, violated Section 10(b) of the Securities Exchange Act by issuing a purportedly false and misleading unqualified audit opinion. The trustee of the bankrupt limited partnership had settled claims against the auditor in New York state court. The court concluded that the plaintiffs lacked standing to assert direct claims against the auditor because they did not demonstrate that their injuries were distinct from the limited partnership's injuries. In fact, the auditor's expert opined that the plaintiffs' losses were the reduced value of their investments, which were shared in common with other limited partners. Those losses were not unique to the plaintiffs. The court explained that suffering only a diminution in the value of shares was insufficient to establish standing to assert direct claims, and the plaintiffs did not introduce evidence showing that they had suffered any other injury to rebut the expert opinion offered by the auditor. The court also explained that the plaintiffs had not provided *any* evidence of what their actual damages might be, further entitling the auditor to summary judgment. In so doing, the court rejected the plaintiffs' attempt to establish a rescissionary measure of damages.

S.D.N.Y. Dismisses Claims Relating to Madoff Feeder Fund

***In re Beacon Assocs. Litig.*, No. 09 Civ. 777 (LBS) (S.D.N.Y. Oct. 5, 2010)**

Judge Leonard B. Sand of the U.S. District Court for the Southern District of New York dismissed claims that Friedberg, the auditor of a Madoff feeder fund, violated Section 10(b) of the Securities Exchange Act because it purportedly failed to investigate red flags. Although the complaint alleged numerous red flags (*e.g.*, Madoff's intense secretiveness and investors' inability to replicate his results with his claimed strategy), it did not allege that Friedberg was aware of those red flags. Friedberg was not required to corroborate Madoff's account statements; the plaintiffs argued that Friedberg ignored the red flags because it did not investigate Madoff, rather than argue the more compelling reason—that it did not investigate Madoff because it relied on his reputation as an industry leader. The court, however, upheld claims against the investment adviser and the feeder fund's general partner because they allegedly knew Madoff's investment strategy was inconsistent with publicly available information, and chose not to disclose this knowledge to investors in order to maintain assets under management, a key metric for the sale of their business, while also not disclosing a decrease in assets under management.

CLASS CERTIFICATION

S.D.N.Y. Denies Class Certification for Failure to Plead Loss Causation

***In re IMAX Sec. Litig.*, No. 06 Civ. 6128 (NRB) (S.D.N.Y. Dec. 20, 2010)**

Judge Naomi Reice Buchwald of the U.S. District Court for the Southern District of New York denied certification of a purported class alleging that IMAX violated Section 10(b) of the Securities Exchange Act because the proposed class representative, Snow Capital, did not adequately plead loss causation. IMAX allegedly violated Section 10(b) in connection with purported misrepresentations as to revenue recognition in two periods: fiscal years 2002 and 2004 (which were revealed through a 2007 disclosure) and fiscal years 2005 and 2006 (which were revealed through a 2006 disclosure). The court determined that the 2006 disclosure did not act as a corrective disclosure for the 2002/2004 alleged misrepresentations because (i) it did not reveal at the time that IMAX may have made misrepresentations in 2002/2004 and (ii) it did not reveal a sustained course of conduct, as the alleged revenue-recognition misrepresentations in 2002/2004 and in 2005/2006 were different. Because Snow Capital purchased all of its IMAX stock *before* the 2005/2006 alleged misrepresentations and sold it *before* the 2007 corrective disclosure for those alleged misrepresentations, the court determined that Snow Capital could not establish loss causation. In doing so, the court rejected Snow Capital's argument that the 2006 corrective disclosure (after which Snow Capital had sold its IMAX stock) was sufficient to establish loss causation because it led to an SEC investigation that resulted in the 2007 corrective disclosure. Consequently, Snow Capital's inability to establish loss causation raised typicality issues and might subject it to a unique defense (*i.e.*, lack of loss causation), and therefore the court could not certify a class with Snow Capital as the class representative. However, the court noted that numerosity, commonality and predominance requirements of Rule 23 of the Federal Rules of Civil Procedure were satisfied, and ordered other parties who wished to be appointed lead plaintiff to file applications with the court.

DIRECTORS AND DIRECTORS' DUTIES

Books and Records

Delaware Supreme Court Reverses Holding on Commencement of Section 220 Proceedings After Derivative Actions

***King v. Verifone Holdings, Inc.*, C.A. No. 330, 2010 (Del. Jan. 28, 2011)**

The Delaware Supreme Court, sitting en banc, reversed the Delaware Court of Chancery's holding that a stockholder-plaintiff who has brought a derivative action without first prosecuting an action to inspect books and records under 8 *Del. C.* § 220 is, for that reason alone, precluded from prosecuting a later-filed Section 220 proceeding.

The court explained that, while commencing a Section 220 proceeding in advance of a derivative action is advisable, the failure to do so did not preclude a Section 220 proceeding. The court discussed three prior Delaware cases in which Section 220 proceedings were permitted following the commencement of a derivative action. The court explained that, under Delaware law, commencing a Section 220 action in order to aid in pleading demand futility is a proper purpose.

Mergers & Acquisitions

Delaware Supreme Court Affirms Decision in Appraisal Action

***Golden Telecom, Inc. v. Global GT LP*, No. 392, 2010 (Del. Dec. 29, 2010)**

The Delaware Supreme Court affirmed the decision of the Delaware Court of Chancery in this appraisal case. Following a tender offer, Golden Telecom merged into Lillian Acquisition, a wholly owned subsidiary of Vimpel-Communications. Golden shareholders received $105 per share in the transaction. A Golden special committee rejected several Vimpel-Communications bids before reaching a definitive merger agreement. The special committee did not, however, conduct a large pre-merger market check because a large stakeholder had committed to refuse support for any transaction with a partner other than Vimpel-Communications. Certain Golden shareholders thereafter sought appraisal. The Delaware Court of Chancery valued Golden at $125.49 per share, and Golden appealed.

In affirming the Court of Chancery's decision, the Delaware Supreme Court rejected the argument that the Court of Chancery erred by failing to defer to the merger price as indicative of Golden's fair value, and concluded that "[r]equiring the Court of Chancery to defer—conclusively or presumptively—to the merger price, even in the face of a pristine, unchallenged transactional process, would contravene the unambiguous language of the [appraisal] statute and the reasoned holdings of our precedent." Further, the court found that the company was not bound in an appraisal proceeding by the company-specific data it had previously sent to stockholders, noting that the appraisal statute does not "require the parties to adhere to previously prepared data," but rather "vests the court with significant discretion to consider 'all relevant factors'" when determining fair value. The Delaware Supreme Court also noted that "[r]equiring public companies to stick to transactional data in an appraisal proceeding would pay short shrift to the difference between valuation at the tender offer stage—seeking 'fair price' under the circumstances of the transaction—and valuation at the appraisal stage—seeking 'fair value' as a going concern." Therefore, the Delaware Supreme Court found that the Court of Chancery had a rational basis for accepting Golden's proposed tax rate in the appraisal proceeding, even though it was different from the tax rate in Golden Telecom's proxy statement. Finally, the Delaware Supreme Court concluded that the vice chancellor did not abuse his discretion in its valuation.

Court of Chancery Grants Limited Preliminary Injunction Prohibiting Shareholder Vote on Transaction Involving Bank Misconduct

***In re Del Monte Foods Co. S'holders Litig.*, C.A. No. 6027-VCL (Del. Ch. Feb. 14, 2011)**

Vice Chancellor J. Travis Laster of the Delaware Court of Chancery granted a limited preliminary injunction prohibiting a shareholder vote on the $5.3 billion leveraged buyout of Del Monte Foods Company for a period of 20 days. Del Monte entered into an agreement and plan of merger with Blue Acquisition Group, Inc. (comprised of three private equity firms) under which, if approved by stockholders, each share of Del Monte common stock would be converted into the right to receive $19 in cash. The consideration represented a premium of approximately 40 percent over the average closing price of Del Monte's common stock for the three-month period ending prior to the announcement of the merger. According to the court, the sale process was engineered in a manner permitting Del Monte's banker "to obtain lucrative buy-side financing fees." The court explained that information was withheld "from the Board that could have led Del Monte to retain a different bank, pursue a different alternative, or deny [the bank] a buy-side role." The court also stated that the bank failed to disclose to the board its "behind-the-scenes efforts" to put Del Monte "into play." These actions, according to the court, were designed to fulfill the bank's goal of providing buy-side financing to the acquirer. The court noted that having this particular bank serve a buy-side financing role "was not necessary to secure sufficient financing for the Merger, nor did it generate a higher price for the Company. It simply gave [the bank] the additional fees it wanted from the outset." The court pointed out that the bank stood to earn slightly more from providing buy-side financing than it would from serving as Del Monte's sell-side adviser.

The court found that the plaintiffs had established a reasonable probability of success on the merits of a claim for breach of fiduciary duty against the individual defendants for "failing to provide the serious oversight" that would have avoided this situation. The court noted, however, that, in light of the protections provided by an exculpatory clause authorized by 8 *Del. C.* § 102(b)(7), its decision did not mean that the directors would face a meaningful threat of monetary liability in the damages portion of the litigation, given that the board appeared to have sought in good faith to fulfill its fiduciary duties, but failed because of the court's findings regarding the bank. As an equitable remedy to the board's breach of fiduciary duty, the court enjoined the vote on the merger for the 20-day period. Pending the vote on the merger, the court enjoined the parties to the merger agreement from enforcing the no-solicitation and match-right provisions, as well as the termination fee provisions relating to topping bids and changes of the board's recommendation. The injunction was conditioned on the plaintiffs posting a bond in the amount of $1.2 million.

Court of Chancery Grants Limited Disclosure-Based Injunction Against Closing of Merger Transaction

***Steinhardt v. Howard-Anderson*, C.A. No. 5878-VCL (Del. Ch. Jan. 24, 2011) (Transcript)**

Vice Chancellor J. Travis Laster of the Delaware Court of Chancery, in a transcript ruling, granted a limited disclosure-based injunction against the closing of a merger transaction offering $3.8337 per share in cash and 0.2925 shares of the acquirer's common stock for each share of the target's stock. The court first engaged in a brief discussion concerning whether *Revlon* duties are triggered in this mixed stock/cash deal, in which public shareholders of the target would own approximately 15 percent of the post-transaction entity if the deal were approved. The court opined that *Revlon*'s reasonableness standard should apply because "[t]his is a situation where the target stockholders are in the end stage in terms of their interest in [the target]. This is the only chance they have to have their fiduciaries bargain for a premium for their shares as the holders of equity interests in that entity." The court continued that "it's just not worth having the dance on the head of a pin as to whether it's 49 percent cash or 51 percent cash or where the line is. This is the only chance that [target] stockholders have to extract a premium, both in the sense of maximizing cash now, and in the sense of maximizing their relative share of the future entity's control premium." Ultimately, however, the court did not see enough in the record to warrant an injunction based on a *Revlon* analysis, concluding that "[g]iven where we are…with no topping bidder, I think it's up to the stockholders to decide whether this is the price and the mix of consideration that they want for their shares. But they have to be able to do that on a fully informed basis."

The court did find that disclosure concerns warranted an injunction. First, the court found the proxy had a "partial disclosure issue" because, while it explained the events concerning the company's "road show" leading up to a merger agreement, it failed to explain the impact of the road show. That impact was, according to the court, a reduction of the cash value delivered to shareholders of approximately $25 million. Second, the court found the failure to disclose fully the accretion/dilution analysis performed in connection with a banker's fairness opinion was a material omission. The court explained that the full analysis, and range derived therefrom, was contained in the final board book, and therefore should be included in the proxy. Third, the court found that an agreement in principle that a target board member would become a director on the surviving company board should be disclosed. Fourth, the court found the proxy's description of certain contacts the target's board made during the process of shopping the company was misleading. Finally, the court found certain disclosures concerning additional aspects of the banker's fairness opinion may be insufficient, and ordered the retaking of the banker's Court of Chancery Rule 30(b)(6) deposition in order to discover whether there is "a good explanation" for certain changes in the banker's analysis that occurred during the process leading to the transaction.

Court of Chancery Holds That Reverse Stock Split Was Not Entirely Fair

***Reis v. Hazelett Strip-Casting Corp.*, C.A. No. 3552-VCL (Del. Ch. Jan. 21, 2011)**

Vice Chancellor J. Travis Laster of the Delaware Court of Chancery, in a post-trial opinion, held that a reverse stock split used in a going-private transaction was not entirely fair, and awarded damages, as well as pre- and post-judgment interest. Hazelett Strip-Casting was formed as a family business in 1956. The company was closely held, with two brothers as the only shareholders. When the brother holding the minority interest died, the controlling shareholder brother offered to purchase the minority interest from the deceased's estate (the Estate) for $1,500 per share, with no valuation analysis. The Estate resisted the stock sale, and the Hazelett board approved, at the behest of the controlling shareholder brother, a reverse split in which every share would become a 1/400 fractional interest. After the split, the Estate would hold 350/400 of a share, and the board determined to issue the Estate cash instead of a fractional share. The Estate sued, arguing the reverse stock split was unfair, and a breach of the board's and its controlling shareholder's fiduciary duties.

The court found that the reverse split was unfair, and held that, when a controlling stockholder uses a reverse split to freeze out minority stockholders without any procedural protections, it will review the transaction under the entire fairness standard of review—Delaware's "most onerous standard"—under which the defendants bear the burden of proof. The court determined that this standard of review was appropriate because a reverse split under these circumstances "is the 'functional equivalent' of a cash-out merger." The court noted that, if the controlling stockholder "permits the board to form a duly empowered and properly functioning special committee, or if the transaction is conditioned on a correctly formulated majority-of-the-minority vote, then the burden could shift to the plaintiff to prove that the transaction was unfair." The court also explained that, had the controlling stockholder permitted both a properly functioning special committee and conditioned the transaction on a correctly formulated majority-of-the-minority vote, application of the business judgment rule would result. However, in this case, the court found that the burden of proof remained with the defendants, and that they failed to prove that the reverse split was entirely fair. The court determined that "[t]here was no dealing in this case that could be called 'fair.' Procedural protections were not implemented, and no one bargained for the minority." Likewise, the defendants failed to show fair price, and they made no effort to determine the fair value of the fractional interests when those entitled to receive such fractions were determined.

The court went on to determine the fair value of Hazelett's shares, relying on two methods—capitalized earnings and book value. In doing so, the court rejected the plaintiffs' comparable companies and capitalized free cash flow methods. Ultimately, the court determined that the fair value of each fractional interest was $3,980, and ordered the defendants to pay the remainder that was not paid in connection with the stock split, as well as pre- and post-judgment interest.

Court of Chancery Concludes Merger Price Is Fair and Board Breached No Fiduciary Duty

***In re John Q. Hammons Hotels Inc. S'holder Litig.*, No. 758-CC (Del. Ch. Jan. 14, 2011)**

Chancellor William B. Chandler III of the Delaware Court of Chancery, in this post-trial opinion, concluded that a $24-per-share cash merger between John Q. Hammons Hotels, Inc. (JQH) and Elian was entirely fair, the JQH board breached no fiduciary duty in connection with the merger, and the plaintiffs failed to state an aiding and abetting claim against the third-party acquirers.

First, the Court of Chancery found that the transaction, which it evaluated under the entire fairness standard, was entirely fair. The court determined that the JQH special committee in charge of negotiating and approving the merger satisfied the threshold requirements for independence, which the plaintiffs also conceded at trial. The court rejected the plaintiffs' contention that the special committee was coerced into accepting Elian's offer to avoid worse outcomes for the minority shareholders, finding "a claim of coercion cannot be premised on the threat of simply maintaining the status quo." Moreover, this alleged threat to the status quo was fully disclosed to potential investors. Further, the court found no credible evidence at trial that demonstrated improper self-dealing by John Q. Hammons, the company's founder and one of JQH's directors, or "strong-arm" conduct that would have coerced the special committee or shareholders into supporting the merger. As to fair price, the court found that the defendants' evidence of fair value was more convincing, persuasive and thorough than the plaintiffs' weak evidence. Moreover, that the unaffiliated stockholders "overwhelmingly supported the transaction" was an "undisputed fact" that further supported the fairness of the merger.

Second, the court rejected the plaintiffs' disclosure claims, finding that none of the alleged omissions was material to JQH shareholders' voting decision. The court found no evidence that the directors were required to disclose that an employee of Lehman, the special committee's adviser, had allegedly contacted Elian about the possibility of underwriting an Elian security offering. The court stated that "directors do not owe a duty to disclose facts that they are not aware of." The court also found that the defendants were not required to disclose that the special committee's legal adviser also represented the entity providing financing for Elian. Finally, the court found that the defendants did not have to disclose the substance of a presentation by Elian to the special committee because it was "premised on a hypothetical scenario."

Third, with respect to the claim against Hammons, the court found that he breached no duty to the minority stockholders. Hammons did not participate as a director in the approval of the merger, and was not involved in the special committee process. The court noted that Hammons was also not on both sides of the merger, as he made no offer as a controlling stockholder and did not engage in any conduct that adversely affected the minority's merger consideration.

Fourth, as for the aiding and abetting claim, there was no evidence that the third-party acquirers knowingly participated in a breach of fiduciary duty by Hammons.

Thus, the court found in favor of all of the defendants, and concluded that the $24-per-share merger price was the fair value of JQH shares.

Court of Chancery Refuses to Dismiss Claims Related to Expeditious Closing of Merger

***Narrowstep, Inc. v. Onstream Media Corp.*, No. 5114-VCP (Del. Ch. Dec. 22, 2010)**

Vice Chancellor Donald F. Parsons Jr. of the Delaware Court of Chancery dismissed breach of covenant of good faith and fair dealing claims, but allowed other claims to proceed, in a case arising out of the failed merger between Narrowstep and Onstream Media Corporation. In 2008, the parties entered into a merger agreement that required them to use their reasonable best efforts to close the merger expeditiously. The merger agreement contained terms that required Narrowstep to cede all operational control to Onstream well before closing in order to expedite the two companies' integration. The merger never closed, and Narrowstep sued Onstream, alleging that Onstream breached the merger agreement and the implied covenant of good faith and fair dealing, unjustly enriched itself and fraudulently induced Narrowstep to enter into the merger agreement. Onstream moved to dismiss the complaint for failure to state a claim.

First, with respect to the breach of the merger agreement claim, the court found that the complaint alleged sufficient facts that supported the inference that Onstream failed to take all steps necessary to consummate the merger expeditiously. For example, the court found that Onstream failed to use its best efforts to timely file the registration statement, and repeatedly stalled and failed to take actions necessary to consummate the merger—including that Onstream refused to close unless Narrowstep acquiesced in three separate amendments to the merger agreement that reduced the merger price. Second, the court found that Narrowstep failed to state a claim for breach of the implied covenant of good faith and fair dealing, noting that the court will not invoke the implied covenant to override the express provisions of the merger agreement, and Narrowstep's implied covenant claims were duplicative of claims alleging breaches of express provisions of the merger agreement. Third, the court found that Narrowstep adequately pleaded common law fraud. The complaint alleged that Onstream made several false representations with respect to closing the merger in an expeditious matter, and also alleged details of Onstream's plan to misappropriate Narrowstep's assets before closing. Fourth, the court found that the complaint stated a claim for equitable fraud because it alleged a special relationship between the parties similar to a fiduciary relationship. The court noted that "[w]hat began as arm's-length commercial bargaining between the parties transitioned into Onstream controlling Narrowstep for all intents and purposes, pursuant to the express terms of the Agreement, even before the merger closed," and that the parties' relationship exhibited "many of the factual indicia usually associated with fiduciary dealings." Finally, the court allowed Narrowstep to proceed with its unjust enrichment claim as an alternative remedial theory.

Court of Chancery Enjoins Stockholder Vote on Proposed Merger

***In re Art Tech. Group, Inc. S'holders Litig.*, C.A. No. 5955-VCL (Del. Ch. Dec. 20, 2010) (Transcript)**

Vice Chancellor J. Travis Laster of the Delaware Court of Chancery, in a transcript ruling, enjoined a stockholder vote on a proposed merger until 10 days after the target provided supplemental disclosures to its stockholders describing the fees that its financial adviser, Morgan Stanley, had been paid by the acquirer, Oracle, over the preceding four years. The court also required a description of the nature of the services Morgan Stanley provided to Oracle during those years. The court found that such disclosures would likely be material to stockholders in deciding how much weight to give the Morgan Stanley fairness opinion issued in connection with the merger. According to the court's subsequent implementing order, the required disclosures were ordered to be made "in a manner reasonably designed to disseminate the information rapidly to ATG's stockholders, such as via a public filing with the Securities and Exchange Commission. A separate mailing is not required."

Court of Chancery Refuses to Enjoin Debt-for-Equity Exchange Offer

***Caspian Alpha Long Credit Fund, L.P. v. Marsico Parent Superholdco, LLC*, No. 5941-VCL (Del. Ch. Nov. 8, 2010) (Transcript)**

Vice Chancellor J. Travis Laster of the Delaware Court of Chancery, in a transcript ruling, refused to enjoin a debt-for-equity exchange offer. The swap was being effected through a consent plus an exchange offer. In the transaction, if the debtholder exchanged, then the debtholder's vote was considered to be cast in favor of amending the existing indenture. The effect of that vote was to strip certain covenant protections of those who did not exchange. The plaintiffs, who were non-exchanging debtholders, claimed that the court should enjoin the exchange offer, as well as the company's restructuring as a whole, arguing that the amendments to the indenture effected by the exchange violated provisions of the indenture that required unanimous consent to strip the covenant protections. The vice chancellor refused to enjoin the transaction or the restructuring, finding the plaintiffs had no probability of success on the merits and that there was no irreparable harm. Significantly, the court found that the balance of hardships favored the company, in that the transaction was beneficial in terms of the company's debt burden and was supported by a large number of noteholders. The court found that, in contrast, the balance of hardships did not favor the plaintiffs, given their relatively small stake and the totality of the circumstances. Thus, the court refused to enjoin the debt-for-equity exchange offer.

FOREIGN CORPORATIONS

S.D.N.Y. Rules Claims Against German Automaker Precluded by *Morrison*

***Elliott Assocs. v. Porsche Automobil Holding SE*, No. 10 Civ. 0532 (HB) (S.D.N.Y. Dec. 30, 2010), *appeal docketed*, No. 11-447 (2d Cir. Jan. 28, 2011)**

Judge Harold Baer, Jr. of the U.S. District Court for the Southern District of New York dismissed claims that Porsche, a German company, and two of its Germany-based senior executives violated Section 10(b) of the Securities Exchange Act by allegedly misrepresenting Porsche's intention to take over Volkswagen, another German company whose stock is traded only on a German bourse. Although the plaintiff hedge funds allegedly had entered into security-swap agreements in New York and Texas referencing Volkswagen's stock, the court determined that the plaintiffs' claims were precluded by the U.S. Supreme Court's decision in *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869 (2010). The court explained that the security-swap agreements were economically equivalent to the purchase of Volkswagen's shares—which would not be subject to Section 10(b) if that were the transaction—and therefore the security-swap agreements were not subject to Section 10(b).

S.D.N.Y. Dismisses Claims Involving Swiss Re's Exposure to Mortgage-Related Securities

***Plumbers' Union Local No. 12 Pension Fund v. Swiss Reinsurance Co.*, No. 08 Civ. 1958 (JGK) (S.D.N.Y. Oct. 1, 2010)**

In a suit over Swiss Re's exposure to mortgage-related securities, Judge John G. Koeltl of the U.S. District Court for the Southern District of New York dismissed claims that Swiss Re and two of its senior officers violated Section 10(b) of the Securities Exchange Act under the transactional test enunciated in *Morrison v. National Australia Bank, Ltd.* The court concluded that, because Swiss Re is a Swiss company whose stock trades only on a foreign bourse, plaintiffs could not bring claims against it for violations of the Securities Exchange Act, even if the plaintiffs are American investors who initiated their purchase orders for Swiss Re's stock from the United States (but the transactions were completed electronically on the foreign exchange platforms). In addition, even if Section 10(b) claims were not precluded by *Morrison*, the court explained that those claims would still fail because (i) Swiss Re's challenged statements about credit-default swap (CDS) risk were not purported to have been made by someone who did not believe the statements to be true and accurate and (ii) to the extent Swiss Re purportedly failed to mark the CDSs to market value, the plaintiffs did not specifically plead that the defendants believed the CDS values were inflated.

INSIDER TRADING CLAIMS

S.D.N.Y. Denies Motion to Dismiss Charges Relating to Misappropriation of Confidential Information

***United States v. Corbin*, No. 09 Cr. 0463 (VM) (S.D.N.Y. Oct. 21, 2010)**

Judge Victor Marrero of the U.S. District Court for the Southern District of New York denied the defendant's motion to dismiss criminal insider trading charges. The defendant was accused of misappropriating confidential information received from the wife of one of the defendant's associates, who worked with a communication firm that provided services to companies in connection with mergers, acquisitions and similar transactions. The court explained that the government sufficiently alleged a duty of confidentiality based upon the associate's express agreement with his wife (and course of conduct with his wife) not to misappropriate information she received in the course of her employment. Further, the court determined that SEC Rule 10b5-2 was not unconstitutionally adopted because that rule was derived from the U.S. Supreme Court's decision in *United States v. O'Hagan*, 521 U.S. 642 (1997). Finally, the court explained that the government was not obligated to allege that the defendant made an improper statement in connection with an insider trading charge.

LOSS CAUSATION

Ninth Circuit Holds That an Earnings Miss Is Insufficient to Establish Loss Causation

***In re Oracle Corp. Sec. Litig.*, No. 09-16502 (9th Cir. Nov. 16, 2010)**

The U.S. Court of Appeals for the Ninth Circuit held that a mere earnings miss is, standing alone, insufficient to establish loss causation. Shareholders of Oracle Corporation brought an action against the software company, alleging that three of its top executive officers issued misleading forecasts about the company's financial condition, in violation of Section 10(b) of the Securities Exchange Act. The shareholders alleged that Oracle's December 2000 internal earnings forecast ignored slowing economic and business conditions, and that Oracle and its executive officers made misrepresentations regarding the quality of its recently released integrated business software. The district court granted summary judgment in favor of Oracle, holding that the plaintiffs failed to identify sufficient evidence as to loss causation for their non-forecasting claims by relying on an earnings miss rather than any actual disclosures about defects in the software.

The Ninth Circuit agreed. Applying the Supreme Court's decision in *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005), the court held that proving loss causation requires more than a mere earnings miss. In particular, the court rejected the shareholders' argument that loss causation can be proved merely by showing that the market reacted to the purported "impact" of the alleged fraud—the earnings miss—rather than to the alleged fraudulent acts themselves. The court found that the "overwhelming evidence produced during discovery indicates the market understood Oracle's earnings miss to be a result of several deals lost in the final weeks of the quarter," rather than customers' failure to buy the products as a result of the defects. Shareholders were thus unable to establish a triable issue that losses were caused by alleged misrepresentations regarding the quality of Oracle's software or alleged fraudulently overstated earnings.

S.D.N.Y. Dismisses Claims Involving Alleged Misrepresentations About Scholastic Divisions

***Alaska Laborer Employers Ret. Fund v. Scholastic Corp.*, No. 07 Civ. 7402 (GBD) (S.D.N.Y. Sept. 30, 2010)**

Judge George B. Daniels of the U.S. District Court for the Southern District of New York dismissed claims that Scholastic, its CEO and its CFO violated Section 10(b) of the Securities Exchange Act by making alleged misrepresentations about two particular Scholastic divisions, which ultimately required Scholastic to restate its financial results. The court concluded that loss causation was not pled because the complaint did not allege sufficient facts showing that the purported misconduct actually caused the plaintiffs' losses. To establish loss causation, plaintiffs must disaggregate their losses due to economic change from those caused by misrepresentations, requiring a connection between purported misstatements and the plaintiffs' alleged losses from the stock price decline. To do so, the plaintiffs pointed to two press releases as purported corrective disclosures; however, the problems disclosed in the first press release had been previously released, and the losses revealed in the second press release were attributed to different Scholastic divisions than that implicated by the purported misrepresentations. Consequently, the court concluded that the complaint failed to allege loss causation.

MORTGAGE-BACKED SECURITIES

S.D.N.Y. Dismisses Claims for Failure to Adequately Plead Misrepresentations

***Footbridge Ltd. Trust v. Countrywide Home Loans, Inc.*, No. 09 Civ. 4050 (PKC) (S.D.N.Y Sept. 28, 2010)**

Judge P. Kevin Castel of the U.S. District Court for the Southern District of New York dismissed claims that Countrywide and its CEO and COO violated Section 10(b) of the Securities Exchange Act by making alleged misrepresentations in connection with the sale of securitized mortgages that Countrywide had originated. According to the complaint, Countrywide allegedly misrepresented what percentage of the securitized mortgages were on owner-occupied properties, the quality of Countrywide's underwriting guidelines and how Countrywide selected borrowers for mortgages based on reduced documentation (*e.g.*, stated income). Unlike many cases challenging mortgage-backed securities, the plaintiffs were not alleging that Countrywide misrepresented the loans as high quality; rather, the plaintiffs conceded that they understood the securitized mortgages were low quality and claimed that Countrywide misrepresented just how low quality the mortgages were. The court, however, determined that the complaint did not adequately plead misrepresentations because it did not tie Countrywide's purported misrepresentations about mortgages it had originated to the specific securitized mortgages at issue, or provide non-conclusory allegations about the details underlying Countrywide's purported misrepresentations. In addition, the court noted that the complaint did not plead scienter (rather, it only set forth conclusory allegations) or loss causation (as it did not plead how, when and to what extent the plaintiffs' losses were the alleged result of the purported misrepresentations).

PSLRA SANCTIONS

Second Circuit Affirms Imposition of Sanctions in Case Involving Purchase of Security 18 Years Ago

***Libaire v. Kaplan*, No. 09-2659-cv (2d Cir. Oct. 6, 2010)**

In a *per curiam* summary opinion, the U.S. Court of Appeals for the Second Circuit affirmed the imposition of sanctions following the dismissal of the plaintiff's claims that North Fork Preserve violated Section 10(b) of the Securities Exchange Act. The court determined that sanctions were appropriate because the plaintiff's sole purchase of a security occurred 18 years before the complaint was filed, which was not disclosed in the complaint, and as a consequence any Securities Exchange Act claims based upon that transaction were time-barred. Moreover, contrary to the plaintiff's unsupported argument, the plaintiff's payment of annual dues in 2005 to North Fork did not constitute the purchase of a security (because that payment was not made "solely" for purposes of a return on an investment). Finally, the district court properly considered that the plaintiff filed the federal action after the plaintiff's virtually identical state-court action had been dismissed.

SARBANES-OXLEY ACT

Second Circuit Vacates Class Settlement Agreement for Indemnifying Chief Officers from Liability Under Section 304

***Cohen v. Viray*, No. 08-3860-cv (2d Cir. Sept. 30, 2010)**

The U.S. Court of Appeals for the Second Circuit vacated a class settlement agreement in a class action against DHB Industries for securities fraud because, under the agreement, DHB improperly indemnified DHB's former CEO and CFO from liability under Section 304 of the Sarbanes-Oxley Act. The court's decision came after a shareholder and the U.S. Department of Justice challenged the validity of the settlement. If a company is forced to restate its financial results due to misconduct, Section 304 requires the individuals who served as CEO and/or CFO at the time of the original financial results to reimburse the company for their bonus and any profits from securities sales for the twelve months after the incorrect financial results were issued. As a threshold matter, the court determined (consistent with the U.S. Courts of Appeals for the Ninth and D.C. Circuits) that there is no private right of action under Section 304 because only the SEC has the express right to exempt an individual from complying with that section. The court then concluded, as a matter of first impression in the federal courts, that the agreement's indemnification provision was invalid because that provision would allow the former CEO and CFO to escape any personal financial liability under Section 304, frustrating the SEC's power to enforce the public's interest in ensuring the integrity of the financial markets.

SEC ENFORCEMENT

Fifth Circuit Allows SEC's Insider Trading Case Against Mark Cuban to Go Forward

***Sec. & Exch. Comm'n v. Cuban*, No. 09-10996 (5th Cir. Sept. 21, 2010)**

The U.S. Court of Appeals for the Fifth Circuit reversed the district court's dismissal of the SEC's insider trading complaint against Mark Cuban, holding that it was at least plausible, based on the SEC's allegations, that Cuban violated a duty not to trade on material, nonpublic information in violation of Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act. The complaint arose out of Cuban's sale of his 6.3 percent stake of Mamma.com Inc. in 2004. The complaint alleged that Mamma.com planned to raise capital through a private placement of its equity (PIPE). Mamma.com's CEO called Cuban, then Mamma.com's largest shareholder, and informed him of the PIPE offering. Cuban agreed to keep the information regarding the PIPE offering confidential. According to the opinion, because this offering would dilute his position, Cuban became upset and said, "Well, now I'm screwed. I can't sell." Nevertheless, he instructed his broker to sell his entire stake in Mamma.com prior to the company's public announcement of the PIPE offering, thereby saving himself over $750,000. The SEC alleged that Cuban was liable for insider trading under the misappropriation theory of liability, under which a person is liable when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. The SEC relied on Rule 10b5-2(b)(1), which states that a person has "a duty of trust and confidence" for purposes of misappropriation liability when that person "agrees to maintain information in confidence." The district court granted Cuban's motion to dismiss, finding that an agreement merely to keep information confidential was insufficient to create a duty to disclose or abstain from trading under the misappropriation theory. Rather, only an express agreement not to trade creates such a duty.

The Fifth Circuit reversed, holding that on the "factually sparse record" an equally plausible inference was that Cuban had in fact agreed not to trade—*i.e.*, that his conversation with the CEO was more than just a confidentiality agreement. The court pointed out that Cuban's position—that he could trade upon learning the information but not relay it to others—in effect gave him "an exclusive license to trade on the material nonpublic information." The court vacated the dismissal and remanded the case for further proceedings.

S.D.N.Y. Denies Motion to Compel SEC to Turn Over Exculpatory Evidence

***Sec. & Exch. Comm'n v. Pentagon Capital Mgmt. PLC*, No. 08 Civ. 3324 (S.D.N.Y. Nov. 12, 2010)**

Judge Robert W. Sweet of the U.S. District Court for the Southern District of New York denied a motion by the defendants in an SEC enforcement action to compel the SEC to turn over any exculpatory evidence pursuant to *Brady v. Maryland*, 373 U.S. 83 (1963), and *United States v. Giglio*, 405 U.S. 150 (1972). The court reasoned that there was no basis to extend *Brady* and *Giglio* to the SEC enforcement action because the defendants had a right to conduct extensive pretrial discovery, and, in fact, had done so. The court also raised, but did not resolve, the open question of whether *Brady* and *Giglio* are limited to only criminal proceedings.

California Federal Court Refuses to Grant Summary Judgment on "Truth-in-the-Market" Defense in Securities Fraud Action

***Sec. & Exch. Comm'n v. Mozilo*, No. CV 09-3994-JFW (C.D. Cal. Sept. 16, 2010)**

Judge John F. Walter of the U.S. District Court for the Central District of California denied the motions for summary judgment of three senior executives of Countrywide Financial Corporation, finding that the SEC's complaint raised genuine issues of material fact regarding whether the executives made misleading statements and omissions about the quality of Countrywide's loan portfolio and underwriting practices. The SEC's complaint alleged, *inter alia*, that the CEO, the COO and the CFO committed securities fraud, in violation of Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act, by misrepresenting the risks of Countrywide's loan portfolio and underwriting practices. In particular, the SEC alleged that the defendants made misleading statements in periodic SEC filings and during earnings calls, conferences and investor presentations that assured investors that Countrywide was an originator of quality mortgages, unlike competitors who primarily engaged in subprime loan origination. However, during the same time period, Countrywide allegedly "undertook an unprecedented loosening or expansion of its underwriting guidelines, to the point of virtually abandoning its guidelines by matching products offered by any competitor, writing riskier and riskier loans, and making exceptions to its already lax underwriting guidelines."

The defendants moved for summary judgment on the SEC's fraud claims primarily on the grounds that the alleged material misrepresentations and omissions were not misleading as a matter of law because accurate information could be found in the market, which factored such information into Countrywide's stock price—*i.e.*, the so-called "truth-in-the-market" defense. The court rejected the defendants' argument that they were entitled to the "truth-in-the-market" defense "in light of Countrywide's extensive disclosures about the risk characteristics of its loan" portfolio. The court concluded that the defendants were attempting to "replace the traditional analysis of materiality, *i.e.*, whether there is a substantial likelihood that a *reasonable investor* would view disclosure of the omitted fact as having significantly altered the total mix of information available, with a 'truth in the market' defense…in this SEC enforcement action." The U.S. Court of Appeals for the Ninth Circuit has held that, "in an action that does not involve the fraud on the market presumption, that truthful information is available elsewhere does not relieve a defendant from liability for misrepresentations in a given filing or statement." *Miller v. Thane Int'l, Inc.*, 519 F.3d 879, 887 n.2 (9th Cir. 2008). According to the court, therefore, because the SEC in an enforcement action need not prove reliance, the fraud-on-the-market presumption "is not relevant," and, thus, the alleged misstatements and omissions by the Countrywide executives were not rendered immaterial as a matter of law simply because truthful information was available to the public elsewhere.

SECONDARY ACTORS

Fifth Circuit Adopts Second Circuit's Approach to Secondary Actor Liability

***Affco Inv. 2001 LLC v. Proskauer Rose L.L.P.*, No. 09-20734 (5th Cir. Oct. 27, 2010)**

The U.S. Court of Appeals for the Fifth Circuit held that a law firm that purportedly assisted in developing alleged fraudulent tax strategies through the provision of certain tax opinions could not be primarily liable under Section 10(b) of the Securities Exchange Act because there was no conduct or statements that could be directly attributable to the law firm. The plaintiffs alleged that the company that promoted the tax strategies informed investors that it would provide independent opinions from "several major national law firms" that had analyzed and approved the tax strategy. Based on these assurances, the plaintiffs allegedly agreed to invest in the purported scheme. After the transactions were complete, but before the plaintiffs filed their tax returns, the IRS issued notices addressing certain transactions it deemed prohibited. In response, the plaintiffs allegedly sought tax opinions from the law firm of Proskauer Rose L.L.P., which Proskauer provided; the opinions allegedly concluded that the "losses" plaintiffs generated through the alleged tax shelter likely were allowable. Based on this advice, the plaintiffs allegedly reported the "losses" from the investment. The IRS later audited the plaintiffs, and they were required to pay back taxes and penalties. The plaintiffs sued Proskauer under Section 10(b) for their involvement, but the district court granted Proskauer's motion to dismiss the plaintiffs' securities claims.

The Court of Appeals agreed with the district court that the plaintiffs had failed to plead sufficiently the element of reliance. Drawing on the U.S. Supreme Court's decisions in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008), and *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), the court held that a secondary actor cannot be held liable in a private Section 10(b) action for deceptive conduct not explicitly attributed to it before an investor decides to invest. Although the plaintiffs claimed to have relied on Proskauer's tax opinions, the court found that they failed to allege "that they ever saw or heard any Proskauer work product before making their decision, nor d[id] they explicitly allege that the promoters specifically identified Proskauer as one of the 'major national law firms.'" Accordingly, the plaintiffs "failed to show reliance on Proskauer" and the law firm could not be a primary violator.

In reaching this conclusion, the Fifth Circuit expressly adopted the standard articulated by the U.S. Court of Appeals for the Second Circuit in *Pacific Investment Management Co. LLC v. Mayer Brown LLP*, 603 F.3d 144 (2d Cir. 2010) (*PIMCO*), which held that a secondary actor could only be liable under Section 10(b) for false statements attributed to it at the time of dissemination. Notably, the Supreme Court has granted certiorari in *In re Mutual Funds Investment Litigation*, 566 F.3d 111 (4th Cir. 2009), *cert. granted*, *Janus Capital Group, Inc. v. First Derivative Traders*, 130 S. Ct. 3499 (2010), and will be reviewing this issue.

SECURITIES ACT CLAIMS

S.D.N.Y. Dismisses Claims Involving Mortgage-Backed Securities

***NECA-IBEW Health & Welfare Fund v. Goldman, Sachs & Co.*, No. 08 Civ. 10783 (MGC) (S.D.N.Y. Oct. 14, 2010)**

Judge Miriam Goldman Cedarbaum of the U.S. District Court for the Southern District of New York dismissed claims that Goldman Sachs violated Section 11 of the Securities Act in connection with mortgage-backed securities issued by a Goldman Sachs subsidiary. The plaintiff is required to have suffered a loss to state a claim for violation of Section 11; because the plaintiff still received the "pass-through" cash flow payments it was entitled to as an owner of those securities, it had not suffered a loss in the traditional sense. Instead, the plaintiff claimed that the value of the securities had declined because it would take a loss if it sold the securities. However, not only did the prospectus disclose that the securities might be illiquid because no secondary market was guaranteed to exist or continued to exist, but the plaintiff also did not adequately plead that any secondary market actually existed for those securities. As such, the plaintiff had not suffered an injury cognizable under Section 11. Finally, the court noted that the increased risk associated with future "pass-through" cash flow payments due to increased risks with the underlying mortgages was also insufficient injury to state a Section 11 claim.

S.D.N.Y. Upholds Claims Against AIG Involving Credit-Default Swaps and Residential Mortgage-Backed Securities

***In re Am. Int'l Group, Inc. 2008 Sec. Litig.*, No. 08 Civ. 4772 (LTS) (S.D.N.Y. Sept. 27, 2010)**

Judge Laura Taylor Swain of the U.S. District Court for the Southern District of New York upheld claims that AIG and its senior officers, directors, underwriters and auditor violated Sections 11 and 12(a)(2) of the Securities Act, in connection with 101 AIG securities offerings, premised upon alleged misrepresentations with respect to AIG's credit-default swaps (CDS) portfolio and residential mortgage-backed securities (RMBS) exposure made in AIG's SEC filings. First, the plaintiffs had standing to assert claims relating to all 101 offerings because all of the offerings used the same shelf registration statement, and the plaintiffs—who purchased in some of those offerings—were challenging alleged misrepresentations and omissions in the shelf registration statement. Second, the Securities Act claims were timely because they were brought within three years of all of the plaintiffs' transactions and within one year of AIG's announcement of the government bailout—when plaintiffs were finally on notice of the claims (inquiry notice did not start earlier, because AIG continued to make misrepresentations throughout the purported class period). Third, the court explained that it would be "inappropriate" to dismiss the Securities Act claims against AIG's auditor on a motion to dismiss when the auditor was accused of blessing financial statements that allegedly violated specified GAAP principles and were "fundamentally misleading." (A discussion of the court's decision about related claims under Section 10(b) of the Securities Exchange Act may be found below under "Securities Fraud Pleading Standards.")

SECURITIES FRAUD PLEADING STANDARDS

Eighth Circuit Affirms Dismissal of Case Against Medtronic and Three of Its Directors

***Detroit Gen. Ret. Sys. v. Medtronic, Inc.*, No. 09-2518 (8th Cir. Sept. 16, 2010)**

The U.S. Court of Appeals for the Eighth Circuit affirmed the dismissal of securities fraud claims against Medtronic, Inc. for failure to plead fraud with sufficient particularity. The complaint alleged that Medtronic engaged in securities fraud by misleading investors regarding the severity of a problem with defibrillator leads the company designed, manufactured, marketed and sold. The complaint further alleged that in March 2007, after being made aware of a potential problem with the device, Medtronic sent a letter to physicians informing them that some clinics had reported higher than normal fail rates and fracturing in the device, and that Medtronic was investigating the reports. In May 2007, according to the complaint, Medtronic filed an application with the Food and Drug Administration to modify the design of the device, and, in October 2007, Medtronic announced it was suspending sales of the device. As a result, the company's stock price dropped approximately 11 percent from its pre-recall price of $56.33 in the days following the recall, falling to a low of $45.54. The plaintiffs filed suit, alleging that the March 2007 letter to physicians "falsely reassured" investors that problems stemmed from doctor error and that the product's failure rate was in line with that of similar products.

The Eighth Circuit agreed with the district court that the letter was not materially misleading as it did not make an equivocal statement regarding the device's safety, nor did it cite doctor error as the sole problem. Rather, the letter presented its information as preliminary and referenced Medtronic's ongoing investigation. The Court of Appeals also agreed with the district court's rejection of the plaintiffs' contention that Medtronic's failure to disclose information about the product's fracture rate rendered the letter materially misleading. The court found that the plaintiffs failed to show that Medtronic possessed the information when the alleged inconsistent statements were made. The court also held the complaint failed to establish scienter because it did not contain facts sufficient to show falsity of the statements and, thus, could not show that Medtronic or its officers knew the statements were false.

S.D.N.Y. Upholds Claims Against Attorney for Alleged Misconduct in Offerings

***Sec. & Exch. Comm'n v. Czarnik*, No. 10 Civ. 745 (PKC) (S.D.N.Y. Nov. 29, 2010)**

Judge P. Kevin Castel of the U.S. District Court for the Southern District of New York upheld most of the claims asserted by the SEC, charging that an attorney violated Section 10(b) of the Securities Exchange Act and Sections 5(a), 5(c) and 17(a) of the Securities Act by drafting legal documents, including opinion letters, for issuers to use in inducing transfer agents to issue unregistered shares of penny stock in three companies in connection with five offerings. The SEC further alleged that the issuers—with whom the attorney worked—sold the unregistered shares to the unsuspecting public in a pump-and-dump scheme. The court dismissed claims as to the attorney's alleged misconduct in the first three offerings and upheld claims as to the attorney's alleged misconduct in the later two offerings because the complaint alleged that the attorney (having become aware of the issuer's purported misrepresentations after the first three offerings were completed) only acted recklessly in connection with the later two offerings. Further, the complaint pled scienter about the later two offerings because the attorney knew that the promoters' representations that they would not sell the stock in the first three offerings were false. Finally, the attorney was a necessary participant and substantial factor in the unregistered offering, and therefore the complaint stated a claim for violations of Sections 5(a) and 5(c).

S.D.N.Y. Dismisses Claim Against Majority Owner Relating to Subsidiary's Statements

***In re Celestica Inc. Sec. Litig.*, No. 07 CV 312 (GBD) (S.D.N.Y. Oct. 14, 2010)**

Judge George B. Daniels of the U.S. District Court for the Southern District of New York dismissed claims that Celestica, its former CEO and CFO, its majority shareholder and its majority shareholder's CEO violated Section 10(b) of the Securities Exchange Act by allegedly misrepresenting Celestica's earnings and corporate restructuring to purportedly inflate Celestica's stock price. The court determined that the complaint did not plead that the majority shareholder or its CEO made the alleged misrepresentations because neither was alleged to have actually made them or had any role in their preparation, issuance or dissemination. It was insufficient to premise the majority shareholder's (or its CEO's) liability solely on its holdings in Celestica or on conclusory allegations that the majority shareholder's CEO attended Celestica's executive committee meetings. Similarly, the complaint did not plead that Celestica's CEO or CFO acted with scienter because it did not provide a specific motive (other than the general motive that their employer should appear profitable and maintain a high stock price) or plead that either acted recklessly (because it did not plead what specific information was provided to the CEO or CFO that was contrary to their public statements).

S.D.N.Y. Upholds Claims Against AIG Involving Credit-Default Swaps and Residential Mortgage-Backed Securities

***In re Am. Int'l Group, Inc. 2008 Sec. Litig.*, No. 08 Civ. 4772 (LTS) (S.D.N.Y. Sept. 27, 2010)**

Judge Laura Taylor Swain of the U.S. District Court for the Southern District of New York upheld claims that AIG and its directors, senior officers, underwriters and auditors violated the federal securities laws through alleged misrepresentations with respect to AIG's credit default swaps (CDS) portfolio and residential mortgage-backed securities (RMBS) exposure made in AIG's SEC filings. The complaint adequately pled violations of Section 10(b) of the Securities Exchange Act by AIG and its senior officers because it pled that AIG made alleged misrepresentations about the extent of the CDS portfolio that AIG subsidiary AIGFP entered into in 2005 (including about AIGFP's risk controls, pre-purchase due diligence for CDS and CDS models) and the percentage of

AIG's securities lending programs made in RMBS. The court explained that the challenged statements were not protected as forward-looking statements under the PSLRA safe-harbor because AIG's risk disclosures were inadequate in light of undisclosed "hard facts" indicating that AIG did not reasonably believe the forward-looking statements. Moreover, scienter was adequately pled because AIG and its senior officers knew about the extent of the CDS exposure and RMBS investments and chose not to disclose those facts, despite internal indicators (and warnings from AIG's auditor) of potential problems. Finally, loss causation was pled because the purported corrective disclosures of the principal undisclosed facts caused AIG's stock price to drop, to the plaintiffs' detriment. (A discussion of the court's decision about related claims under Sections 11 and 12(a)(2) of the Securities Act against AIG may be found above under "Securities Act Claims.")

S.D.N.Y. Upholds Claims Against Sallie Mae Relating to Loan Issuance Standards

***In re SLM Corp. Sec. Litig.*, No. 08 Civ. 1029 (WHP) (S.D.N.Y. Sept. 24, 2010)**

Judge William H. Pauley III of the U.S. District Court for the Southern District of New York upheld claims that Sallie Mae and its CEO violated Section 10(b) of the Securities Exchange Act through alleged misrepresentations about Sallie Mae's practices with private educational loans. The complaint pled that Sallie Mae allegedly misrepresented its loan issuance standards, understated its loan loss reserves and improperly shifted defaulted loans into "forbearance" (allowing deferral of payments while interest continued to accrue) to hide defaults. The court determined that the complaint adequately pled that the CEO, and therefore Sallie Mae, acted with scienter because the complaint alleged a specific motive for the CEO to wish to keep Sallie Mae's stock price high. The CEO allegedly wished to keep Sallie Mae's stock price high because (i) Sallie Mae had entered into futures contracts that would subject Sallie Mae to significant liability if its stock price fell below a certain price, (ii) the CEO was attempting to engineer a merger with another company, which would pay him $225 million if completed, and needed to keep Sallie Mae's stock price above the trigger price in the futures contracts to keep the merger viable, and (iii) during the purported class period, the CEO sold approximately 97 percent of his Sallie Mae stock. However, the court dismissed Section 10(b) claims against Sallie Mae's former CFO for failure to adequately plead scienter because he was not alleged to have engaged in unusual trading activity and was not specifically alleged to have acted recklessly, *e.g.*, making a statement while in possession of a specific report indicating the statement was false. Further, the complaint adequately pled misrepresentations by pleading facts showing that the challenged statements were false and were known to be false when made and were directed at Sallie Mae's present condition.

STATUTES OF LIMITATIONS

D.C. Circuit Affirms SEC Administrative Sanctions and Disgorgement Order Against Individual

***Riordan v. Sec. & Exch. Comm'n*, No. 10-1034 (D.C. Cir. Dec. 28, 2010)**

The U.S. Court of Appeals for the D.C. Circuit affirmed the SEC's administrative sanctions and disgorgement order against an individual, Guy P. Riordan, who was found to have violated Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act. Riordan had paid kickbacks to New Mexico's state treasurer in exchange for steering state securities transactions to Riordan's brokerage firms from 1996 to 2002. However, SEC enforcement actions seeking a "civil fine, penalty, or forfeiture" are subject to a five-year limitations period, and the SEC brought its enforcement action in late 2007. Both the civil fine and association bar that Riordan received were subject to that limitations period, but the SEC properly considered Riordan's conduct only in late 2002 in determining the amount of the fine and whether to impose an association bar. Further, the SEC could consider Riordan's pre-2002 conduct in determining how much he would be required to disgorge because, under *Zacharias v. Sec. & Exch. Comm'n*, 569 F.3d 458 (D.C. Cir. 2009), disgorgement is not a "civil penalty," and therefore is not subject to the five-year limitations period. Applying *Drath v. FTC*, 239 F.2d 452 (D.C. Cir. 1956), the court further determined that the SEC could consider Riordan's pre-2002 conduct in determining whether to impose a cease-and-desist order because those orders are "purely remedial and preventive" and not a "penalty or forfeiture," and so are not subject to the five-year limitations period.

S.D.N.Y. Dismisses Claims Relating to Sale of ARS to Non-Qualified Buyer

***Teva Pharm. Indus. Ltd. v. Deutsche Bank Sec., Inc.*, No. 09 Civ. 6205 (AKH) (S.D.N.Y. Dec. 14, 2010)**

Judge Alvin K. Hellerstein of the U.S. District Court for the Southern District of New York dismissed claims that the broker-dealer for auction rate securities (ARS) issued by special purpose vehicles organized by the broker-dealer violated Sections 12(a)(1) and 12(a)(2) of the Securities Act. The ARS were issued as exempt from registration because they only were offered to qualified institutional buyers; however, some of the ARS were sold to an entity that was not a qualified institutional buyer, a fact that the entity disclosed in an SEC filing. The court concluded that both claims were barred by the one-year statute of limitations applicable to Securities Act claims. As to the Section 12(a)(1) claim, the court explained that the one-year statute of limitations was an absolute limitations period that was not subject to the discovery rule; because that claim was filed more than one year after the ARS were sold to the entity that was not a qualified institutional buyer, it was time-barred. As to the Section 12(a)(2) claim, although the limitations period was subject to the discovery rule, the court concluded that the plaintiff was on inquiry notice of its claim more than a year before filing suit because the sale to a non-qualified institutional buyer was disclosed in an SEC filing, and the plaintiff, as a sophisticated investor, would have reviewed SEC filings.

TOLLING

Ninth Circuit Reaffirms Rule Regarding Section 16(b) Statute of Limitations

Simmonds v. Credit Suisse Sec. (USA) LLC, Nos. 09-35262 (9th Cir. Dec. 2, 2010)

The U.S. Court of Appeals for the Ninth Circuit held that the statute of limitations for claims brought under Section 16(b) of the Securities Exchange Act—which requires corporate insiders to disgorge profits realized on securities sold within six months of the date of their purchase—is tolled until the insider discloses such "short-swing" transactions in a Section 16(a) filing, regardless of whether the plaintiff knew or should have known of the conduct at issue. Vanessa Simmonds brought 54 related complaints under Section 16(b), alleging that various investment banks violated the prohibition on short-swing transactions in connection with the initial public offerings of 54 companies between 1999 and 2000. Thirty underwriter defendants moved to dismiss based on Simmonds' failure to present an adequate demand letter to the companies' boards prior to filing her lawsuits. The remaining 24 underwriter defendants moved to dismiss on the grounds that Simmonds' claims were barred by Section 16(b)'s two-year statute of limitations. The district court granted the defendants' motions to dismiss all 54 complaints. On appeal, the Ninth Circuit affirmed the district court's conclusion that Simmonds failed to make adequate demand as to 30 complaints, but reversed the district court's conclusion that the remaining 24 cases were barred by Section 16(b)'s two-year statute of limitations.

Section 16(b) provides that "no…suit shall be brought more than two years after the date such profit was realized" from the alleged short-swing transactions and, further, Section 16(a) imposes a reporting requirement on persons who beneficially own more than 10 percent of the issuer's securities, requiring them to file Form 4s with the SEC, disclosing their acquisitions and dispositions of the issuer's stock. In the 1981 decision of *Whittaker v. Whittaker Corp.*, 639 F.2d 516 (9th Cir. 1981), the Ninth Circuit adopted a "disclosure approach" to Section 16(b)'s statute of limitations provision, under which "an insider's failure to disclose covered transactions in the required Section 16(a) reports tolls the two year limitations period for suits under Section 16(b) to recover profits connected with such a non-disclosed transaction. The two-year period for Section 16(b) begins to run when the transactions are disclosed in the insider's Section 16(a) report." Here, the Ninth Circuit rejected the underwriter defendants' argument that *Whittaker*'s tolling rule should not apply to cases in which plaintiffs knew or should have known of the alleged wrongful conduct. Instead, the Ninth Circuit held that *Whittaker* established a "blanket rule that applies in *all* Section 16(b) actions," "regardless of whether the plaintiff knew or should have known of the conduct at issue."

Judge Milan Smith took the atypical step of writing a special concurrence to the majority opinion, which he authored, in order to criticize *Whittaker*'s blanket rule. He noted that a strict reading of Section 16(b)—under which no suit could be filed over two years after a short-swing profit is realized—is "eminently logical." Nevertheless, Judge Smith wrote that he was bound to apply *Whittaker* under *stare decisis* principles. On Dec. 16, 2010, the underwriter defendants petitioned the Ninth Circuit for rehearing en banc.

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Preferred Creditor Support for Regulated Institutions in CRE and MBS Transactions

By Charles Wallshein and Craig Knutson

Lenders have been using participation agreements whereby two or more entities could enter into loans under a single note and mortgage. The agreement spelled out the rights of the participants. The law on, and hence the form of, participation agreements was settled, stable and predictable. Add the fact that many banking participants did continuous and recurring business together, and the participation transaction became a very popular capital management and risk management tool. As of January 1, 2010 the participation agreement transaction changed with the adoption of Financial Accounting Standards Board Statement 166 (FASB 166).

In summary, FASB 166 states:[1]

- It must represent a proportionate (pro-rata) ownership interest in an entire financial asset;
- All cash flows received from the entire financial asset, except any cash flows allocated as compensation for servicing or other services performed (which must not be subordinated and must not significantly exceed an amount that would fairly compensate a substitute service provider should one be required), must be divided proportionately among the participating interest holders in an amount equal to their share of ownership;
- The rights of each participating interest holder (including the lead lender) must have the same priority, no interest is subordinated to another interest, and no participating interest holder has recourse to the lead lender or another participating interest holder other than standard representations and warranties and ongoing contractual servicing and administration obligations; and
- No party has the right to pledge or exchange the entire financial asset unless all participating interest holders agree to do so.

If a transfer of a portion of a financial asset does not meet the definition of a participating interest, both the lead lender transferring the participation and the party acquiring the participation must account for the transaction as a secured borrowing with a pledge of collateral.

FASB 166 redefined the participation transaction. If a participation between entities did not meet certain criteria, the "sale" of the asset would be re-classified as a loan from one entity to the other. The determination of whether the entities' interest in a participation as a sale of the asset, or as a loan to the participating entity, has remarkable and possible devastating ramifications in terms of the participant's capital accounting and regulatory capital. Similarly, attorneys must be aware of the change in classification and the subsequent consequences and ramifications.

Participation agreements were widely used by small banks that needed to raise capital or defray risk by selling off portions (in participation form) of their loans. Loan participations are also executed so community bankers can issue loans to customers that the bank, because of legal lending limits and other risk-based reasons, might not otherwise be able to make. However, FASB 166 has the unintended effect of chilling this valuable tool for institutions that did not engage in securitizations.

The primary goal of FASB 166 is stated in the Statement's summary:

> The Board's objective in issuing this Statement is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets.[2]

The regulatory capital issue FASB 166 was designed to address was the treatment of risk weighted Asset Backed Commercial Paper (ABCP) and the relationships between the entities participating in securitizations of same. Under FASB 140 banks were allowed to transfer assets to a *Qualified Special Purpose Entity* (QSPE) or a *Variable Interest Entity* (VIE) and technically remove the asset and the associated risk from its balance sheet, while still retaining a portion of the asset (usually the riskiest piece) on its balance sheet. This methodology typically showed a much lower exposure (risk) to the original asset, while in reality, the bank retained much if not all of the original risk through its retention of the B piece.

FASB 166 redefined the concept of the "*participating interest*." When a portion of a financial asset is transferred, that portion must have certain characteristics in order to qualify for *sale* accounting. If that portion does not have all the required characteristics, the transfer will not qualify as a sale and the applicable portion remains on the balance sheet of the transferor. If the entire asset remains on the transferor's balance sheet, the main purpose of the transaction is defeated, to wit, reducing the regulatory capital requirements. The FDIC adopted this accounting method in its *Final Rule Amending the Risk-Based Capital Rules to Reflect the Issuance of FAS 166 and FAS 167*.[3]

Perhaps Unintended Results?

However, FASB 166 did not contemplate a structured transaction where the originator receives a *reduced* cash flow in exchange for a true reduction in risk. The originating institution in a *Preferred Creditor Transaction* (PCT) does not retain any portion of the junior debt. The amendments to FASB 140 to address the problem were contemplated as early as 2004 when the issues of regulatory risk, falling asset values and the corresponding requirement for increased reserves were not prevalent. FASB 166 does clarify the accounting methodology for participants in securitized transactions but at the same time makes risk management through loan participations nearly impossible for smaller institutions.

On the regulatory side, the *Final Rule* allows the Agency to retain the authority to require the originating institution to hold capital against its risk exposure. Like FASB, the FDIC did not contemplate the structure of the *Preferred Creditor Transaction* in adopting GAAP's narrow classifications for transfers of financial assets.

The initial conclusion is that any participation must have "vertical" strips to be considered a sale of assets. For a regulated institution to enter into such a transaction for any purpose other than being able to originate and participate in loans that exceed its loan limits is pointless. Under the current structure, the *Final Rule* prohibits sale accounting if the participants attempt to contractually divide loan yield, default risk, or any other derivative aspect of a whole loan.

The banking Bar's reaction to FASB 166 and the *Final Rule* should be to design a transaction that preserves the spirit of FASB 166 while allowing participants to contractually divide the derivative income and risk (asset and liability) components of a loan. The Bar should likewise be aware of the dire consequences for its banking clients should the participation run afoul of FASB 166.

The Transaction

The opportunity exists for non-regulated entities (the "Investor") to provide needed capital to regulated institutions (the "Bank") as creditor support on their loan portfolios. Described in the simplest way, the Bank would sell a portfolio of loans to a trust, and the trust would issue certificates or tranches. The Bank would buy back the safest cash flow tranche(s) from the trust. The Investor would purchase the riskier tranches (the "B piece") from the trust at discounts commensurate to their respective risk.

The Bank would receive credit support by transferring a group of loans to a trust wherein the whole loan or loans are removed from the balance sheet (removing the risk weighted asset) in exchange for cash. The assumption is that the transaction would be priced at the point where the discounted cash flow from the senior portion of the debt is greater than the discounted cost of maintaining regulatory capital.

The trust would engage a third party servicer that would administer the distribution of cash flows. The trust agreement would contain provisions similar to a *Pooling and Servicing Agreement* (PSA). The trust's *servicing agreement* (there is no pooling) would also contain provisions and define rights concerning recovery methods of the junior members for delinquent and defaulted loans.

Any losses occurring on the underlying loan portfolio would be borne by the B piece (purchased by the Investor) until its certificate balance is reduced to zero. The Bank would thus obtain credit enhancement equal to the amount of the B piece purchased by the Investor. There is no recourse to the originating institution other than representations and warranties and possible fees for servicing.

The transaction derives its structure from elements of other common CRE and CMBS transactions. The transaction is structured to ensure the following: (a) that the trust is insulated and isolated from the insolvency, bankruptcy or receivership of both the Bank and the Investor; (b) the cash flows are distributed to the holders of the certificates according to the provisions of the trust agreement; (c) the transaction involves no recourse (other than standard representations and warranties) to the parties of the transaction.

Now that "Participation" is a dirty word the issue of what to name and how the transaction is characterized is critical. The transaction should not be characterized as a *Participation* under FASB 166 Paragraph 8B or 9. FASB Statement 166 replaces FASB 140. FASB 140 was amended because originators of securitized assets were retaining the riskiest portion of the securitization and treating the transaction as an "off balance sheet" transaction. The FASB felt, and perhaps rightfully so, that accounting in this manner led to inaccurate accounting and lacked sufficient transparency. This "new" structure has the exact opposite effect.

It Is Definitely NOT a Securitization

The *Preferred Creditor Transaction* is definitely not a securitization for a number of reasons. First, each transaction in the trust is treated as a separate sub-entity. There is no pooling of loans into a group. Second, there is no security created. Third, each loan in the trust is booked at its *fair value*. Fourth, the *fair value* accounting between participant tranches is always booked with *zero-sum*, *mirror image* values. The assets and liabilities are always booked for each loan simultaneously by internal and regulatory audits and must carry over to the certificate holder's balance sheet in that manner. In these four ways the transaction is, for accounting purposes, completely transparent.

The Asset Is Sold

The substance of the transaction is that the regulated institution sells the entire asset (one loan) to a third party (the trust) and buys back, at a discounted yield, the most secure cash flow tranche of that loan. The originating bank receives cash for the entire asset (the whole loan). Then, in a separate transaction, the originating bank buys a portion of the right to receive cash flow in the form of a trust certificate.

The Question of How to Value the Trust Certificate

In terms of valuation of whole loans, assets are valued according to their probability of repayment. Logic dictates that almost every income-producing real estate asset has some intrinsic value. These values are based on the method of recovery contemplated by the asset holder.

In determining the asset's value for regulatory capital purposes the valuation methodology is exactly the same for a PCT as it would be for the whole loan. The sum of the cash flow tranches of the trust certificate are exactly the value of the whole loan had it been held in whole form by the originator. However, in the PCT, the different tranches have different perceived values due to a spread created by the cost of maintaining regulatory capital.

Securitization, Participation, Secured Loan or Something Else?

The *Preferred Creditor Transaction* is "something else." It is neither a *Participation* nor a *Securitization* in the traditional sense. The *Preferred Creditor Transaction* is unique in that it maintains the spirit of FASB 166 in its structural integrity by ensuring that the transaction is transparent and that all assets' risk components are evaluated, booked at *fair value* and uniformly reported on all parties' balance sheets.

Endnotes

1. Financial Accounting Standards Board Statement 166.
2. *Id*. at page i.
3. As a result of the implementation of FAS 166 and FAS 167, the categories of securitization and structured finance exposures that are currently off-balance sheet that are likely to be subject to consolidation on the balance sheet of the originating or servicing bank include: ABCP conduits; loan securitizations in which a bank retains a residual interest and servicing rights; revolving securitizations structured as master trusts; and certain tender option bond trusts that were designed as QSPEs. Thus, the implementation of FAS 166 and FAS 167 will for some banks increase the amount of assets and liabilities reported on their balance sheets and may result in significantly higher regulatory capital requirements. *Final Rule Amending the Risk-Based Capital Rules to Reflect the Issuance of FAS 166 and FAS 167*. FDIC, January, 2010.

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SEC Adopts New Rules for "Say-on-Pay"

By Guy P. Lander

As a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") the SEC has been very active adopting and proposing new rules. This article will describe the new rules adopted for "Say-on-Pay," "Say-on-Frequency" and "Say-on Golden Parachutes."

On January 25, 2011, the SEC adopted final rules implementing Section 951 of the Dodd-Frank Act that require U.S. public companies to conduct separate shareholder advisory votes on:

1. executive pay ("say-on-pay");
2. frequency of the vote on say-on-pay ("say-on-frequency"); and
3. executive compensation in connection with mergers and acquisitions ("M&A") transactions that are submitted to shareholders for approval ("say-on-golden parachutes").

Say-on-Pay

Under new Rule 14a-21(a), issuers must provide shareholders with a separate advisory (i.e., non-binding) vote in proxy statements to approve the compensation of their named executive officers at least once every three years.

Say-on-Pay (and say-on-frequency votes) are required only for annual meetings of shareholders in which proxies are being solicited to elect directors or a special meeting in lieu thereof.

The say-on-pay vote:

- covers all of Compensation Discussion and Analysis (CD&A), the compensation tables and the narrative compensation discussion provided under Regulation S-K, Item 402;
- does not cover director compensation; and
- does not cover disclosure under Regulation S-K, Item 402(s), related to compensation policies and practices for employees that are reasonably likely to have an adverse material effect on the company. But if risks arising from compensation policies are discussed as part of CD&A, that discussion will be covered by the say-on-pay vote, because it is part of the CD&A disclosure.

While the final rules do not require specific language or form for the say-on-pay resolution, a company must indicate that the say-on-pay vote is a vote to approve all executive compensation disclosed pursuant to Item 402 of Regulation S-K.[1]

The SEC also adopted amendments to require issuers to address in the CD&A whether, and if so, how, their compensation policies and decisions have taken into account the results of the most recent shareholder advisory vote on executive compensation. It is the SEC's view that companies must use the CD&A to address their consideration of earlier say-on-pay votes to the extent that consideration is material to a company's compensation policies and decisions. Smaller reporting companies would not be subject to this requirement, but they are already required to provide a narrative description of material factors necessary to understand the summary compensation table, and therefore would need to disclose the effect of prior say-on-pay votes if that is a material factor in setting compensation. This requirement is for disclosure only and does not require a board to conform to a vote on say-on-pay.

Generally, to date shareholders of almost all companies have approved the executive compensation submitted to a "say-on-pay" vote.

Say-on-Frequency

Under new Rule 14a-21(b), issuers are required, at least once every six calendar years, to provide shareholders with a separate advisory (i.e., non-binding) vote in proxy statements to determine whether the say-on-pay vote will occur every one, two, or three years. Frequency votes are required only for annual meetings of shareholders in which proxies are solicited to elect directors or a special meeting in lieu thereof.

Shareholders must be given four choices, i.e., voting on whether the say-on-pay vote should occur every one, two, or three years, or abstaining from voting on the matter. While the company's board of directors may include a recommendation as to how shareholders should vote on the frequency of the say-on-pay vote, the company must make it clear that all four choices are available and that the shareholders are not voting to approve or disapprove the board's recommendation.[2]

Companies may vote uninstructed proxy cards in favor of the board's say-on-frequency recommendation, but only if:

a. the proxy describes the board's recommendation;

b. the company is presenting all four options (1, 2 or 3 years or abstain); and

c. bold language on the proxy card advises stockholders how uninstructed shares will be voted.

Companies must disclose their decisions as to how often they will hold say-on-pay votes going forward either in the Form 8-K disclosing their annual meeting voting results or in an amendment to that Form 8-K. If companies choose the amendment to the Form 8-K, it must be filed no later than 150 calendar days following their annual meetings and at least 60 calendar days before their deadlines for submission of shareholder proposals. Missing the filing deadline for this Item 5.07 of Form 8-K will cause issuers to lose their eligibility to file Form S-3 registration statements (absent a subsequent waiver from the SEC Staff).

Under new Item 24 of Schedule 14A, a company must (i) disclose that it is providing a separate shareholder vote on executive compensation and on the frequency of the executive compensation vote in the proxy statement for those votes, (ii) briefly explain the general effect of the votes, such as that the votes are non-binding, and (iii) disclose the current frequency of the company's say-on-pay vote and when the next say-on-pay vote will be conducted.

Amended Rule 14a-6 now states that a preliminary proxy statement is not required for shareholder advisory votes on executive compensation (including shareholder votes on say-on-pay and say-on-frequency).

IPO companies have been given no exemption from the new rules.

Smaller reporting companies need not propose say-on-pay and say-on-frequency votes until stockholder meetings occurring on or after January 21, 2013. New CDIs 169.01-169.03 provide specific transition guidance for companies entering and exiting smaller reporting company status.

Generally, to date shareholders of most companies have preferred annual say-on-frequency voting, with the preference being expressed even more frequently among the largest companies. Of the three say-on-frequency choices (1, 2 or 3 years) voting every two years has been by far the least popular.

Say-on-Golden Parachutes

Under the new rules, issuers must comply with requirements for disclosure of golden parachute arrangements and for a separate shareholder advisory vote to approve golden parachute arrangements. Under new Rule 14a-21(c) in any proxy or consent solicitation for a meeting at which shareholders are asked to approve an M&A transaction, companies must provide a separate shareholder advisory vote to approve the golden parachute payments disclosed under new Item 402(t) of Regulation S-K, described below. An M&A transaction covered by the new rules is any acquisition, merger, consolidation or proposed sale or disposition of all or substantially all of an issuer's assets.

The SEC adopted Item 402(t) of Regulation S-K, which requires disclosure of the golden parachute arrangements of named executive officers in both tabular and narrative formats. "Golden parachutes" are broadly defined so that disclosure is required for all agreements or understandings between the named executive officers and either the acquiring company or the target company related to the applicable M&A transaction. The disclosure is required in both tabular and narrative forms, must include all arrangements and has no de minimis exception.

The table should present, in a series of columns for each named executive officer, the dollar value of all golden parachute payments potentially payable in connection with the transaction. The table should include columns for the dollar value of: cash severance; equity awards that are accelerated or otherwise cashed out; pension and nonqualified deferred compensation enhancements; perquisites and other personal and health and welfare benefits; tax reimbursements; other compensation; and the total amount of all such compensation. Each individual element of compensation is required to be quantified separately in footnote disclosure.

If the target company is the soliciting person, then agreements or understandings between the acquirer and the named executive officers of the target, while required to be disclosed, are not subject to the say-on-golden parachute vote.

Companies are not required to conduct say-on-golden parachute votes if the golden parachute arrangements were already voted upon in an annual say-on-pay vote and have not been modified. Changes to golden parachute arrangements that decrease the total compensation do not require a subsequent shareholder vote.

There appears to be little advantage to including the necessary enhanced golden parachute disclosure in an annual proxy statement because subsequently adopted arrangements or changes would have to be voted on at the shareholders meeting for the transaction. There also may be a reluctance to subject golden parachute arrangements to a shareholder vote in the absence of an actual M&A transaction.

The SEC amended the disclosure requirements of SEC forms other than proxy statements to require golden parachute payment disclosure in other business combination transactions, such as tender offers, going-private transactions, or transactions involving an information statement not subject to Regulation 14A. However, bidders in third-party tender offers are not required to provide golden parachute disclosure on Schedule TO if the third-party tender offer is not also a Rule 13e-3 going-private transaction. Additionally, shareholder approval would not be required in connection with these additional disclosure requirements.

Item 402(t) disclosure will be required in essentially all documents that relate to a business combination, including:

- Information statements filed pursuant to Regulation 14C;
- Proxy or consent solicitations that do not contain merger proposals but require disclosure of information under Item 14 of Schedule 14A pursuant to Note A of Schedule 14A (for example, proxies solicited to approve the issuance of new shares or a reverse stock split in order to conduct a merger transaction);
- Registration statements on Forms S-4 and F-4 (that do not otherwise contain certain proxy statement disclosure) containing disclosure relating to mergers and similar transactions;
- Going private transactions statements on Schedule 13E-3; and
- Schedule 14D-9 solicitation/recommendation statements.

Shareholder approval, however, would not be required in connection with these additional disclosure requirements.

Companies Covered by the New Rules

The new rules apply to all companies that are subject to the proxy solicitation requirements of the Exchange Act, including all domestic issuers. Foreign private issuers will generally not be subject to the new rules.

Effective Date

While the say-on-pay and say-on-frequency rules were not technically effective until April 4, 2011, implementation by public companies (other than smaller reporting companies) will occur immediately as the Dodd-Frank Act already requires those companies to hold say-on-pay and say-on-frequency votes at the company's first shareholder meetings held on or after January 21, 2011. Smaller reporting companies are not required to comply with the say-on-pay and say-on-frequency rules until their first annual shareholder meeting on or after January 21, 2013.

The new disclosure and voting requirements for golden parachutes applies to initial filings of the applicable statements and schedules by issuers (including smaller reporting companies) made on or after April 25, 2011.

Endnotes

1. The final rules provide the following example: "RESOLVED, that the compensation paid to the company's named executive officers, as disclosed pursuant to Item 402 of Regulation S-K, including the compensation Discussion and Analysis, compensation tables and narrative discussion, is hereby APPROVED."

   New CDI 169.05 permits issuers to substitute plain English wording for "pursuant to Item 402 of Regulation S-K" in this sample resolution, such as:

   > pursuant to the compensation disclosure rules of the Securities and Exchange Commission, including the compensation discussion and analysis, the compensation tables and any related material disclosed in this proxy statement.

2. The final rules do not prescribe a form of resolution for the say-on-frequency vote, and the new CDI 169.04 clarifies that no formal resolution need be proposed at all. New CDI 169.06 also provides flexibility for the wording of the vote, allowing it to include the words "every year, every other year, or every three years, or abstain" instead of the words, "every 1, 2, or 3 years, or abstain."

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Employment Law Update

By James R. Grasso

A) New York State Construction Industry Fair Play Act

Due to "dangerous levels of employee misclassification fraud," the New York State Legislature amended the New York Labor Law by adding a new article 25-B, known as the New York State Construction Industry Fair Play Act, effective October 26, 2010. This new law provides that any person performing services for a construction contractor or subcontractor is deemed an employee, unless (a) the individual is free from control and direction in performing the job, both under his or her contract and in fact; (b) the service is performed outside the usual course of business for which the service is performed; and (c) the individual is customarily engaged in an independently established trade, occupation, profession or business that is similar to the service at issue. A business entity will be considered a separate entity from the contractor or subcontractor where all of the following criteria are met:

(1) the business entity is performing the service free from the direction or control over the means and manner of providing the service, subject only to the right of the contractor for whom the service is provided to specify the desired result;

(2) the business entity is not subject to cancellation or destruction upon severance of the relationship with the contractor;

(3) the business entity has a substantial investment of capital in the business entity beyond ordinary tools, equipment and a personal vehicle;

(4) the business entity owns the capital goods and gains the profits and bears the losses of the business entity;

(5) the business entity makes its services available to the general public or the business community on a continuing basis;

(6) the business entity includes services rendered on a Federal Income Tax Schedule as an independent business or profession;

(7) the business entity performs services for the contractor under the business entity's name;

(8) when the services being provided require a license or permit, the business entity obtains and pays for the license or permit in the business entity's name;

(9) the business entity furnishes the tools and equipment necessary to provide the service;

(10) if necessary, the business entity hires its own employees without contractor approval, pays the employees without reimbursement from the contractor and reports the employees' income to the Internal Revenue Service;

(11) the contractor does not represent the business entity as an employee of the contractor to its customers; and

(12) the business entity has the right to perform similar services for others on whatever basis it chooses and whenever it chooses.

The new law requires construction contractors and subcontractors to post a notice at the work site listing the responsibility of independent contractors to pay taxes as well as the various rights of employees, including their right to workers' compensation, unemployment benefits, minimum wages, overtime, and other federal and state protections. Employers who fail to post the required notice or who improperly classify an employee are subject to civil and criminal penalties. The civil penalties provide for a fine of $2,500 for the first misclassification violation and $5,000 for each subsequent violation within five years. Criminal penalties include 30 days imprisonment or a fine of up to $25,000 for the first violation, and 60 days in prison and $50,000 for each subsequent violation of this law. Further, any officer of the corporation or shareholder holding ten percent or more of the offending corporation is also subject to civil and criminal liability and any such person or contractor or subcontractor convicted of a misdemeanor is automatically barred from submitting bids on public works contracts for up to one year for the first violation and up to five years for any subsequent violation.

B) EEOC Issues Final GINA Regulations

On November 9, 2010, the Equal Employment Opportunity Commission ("EEOC") issued final regulations implementing Title II of the Genetic Information and Nondiscrimination Act ("GINA"), which applies to employers with at least 15 employees. GINA prohibits discrimination against employees based on genetic information and governs the acquisition, storage and disclosure of genetic information. The GINA regulations became effective January 10, 2011, and provide guidance on those issues.

What Is Genetic Information?

Genetic information means information about: (i) the genetic tests of an employee or his/her family members; (ii) the manifestation of a disease or disorder in an employee's family member; (iii) information about an employee's request for or receipt of genetic services, or participation in clinical research that includes genetic services by the employee or a family member; (iv) genetic information about the fetus carried by a female employee or her female family members; and (v) the genetic information of an embryo held by an employee or an employee's family member using assisted reproductive technology.

Who Is A Family Member?

The regulations define a "family member" as including any person who is a dependent of an employee as the result of marriage, birth, adoption or placement for adoption, or any relative up to the fourth degree, which includes parents, siblings, children (by birth and adoption), grandparents, grandchildren, uncles, aunts, nephews, nieces, half-siblings, great-grandparents, great-grandchildren, great-aunts and uncles, first cousins, great-great grandparents, great-great grandchildren, and first cousins once-removed.

Restrictions on Acquisition of Genetic Information

Although GINA prohibits discrimination based on genetic information, the most significant changes GINA will require employers to implement concern obtaining, storing and disclosing genetic information. *Under GINA, covered employers are prohibited from requesting, requiring or purchasing genetic information of employees or their family members, unless a specific exception applies.* The regulations define "requesting" broadly to include conduct such as conducting an Internet search that is likely to reveal genetic information, actively listening to third-party conversations or searching a person's personal effects for the purpose of obtaining genetic information, and making requests for information in a way that is likely to result in the disclosure of genetic information. GINA defines "employee" to include not only current employees, but also former employees and applicants.

What Are the Exceptions That Allow Genetic Information to Be Obtained Lawfully?

***Requests for medical information*—**GINA is not violated if genetic information is inadvertently obtained in response to a lawful request for medical information (*e.g.*, requests for information to support a reasonable accommodation or Family and Medical Leave Act ("FMLA") request). However, such information will not generally be considered to have been obtained inadvertently unless the employee or other responding party is notified not to provide the information. *The regulations specifically require that a covered employer must tell a health care provider conducting an employment-related medical examination intended to determine an employee's ability to perform a job not to collect genetic information, including family history.* The GINA regulations contain a sample statement for this purpose.

Inadvertent acquisition—GINA is not violated when a representative of a covered employer inadvertently obtains genetic information: (i) by overhearing a conversation between the person and others; (ii) from the person in response to an ordinary expression of concern, such as asking "how are you?" or "will your daughter be OK?"; (iii) by receiving it in an unsolicited fashion; or (iv) from a "social media platform" to which the person has given the representative permission to access.

***Wellness programs*—**GINA is not violated when a person voluntarily participates in an employer-provided health or wellness program and voluntarily discloses genetic information after providing a GINA-compliant written authorization. Covered employers may not offer a financial incentive for persons to provide genetic information. However, financial incentives may be offered for completion of a health risk assessment that includes questions about family medical history or other genetic information, provided that written notice is given that states the incentive will be paid whether or not the person answers such questions.

***Public and commercial records*—**Covered employers generally are not prohibited from acquiring genetic information from publicly and commercially available sources, as long as such records are not accessed with the intent of obtaining genetic information. Social networking and media sources that require permission to access from a specific person or where access is conditioned on membership in a particular group are *not* considered publicly available sources, unless the covered employer can show that access is routinely granted to all who request it.

***Genetic monitoring*—**GINA allows the acquisition of genetic information to conduct genetic monitoring of the effects of toxic substances, as long as the employee is provided with GINA-compliant written notice and he/she is informed of the results.

***DNA testing*—**GINA is not violated when an employer that conducts DNA analysis for law enforcement purposes or identification of human remains requests or requires genetic information from employees to the extent such information is used to detect sample contamination.

How Must Genetic Information Be Stored?

GINA requires that genetic information be treated as confidential medical information and maintained separately from personnel files. Genetic information may be stored in the same files used to maintain confidential medical information under the Americans with Disabilities Act ("ADA"). However, any genetic information placed in an employee's personnel file prior to November 21, 2009, need not be removed. Conversely, any genetic information placed in an employee's personnel file after that date should be removed.

Can Genetic Information Be Disclosed?

Yes, but only as follows:

- To the person about whom the information pertains, upon written request;
- To an occupational or other health researcher if the research is conducted in compliance with Occupational Safety and Health ("OSHA") regulations;

- In support of an employee's compliance with the FMLA's medical certification requirements;
- In response to a court order, but only to the extent expressly authorized by the order. If the order was secured without the person's knowledge, you must inform the person of the court order and any genetic information that was disclosed in response to it;
- To any government official investigating compliance with GINA, if the information is relevant to the investigation; or
- To a public health agency, if the information relates to the manifestation of a disease or disorder that concerns a contagious disease that presents an imminent hazard of death or life-threatening illness, but only if the subject person is notified of the disclosure.

C) New York Wage Theft Prevention Act

As of April 2011, New York employers must comply with the recently enacted Wage Theft Prevention Act ("Act"). The Act requires New York employers to provide employees with notices of certain wage information, increases payroll recordkeeping requirements, increases penalties for violations, expands the Commissioner of Labor's ("Commissioner") enforcement authority and increases employee whistleblower protections.

New Notice Requirements

Upon the effective date of the Act, employers must provide each employee at the time of hire and on or before February 1st of each subsequent year of employment with a written notice that includes the following information:

- The rate or rates of pay and the basis of the rate;
- Whether paid by the hour, shift, day, week, salary, piece, commission or other method;
- Allowances, if any, claimed as part of the minimum wage, including tip, meal or lodging allowances;
- The regular pay day designated by the employer;
- The name of the employer;
- Any "doing business as" names used by the employer;
- The physical address of the employer's main office or principal place of business and the mailing address, if different;
- The telephone number of the employer; and
- Such other information as the Commissioner deems material and necessary.

The Act requires that the notice be provided in English and the language identified by the employee as his or her primary language at the time of hire. The Act also requires that each time an employer provides such a notice to an employee, the employer must obtain from the employee a signed and dated written acknowledgement of receipt in English and in the employee's identified primary language. The employee must affirm in the acknowledgment that he or she accurately identified his or her primary language to the employer and that he or she received a copy of the notice in his or her primary language. These acknowledgments must be maintained for six years. In the case of employees eligible for overtime, the notice must also state the employee's regular hourly rate and overtime rate of pay. The Commissioner will prepare and make available template notices for employers, including dual language notices. Employees must be notified of any change to the above-listed information at least seven days before the change is effective.

New Pay Statement and Recordkeeping Requirements

The Act also requires that every pay statement include the following information: (1) the dates of work covered by that payment of wages; (2) the name of the employee; (3) the name of the employer; (4) the address and phone number of the employer; (5) the rate or rates of pay and the basis thereof; (6) whether the employee is paid by the hour, shift, day, week, salary, piece, commission or other method; (7) gross wages; (8) allowances, if any, claimed as part of the minimum wage; and (9) net wages. If the employee is eligible for overtime, the statement must include the regular hourly rate or rates of pay, the overtime rate or rates of pay, the number of regular hours worked, and the number of overtime hours worked. If the employee is paid on a piece rate, the statement must include the applicable piece rate or rates of pay and the number of pieces completed at each piece rate. Employers must also maintain for six years contemporaneous, true and accurate payroll records of such information for each employee for each week worked. Also, upon an employee's request, the employer must furnish the employee with an explanation in writing of how his or her wages were computed.

Increased Penalties

Failure to provide the required notice within 10 business days of an employee's first day of employment subjects an employer to a civil action by the employee for damages of $50 for each work week for which the notice is not provided, up to a maximum of $2,500, together with court costs, attorneys' fees, and injunctive relief. Likewise, if an employee is not provided with the required wage information with each wage payment the employee may sue the employer for damages of $100 for each week that the violation occurred, up to a maximum of $2,500, together with court costs, attorneys' fees, and injunctive relief. The Commissioner may also bring a court or administrative action for such violations, and if he or she does so there is no cap on damages. In cases where an employer fails to pay wages both the employee and the Commissioner may bring either an administrative proceeding or court action to recover the unpaid wages, and the Act increases the amount of liquidated damages that may be recovered from 25 percent to 100 percent.

The Act also expands the type of employers subject to criminal liability for failing to pay wages to include partnerships and limited liability corporations. The Act also expands the persons subject to criminal liability for knowingly allowing an employer not to pay its employees' wages as required by law to include not only the officers and agents of a corporation, but also the officers and agents of any partnership or limited liability corporation.

Increased Enforcement Powers of the Commissioner

The Act increases the Commissioner's remedial powers in several respects. For example, where an employee has been retaliated against for exercising his or her rights under the wage laws, the Commissioner now has the authority not only to recover the employee's lost wages, but also to order reinstatement and award front pay, up to $10,000 in liquidated damages and all other "appropriate relief." The Act also empowers the Commissioner to require an employer who has violated the wage laws to post a notice summarizing the violations in an area visible to employees for up to one year. If the violation is willful, the Commissioner can require that such a notice be posted for up to 90 days in an area visible to the general public.

Increased Whistleblower Protections

The Act substantially strengthens employee whistleblower protections. Employers are now prohibited from retaliating against an employee not only for making a complaint to his or her employer or the Commissioner, but also for making a complaint to the Attorney General "or any other person." An employee need not have actually made a complaint to be protected from retaliation, as the Act makes it illegal for an employer to retaliate if the employer merely believes that an employee has made a complaint. The Act also makes clear that employees who make complaints are protected from retaliation even if the conduct they complain about does not violate the law, so long as the employee reasonably and in good faith believes that it violates the law.

D) New York Extends Employment Rights to Domestic Workers

As the result of amendments to the New York Labor Law, Executive Law and Workers' Compensation Law, New York has significantly expanded the rights of certain domestic workers, effective November 29, 2010. Under the amendments, a covered "domestic worker" is any "person employed in a home or residence for the purposes of caring for a child; serving as a companion for a sick, convalescing or elderly person; for housekeeping; or for any other domestic service purpose." However, "domestic worker" does not include any person working on a casual basis, any person employed by an employer or agency other than the family or household using his or her services, or relatives through blood, marriage or adoption who provide domestic services.

The amendments to the Executive Law make it unlawful to sexually harass a covered domestic worker or otherwise harass him or her because of gender, race, religion or national origin. The amendments to the Labor Law require that covered domestic workers must be paid overtime for hours worked over 40 in a work week, must be provided at least 24 hours of rest in each calendar week (the worker may agree to work on the day of rest but must receive overtime for doing so) and must be provided three days of paid leave per year after one year of employment. The amendments also extend unemployment benefits coverage to domestic workers. Likewise, the amendments to the Workers' Compensation Law extend workers' compensation benefits to covered domestic workers.

E) New York Extends Bereavement Leave Rights to Same-Sex Partners

As the result of the enactment of § 79-n of the New York Civil Rights Law, effective October 29, 2010, New York employers who provide bereavement leave for the death of an employee's spouse or the child, parent or other relative of the spouse, must provide the same leave to an employee for the death of the employee's same-sex committed partner or the child, parent or other relative of the same-sex committed partner. The new law does not require employers to provide bereavement leave to employees. However, if an employer provides bereavement leave to its employees for the death of a spouse or the child, parent or other relative of the spouse, then an employee's committed same-sex partner must be considered as the employee's spouse for purposes of such leave. The statute defines same-sex committed partners to be "those who are financially and emotionally interdependent in a manner commonly presumed of spouses."

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An Analysis of High Frequency Trading

By Manny Alicandro

Introduction

The events of May 6, 2010 changed the stock market forever. A mutual fund's routine effort to hedge against losses helped set off a chain of events that turned an orderly sell-off into a crash that erased $862 billion in U.S. equity value in less than 20 minutes as the Dow Jones Industrial Average lost almost 1,000 points.[1] At 2:32 p.m, a trader at the Overland Park, Kansas-based mutual fund, Waddell & Reed ("Waddell"), placed an order to sell 75,000 CME Group Inc.'s E-mini futures on the Standard & Poor's 500 Index contracts ("E-mini").[2] An execution algorithm automatically executed the trade. High-frequency trading ("HFT") firms, recognizing the order, began buying and selling the issue, increasing volume and putting downward pressure on the security while the institutional investor continued to sell the remainder of its contracts.[3] The security in question lost 3% of value in four minutes, leading to increased volatility and significant loss in the broader market.[4] As a result of the "flash crash," the Securities and Exchange Commission ("SEC"), Commodity Futures Trading Commission ("CFTC"), and exchanges have begun to address rules governing halting of trading and the obligation of market makers.[5] The SEC and CFTC have explored possible linkages between price declines in equity index futures, exchange-traded funds ("ETF"s) and individual securities and the "extent to which activity in one market may have led the others."[6]

The impact of HFT on the U.S. equity markets has received considerable attention in the wake of the financial crisis of 2008 and the so-called "flash-crash" of May 6, 2010. On October 10, 2010, *60 Minutes* ran a story on HFT titled, "How Speed Traders Are Changing Wall Street; Steve Kroft Gets a Rare Look Inside the Secretive World of High-Frequency Trading."[7] The story portrayed HFT firms as "using these supercomputers—which actually decide which stocks to buy and sell—…operating on highly secret instructions programmed into them by math wizards who may or may not know anything about the value of the companies that are being traded."[8] Just four years ago, HFT accounted for 30% of the stock trades in the United States.[9] Estimates vary, but Andy Nybo of Tabb Group ("Tabb") estimates that HFT strategies account for 61% of trading activity in U.S. equity markets.[10] The Chicago Mercantile Exchange ("CME") reported in the fourth quarter of 2009 that 43% of the trading volume on the Chicago Board of Trade ("CBOT") came from proprietary trading firms, primarily algorithmic, which probably means high frequency trading.[11] By any measure, HFT has become a significant component of financial markets.[12] About 25% of futures volume comes from automated trading companies that use their own money to rapidly buy and sell contracts, according to Aite Group, LLC ("Aite").[13] Aite estimated the level will rise to 40% by 2015.[14] Electronic trading on futures exchanges last year accounted for 81% of volume, up from about 9% in 2000, the CFTC said.[15] HFT firms already account for one-half to two-thirds of the average daily U.S. equity trading volume, based on estimates by Rosenblatt Securities and Tabb.[16] It is estimated that some of the biggest players trade more than a billion shares in equity securities a day.[17]

Some argue that HFT saved us from fiscal ruin in restoring the stability in the markets by absorbing volatility. Proponents also laud computerized trading for eliminating the suspicious transactions that often occurred in the past when humans were directly involved in trading.[18] There are many empirical analyses including those prepared by the Aite and RGM Advisors, LLC that present evidence showing that the U.S. equity markets appear to have become more efficient with tighter spreads, greater liquidity at the inside, and less mean reversion of mid-market quotes over the past several years; a period that has seen a sizable increase in the prevalence of HFT, and a period during which there has been coincident growth in automation and speed on many exchanges.[19] To the contrary, others claim that the trading patterns of HFT have caused extreme volatility in the market and thus are the root cause of the destabilization of the market.

The purpose of this article is to explore the rise of HFT in the market, and analyze the benefits and detriments of HFT. In addition, this article will formally assess the impact of HFT on the market and the future prospects of regulation. Part One will discuss the definition of high frequency trading, functionality and strategy employed. Part Two will discuss the background of the securities industry and market conditions that gave rise to the use of HFT. Part Three will discuss the inherent risks involved with HFT on the current markets. Part Four will address the regulatory response to such risks. Part Five will discuss the potential solutions to address industry concerns.

I. Definition and Functionality of HFT

Definition of High Frequency Trading

As stated by David Babulak, CEO of the HFT firm GETCO, "High-frequency trading is not an industry, it's not a strategy—it's a technique.[20] Our view is that we use HFT as a technique to help us to make markets.[21] It's just the natural evolution of how people have always made markets. It's applying the technology to it."[22] According to Andrei Kirilenko, Senior Financial Economist, CFTC Office of the Chief Economist, *On High Frequency Traders And Asset Prices*, "HFT typically refers to trading activity that employs extremely fast automated programs for creating, routing, canceling, modifying, and executing orders in electronic markets.[23] High frequency traders submit and cancel a massive number of orders and execute a large number of trades, trade in and out of positions very quickly, and end each trading day without a significant open position."[24] The CFTC Glossary defines HFT as, "computerized or algorithmic trading in which transactions are completed in very small fractions of a second."[25] There is no rule as to when, exactly, a trade lasts so long that it can't be counted as high frequency. In the SEC Concept Release on Market Structure, dated January 13, 2010, the SEC referred to HFT as one of the most significant market structure developments in recent years.[26] The term is relatively new and is not yet clearly defined.[27] It typically is used to refer to professional traders acting in a proprietary capacity that engage in strategies that generate a large number of trades on a daily basis. Characteristics often attributed to proprietary firms engaged in HFT are: (1) the use of extraordinarily high-speed and sophisticated computer programs for generating, routing, and executing orders; (2) use of co-location services and individual data feeds offered by exchanges and others to minimize network and other types of latencies; (3) very short time frames for establishing and liquidating positions; (4) the submission of numerous orders that are cancelled shortly after submission; and (5) ending the trading day in as close to a flat position as possible (that is, not carrying significant, unhedged positions overnight).[28] Nevertheless, the lack of a clear definition of HFT complicates the SEC's broader review of market structure issues and the ability to implement and enforce proper regulation.[29]

Quantitative Strategies of HFT

HFT can be considered both a technique to implement a trading strategy and an investment/trading strategy of its own.[30] HFT uses computerized quantitative processes to search for, and take advantage of, inefficiencies in pricing, often found in aberrations in the pricing relationship between two securities.[31] Algorithms attempt to trade both securities at prices that appear to be outside the normal pricing relationship prior to the convergence of the pricing of the stocks.[32] Thus, firms that utilize HFT are able to leverage their technology when responding to conditions and market data that change in milliseconds, and thus can identify opportunities faster than market competitors who do not.[33]

HFT strategies generally fit into one of the following general categories: automated market making (liquidity providing); order flow recognition (trading the tape); macroeconomic events (news, rumors); or deviation arbitrage (statistical).[34] Automated market making ("AMM") is a passive strategy in which high frequency traders place limit orders that are not immediately marketable, and thus act as providers of liquidity to the market.[35] On the other hand, filter trading involves monitoring securities for significant price movement or volume increases which may indicate news announcements or rumors and buy or sell accordingly until the momentum subsides.[36] Momentum trading seeks to identify short-term supply and demand imbalances and trade with the momentum until the balance is restored. Order anticipation is a momentum strategy which relies on spotting movement in the market or a security and taking liquidity ahead of other market participants.[37]

In addition, high frequency traders also use enhanced direct market access ("DMA") strategies and quantitative algorithms such as "iceberging" where a large order can be partially hidden from other market participants by specifying a maximum number of shares to be shown.[38] High-frequency traders use smart order routing where liquidity from many sources is aggregated and orders are sent out to the destination offering the best price or liquidity.[39] High-frequency traders also use market on close ("MOC") orders where an enhanced MOC strategy optimizes risk and impact, possibly starting trading before the closing auction.[40] "Guerrilla" algorithms are another type of algorithm used by high frequency traders that attempts to work an order with minimal price impact and signaling or information leakage.[41]

Most active HFT strategies currently operate in domestic equity markets, foreign exchange, and listed derivatives markets.[42] The futures market has also received attention from HFT firms because of its high liquidity, a supportive execution infrastructure, and relative fragmentation of liquidity.[43] HFT firms are most active in futures in energy, precious and base metals as these markets have deep liquidity and a large numbers of active participants, including investors, speculators, and commercial end-users.[44]

Although a factor in the options markets, HFT has seen a further surge in options trading as all of the options markets offer electronic trading.[45] There has even been an increase in HFT for foreign exchange as those markets also now trade electronically.[46]

II. Historical Conditions Giving Rise to HFT

In order to discuss the current state of electronic trading, it is important to explain the history that gave rise to the beginning of HFT. Industry conditions have constantly changed with the advent of electronic trading. Rather than individuals trading face to face on a floor, trading is now done via computer to computer. A primary driver and enabler of this transformation of equity trading has been the continual evolution of technologies for generating, routing, and executing orders by dramatically improving the speed, capacity, and sophistication of the trading functions available to market participants.[47] Further, there were fundamental regulatory events that have occurred since the 1990s that have not only forever changed the complexion of the market but changed how the markets trade. In 1996, the SEC adopted the Order

Handling Rule, as well, taking enforcement actions, such as those addressing anti-competitive behavior by market makers in NASDAQ stocks.[48] In 1998 the SEC adopted the Alternative Trading System ("ATS") Regulation ("Reg ATS"), enabling the creation of electronic communications networks (ECNs).[49] In 2001, decimalization was completed where the minimum price variation went from an eighth of a dollar to a penny.[50] Decimalization led not only to decreased bid-ask spreads but also to smaller displayed order sizes.[51] The SEC's adoption of Regulation NMS ("Reg NMS") in 2005 eliminated the trade-through protection for manual quotations and replaced the legacy intermarket trading system ("ITS") rules of how the market was linked.[52] Reg NMS greatly changed the national market system: with its focus on efficiency and its efforts to link markets, it supported the framework that allows HFT strategies to thrive.[53] In addition to a change in the regulatory framework, market conditions have paved the way for HFT to become a dominant feature in today's trading strategies. Specifically, pricing, flash orders, dark pools, algorithmic trading, proprietary trading, co-location, and sponsored access all have opened a window of opportunity for HFT to grow within the securities industry.

Incentives and Pricing—Maker/Taker Pricing

Among the major impacts on the growth of HFT, pricing has a large impact due to the competitive tiered make or take pricing on exchanges. Since the early 1990s, when the Island ECN first introduced rebate trading, the equity market has used a maker/taker model.[54] Nearly all exchanges and ECNs provide different tiers of pricing for different levels of liquidity providers. In the make or take pricing model, exchanges (and some alternative trading systems) charge an access fee for executing marketable orders that fill against (take) standing orders and provide a liquidity rebate for executed standing orders that make markets. Normally, the rebate is less than the take fee; tiered pricing rewards for the more orders one posts (adds) or takes (removes) since higher tiers offer the ability for increased charges or rebates.[55] This model has become the standard for all market centers. In general, pricing tiers make it more attractive to trade more and send over more orders.

Flash Orders

Flash orders, or "step up" orders, allow a venue to execute marketable orders in-house when that market is not at the national best bid or offer ("NBBO"), instead of routing those orders to rival markets.[56] This is accomplished by briefly displaying information about the order to the venue's participants and soliciting NBBO-priced responses.[57] If there are no responses, the order can be canceled or routed to the market with the best price.[58] The recipients of flashes can use the information they gain to trade in ways that hurt the customer whose order was flashed. On September 17, 2009, the SEC proposed a flash order ban.[59] The NASDAQ Stock Market ("NASDAQ") and BATS Exchange ("BATS") voluntarily ended flash orders on September 1, 2009.[60] At the present time, the SEC has yet to issue a formal order banning flash orders.

Dark Pools

The growth and popularity of dark pools has also led to the growth of HFT, and in turn, HFT firms routing to dark pools. Dark pools are essentially private trading systems in which participants can transact their trades without displaying quotations to the public.[61] Many dark pools disseminate indications of interest ("IOIs") to their subscribers when they have liquidity.[62] However, this practice is a growing concern among brokerage firms, in that the practice will be used to front run orders, a prohibited practice.[63] "The proliferation of high frequency trading firms in the last year has some Wall Street brokers worried that IOIs could be used to front-run their orders. They worry that dark pools backed by super-fast trading outfits could send IOIs to get a look at unfilled stock orders, choose not to act on them, and rush to trade against them before the orders are completed in another market."[64] Other dark pools permit "pinging," the ability of certain participants to view the orders before they are routed to the market.[65] Pinging involves blindly sending immediate-or-cancel orders ("IOCs") to dark pools and other hidden sources of liquidity in the hope of finding a match or drawing a response.[66] In October 2009, the SEC proposed that actionable IOIs be treated like quotations and be subjected to the same disclosure rules as those that apply to quotations.[67] The role of dark pools was also raised in the SEC Concept Release on Market Structure.[68]

Algorithms

HFT is a type of algorithmic trading, characterized by the speed and frequency of the order flow, used to generate trading signals and manage orders.[69] Computerized trading systems implement algorithms based on information available to them from trade and quotation feeds.[70] Many algorithmic strategies are based on substantial statistical analyses into how orders execute on average and in specific situations.[71]

Algorithms differ according to whether they offer or take liquidity, although many are capable of both. For example, some algorithms immediately take liquidity upon starting up. They then post limit orders to obtain better fill prices.[72] While posting liquidity, they may often cancel their orders to obscure their presence and thereby frustrate traders who would try to exploit information in their orders.[73]

Proprietary Trading

By providing very fast and inexpensive systems, today's electronic markets allow nontraditional dealers to offer liquidity using electronic proprietary trading systems. These traders use various HFT strategies to provide liquidity. They could act as dealers who commit capital to connect buyers to sellers who arrive at different times, or they could act as arbitrageurs who connect buyers in one market to sellers in another correlated market.[74]

Co-location and Proximity Hosting

Co-location ("co-lo") is a combination of hardware, power and telecommunication services that allows market participants to place their own electronic trading equipment in close physical proximity to the trading facilities of exchanges and other market centers to reduce message latency.[75] The CFTC Glossary defines co-lo as the placement of servers used by market participants in close physical proximity to an electronic trading facility's matching engine in order to facilitate HFT.[76] Communications latencies are due to time lost as messages travel at the speed of light and to delays caused by passing messages through routers.[77] To speed their communications, high frequency traders co-locate their servers as close as possible to the exchange servers that produce market information and collect orders.[78] Co-lo is no different than the traditional practice of locating brokerage firms close to the stock exchange to reduce the time and expense of filling an order. While it can be argued that certain traders have an advantage through co-lo, in the old floor days customers would complain about being at a disadvantage to locals. Locals and filling brokerage groups would literally wrestle for position in the pit.[79] The CFTC cited an unnamed venue that said 29% of its traders used co-lo, accounting for 68% of volume.[80] Another said 100 firms employed co-lo, which represented 39% of that venue's trading.[81] All of the major exchanges, including NASDAQ, NYSE Euronext ("NYSE"), Direct Edge ("EDGE"), BATS, NYSE Arca ("ARCA"), CME, and the Intercontinental Exchange ("ICE") offer co-lo services to their clients.[82]

Direct Market Access/Sponsored Access

DMA is a technological innovation that arrived on the scene as a way to speed up the execution of trades.[83] Fueled by traders' demands to adopt another cutting edge trading innovation, DMA shaves off inefficiencies from the traditional broker execution process.[84] DMA is a way to connect to the execution venue with little, if any, "touch" from broker-dealers. Direct access is not a trading strategy but instead is a computerized process to transmit trading and portfolio allocation decisions to an exchange or an ATS. Latency-sensitive traders that rely on direct access can play a vital role in the marketplace, bringing liquidity to the markets, reducing volatility, tightening bid-ask spreads, and contributing to price discovery.[85]

On November 3, 2010, the SEC unanimously approved new Rule 15c3-5, which requires broker-dealers ("BD"s) to adopt and implement risk controls to govern their provision of DMA and "sponsored access" to their customers.[86] In the case of sponsored access, the customer's order will bypass the BD's trading systems and flow directly to the trading center, sometimes with the assistance of a third-party technology provider. In the equities markets, while most exchanges require both BD registration and securities registration of the BD employees, such as the Series 7, some exchanges do not require Series 7 registration for employees that trade only on a proprietary basis. Rule 15c3-5 effectively prohibits the practice of providing customers with unfiltered, or "naked," access to an exchange or ATS.[87] Naked access is a subcategory of sponsored access that permits the customer to enter orders into a trading center without any pre-trade filters or controls.[88] The compliance date was July 14, 2011 for certain provisions of the rule, and is November 30, 2011 for other provisions of the rule.[89] On the futures markets, direct access firms either join the exchanges as non-clearing members ("NCM"s) or access the exchanges in the name of their clearing member.[90] NCMs are subject to exchange membership approval and as such are subject to exchange rules such as market manipulation, wash trades and message limit violations.[91]

III. Risks with HFT

According to Andrei Kirilenko in *The Flash Crash: The Impact of High Frequency Trading on an Electronic Market*, "…irrespective of technology, markets can become fragile when imbalances arise as a result of large traders seeking to buy or sell quantities larger than intermediaries are willing to temporarily hold, and simultaneously long-term suppliers of liquidity are not forthcoming even if significant price concessions are offered."[92] "The Findings Regarding the Market Events of May 6, 2010 Report of the Staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues" stated, "however, the interconnection among markets, the order and the method with which it was executed likely served as a catalyst for the reduction in liquidity and the 'erroneous' stock trades experienced seconds later."[93]

The risks that have been attributed to HFT include: pre-arranged trading, front running or trading against or ahead of customer orders, cross trading, facilitating money laundering, insider trading, painting the tape, and wash sales.[94] It is important to note that these risks are not specific or unique to HFT. Nonetheless, the events of May 6th did heighten the perception problems about automated markets and high frequency traders regarding the exacerbation of existing risk in the marketplace, including, among others, systemic risk, quoting manipulation, layering, algorithm matching, and cross market manipulation.[95]

Systemic Risk

High frequency traders and algorithms use the same type of information and strategies, but the speed with which they receive, analyze, and trade may present a systemic risk to the financial system.[96] In the SEC Concept Release on Market Structure, the SEC questioned whether the particular strategies and tools used by high frequency traders pose significant risks to the integrity of the current equity market structure.[97] For example, the SEC questioned whether the high speed and enormous message traffic of automated trading systems threatened the integrity of trading center operations.[98] The SEC also questioned whether many proprietary firms potentially could engage in similar or connected trading strategies that, if such strategies generated significant losses at the same time, might cause many proprietary firms to become financially distressed and lead to large fluctuations in market prices.[99] Even Delaware Senator Ted Kaufman and New York Senator Charles Schumer have warned that HFT could lead to market chaos and systemic risk.

Potential Manipulation "Quoting Practices"

One potential concern is that the HFT firm will not provide liquidity to the "natural" order flow in the stock when it is needed.[100] The HFT firm's quoting and order activity may have been designed to give the appearance of liquidity and/or to induce order flow.[101] The HFT firm may have potentially coordinated its activity, either through the use of different executing brokers or in conjunction with other market participants, to provide the misleading appearance of liquidity on the one hand, and to then provide liquidity at prices away from the market.[102] In spoofing, a trader gives the impression of putting in a buy or sell order it does not want to complete to drive down the stock's price.[103] For example, a firm is "entering orders into an electronic trading system, at prices which are higher than the previous bid or lower than the previous offer, and withdrawing them before they are executed, in order to give a misleading impression that there is demand for or supply of the qualifying investment at that price."[104]

Quote stuffing is where a Firm A enters an enormous number of bids and offers significantly outside the current bid-offer spread so that another competitor firm, Firm B, has to process, but Firm A can ignore the quotes since they were generated by Firm A.[105] In doing this Firm A gains valuable processing time. Effectively, quote stuffing is intended to jam up competing algorithmic traders. This strategy effectively generates a large volume of orders, algorithms are programmed to disregard those orders so that they can process normal market information, but at the same time, those who don't have that information are now processing an enormous amount of spurious information that does nothing but slow them down by possibly a few nanoseconds.[106]

Potential Manipulation "Layering"

Layering basically involves submitting a series of non-bona fide orders to create the appearance of market activity that conveys a false sense of buying or selling demand.[107] The intention is that other traders will pile in and eventually either raise or lower prices to make the trades much more advantageous to the firm submitting the non-bona fide orders. The non-bona fide orders are placed at incremental price levels, for varying share quantities, just outside the inside market. Layering is used to deceive algorithms that were designed to predict share price direction based upon historical patterns and depth of market available at varying price levels.[108]

Potential Manipulation "Algorithm Matching"

In algorithm matching, two apparent "market making" algorithms could trade with each other in approximately a dozen different securities. Both algorithms are operated by different firms with no apparent connection. Each algorithm enters thousands of buy and sell orders in the same securities on the same trade dates, in what appears to be a "market making" strategy geared to earn a small spread in the stocks traded.[109]

Cross Market Manipulation

In a potential cross market manipulation, an HFT firm enters orders to sell a selected security in the closing process on the security's primary listing exchange.[110] In the minutes leading up to the close of the regular market session, the HFT firm begins buying in the selected security on a market center less liquid than the security's primary listing exchange. The HFT firm's buy-side order and trading activity on the less liquid market center cause a price increase on the market center. The HFT firm buying activity continues on the less liquid market center through the close of the regular market session. As such, the closing process on the primary listing center is impacted by the increase. The HFT firm receives favorable execution of the sell order entered into the closing process on the primary listing market while taking on the minimal risk of buying on the less liquid market center.[111]

IV. Regulatory Action

In response to the widespread growth of HFT, and the inherent consequences of HFT strategies employed, regulators are addressing the question of whether high cancellation volumes—intentional or not—hurt some investors by distorting stock prices, and whether such action is a regulatory violation.[112] For example, the CFTC and the regulatory unit of the CME are presently probing whether a computer glitch at Infinium Capital Management ("Infinium") caused a sudden spike in oil prices in February, 2010.[113]

At Infinium, the trade in question involved a new program designed to profit from pricing relationships between an oil ETF and a widely traded crude-oil futures contract.[114] On February 3, 2010, four minutes before the end of the New York Mercantile Exchange ("NYMEX") floor trading, Infinium turned on an algorithm that was less than one day old. The algorithm unexpectedly sent 4,612 buy limit orders into the market without communicating any offsetting orders.[115] The algorithm overloaded its order router and was shut down within five seconds of being activated. Infinium offset its position through large block trades but realized a loss of $1.03 million.[116] According to the CFTC, this malfunctioning algorithm caused a $1 surge in oil prices. In subsequent trading, oil prices sank as investors worried that the high volume might be a sign of a distressed seller.[117]

Likewise, the Financial Industry Regulatory Authority, Inc. ("FINRA") recently fined a New York proprietary trading firm $1 million for market manipulation for "baiting high-frequency traders with high-volume stock orders."[118] Nine traders at Trillium Brokerage Services, LLC ("TRIL") sent more than 46,000 illegitimate orders to the market in 2006 and 2007.[119] The traders tried to make volume appear artificially high by entering large volumes of orders, which they intended to cancel, in an attempt to encourage favorable action by HFT firms.[120]

According to FINRA, TRIL traders knowingly and intentionally engaged in a repeated pattern of layering conduct to take advantage of trading, including algorithmic trading by other firms, when TRIL traders entered a buy (sell) limit order in a NASDAQ security through NASDAQ primarily at a price that was either at the NASDAQ Best Bid (Offer) ("NASDAQ BBO") or that improved the NASDAQ BBO and obtained a full or partial execution for that order through the entry of numerous layered, non-bona fide, market moving orders on the side of the market opposite the limit order.[121]

However, in addressing the concerns regarding HFT in the marketplace, the SEC and CFTC have encountered difficulty in sanctioning the practice through existing case law. Specifically, case law is not clear as to whether one can be liable for manipulation where the actor's conduct is entirely legal, but the actor's intent was manipulative. In *GFL Advantage Fund Ltd. v. Colkitt*, the Court of Appeals for the Third Circuit rejected the SEC's approach under SEC Rule 10b-5 and held that manipulative intent alone is not enough to make open-market transactions amount to illegal market manipulation.[122]

Conversely, in *Markowski v. SEC*, the Court of Appeals for the D.C. Circuit accepted the theory, upholding an SEC administrative order sustaining disciplinary action in an open-market manipulation case based on what it characterized as "Congress' determination that 'manipulation' can be illegal solely because of the actor's purpose."[123] The court noted that without fictitious transactions such as wash sales and matched orders, "[i]t may be hard to separate a 'manipulative' investor from one who is simply over-enthusiastic, a true believer [or disbeliever] in the object of the investment."[124]

In *SEC v. Masri*, the District Court for the Southern District of New York grappled with the unsettled issue of whether a series of otherwise legitimate "open market" stock transactions can be transformed into an illegal market manipulation scheme based solely on the trader's state of mind when the trades were executed.[125] Even though the SEC has long advocated the position that open-market transactions coupled with manipulative intent can give rise to liability under §10(b) of the '34 Act and SEC Rule 10b-5, the court found that for an open market manipulation claim to survive a motion to dismiss there must also be some specific allegation that the defendant "injected inaccurate information into the market or created a false impression of market activity."[126]

SEC Action

It is apparent from the case law discussed that the activity of HFT firms and the associated risks are extremely difficult to address under existing SEC rules. However, many of the risks attributed to HFT or the market as a whole are diminished by the fact that the SEC has recently adopted rules to address the market risks responsible for industry concern. In October 2009, the SEC approved new exchange rules for breaking stock trades that deviate so substantially from current market prices that they are considered "clearly erroneous."[127] The rules would for the first time provide a consistent standard across stock exchanges and reduce uncertainty about what happens to a trade depending on where it is executed.[128]

On April 14, 2010, the SEC proposed the creation of a large trader reporting system that would enhance its ability to identify large market participants, collect information on their trades, and analyze their trading activity.[129] The need for the SEC to consider monitoring these entities is heightened by the fact that large traders, including high frequency traders, appear to be playing an increasingly prominent role in the securities markets.[130] In addition, the SEC proposed a new rule in May, 2010 that would require the self-regulatory organizations ("SRO"s) to establish a consolidated audit trail ("CAT") system that would enable regulators to track information related to trading orders received and executed across the securities markets.[131] CAT would help regulators keep pace with new technology and trading patterns in the markets and deal with the lack of transparency.[132] Currently, there is no single database of comprehensive and readily accessible data regarding orders and executions.[133] NASDAQ, in June, 2010, adopted rules on a six-month pilot basis with the SEC to establish a trading pause for individual stocks in the S&P 500 Index that experience a price change of 10% or more during a rolling five-minute period for securities included in the Russell 1000 Index and select ETFs.[134]

The SEC has adopted amendments to Rule 201 of Regulation SHO with a compliance date of February 28, 2011.[135] Under Rule 201, the SEC is introducing a short sale-related circuit breaker that, when triggered, will impose a restriction on prices at which securities may be sold short.[136] In November, 2010, the SEC approved new rules proposed by NASDAQ, in concert with other U.S. equity markets, to enhance minimum market maker quotation obligations on NASDAQ.[137] These enhanced market maker quotation requirements are intended to eliminate trade executions against market maker placeholder quotations traditionally priced far away from the inside market, commonly known as "stub quotes."[138]

CFTC

On July 14, 2010, the CFTC Technology Advisory Committee ("TAC") met to address the necessity of applying appropriate risk management and best practices for high frequency and algorithmic trading.[139] The second meeting of TAC, entitled "Technology: Achieving the Statutory Goals and Regulatory Objectives of the Dodd-Frank Act" ("Dodd-Frank"), was held on October 12, 2010.[140] The TAC continued its discussion of computerized trade strategies and their role in the events of May 6, 2010 as they informed and guided regulatory reforms under Dodd-Frank.[141] The May 6, 2010 joint CFTC and SEC staff report was summarized, as well as discussion on new manipulation and anti-disruptive trading practices, in the Dodd-Frank rulemakings.[142] Further, on November 2, 2010, CFTC Commissioner Gary Gensler met with European Commissioner Michael Bamier to discuss the importance for regulators of taking into account technological developments in the markets and considering the effects of HFT.[143]

Disruptive Trading CFTC

The new Wall Street reform law gives the CFTC power to write regulations to prevent disruptive trading practices, CFTC Commissioner O'Malia has noted. "Whatever we do, the risks posed by high speed and algorithmic trading must be handled with great care because when things go wrong, five seconds can generate a lifetime's worth of trading, not to mention a toxic trail."[144] On October 26, 2010, the CFTC issued an advance notice of proposed rulemaking to implement Section 747 of the Dodd-Frank Act relating to so-called "disruptive trading practices."[145] That provision authorizes the CFTC to prohibit certain specified trading practices as follows: any activity which (i) violates bids or offers; (ii) demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period; or (iii) constitutes "spoofing" (bidding or offering with the intent to cancel the bid or offer before execution), as well as any other trading practice that is "disruptive of fair and equitable trading."[146] The prohibition on the disruptive practices specified in new section 4c(a) of the CEA by its terms was to become effective July 16, 2011.[147]

Prohibition of Market Manipulation

The CFTC is proposing rules to implement its enhanced authority to prohibit fraud and manipulation pursuant to Section 6(c) of the Commodity Exchange Act ("CEA"), as amended by Section 753 of Dodd-Frank.[148] Among other things, the CFTC is proposing to add: (i) a rule patterned after SEC Rule 10b-5, subject to modifications to reflect the CFTC's distinct mission and responsibilities (e.g., no SEC-type prohibition on insider trading), and (ii) a rule that would restate the expanded prohibition on manipulation and attempted manipulation, which now reaches "every effort to influence the price of a swap, commodity or commodity futures contract that is intended to interfere with the legitimate forces of supply and demand in the marketplace."[149]

For the first time, the CFTC would be able to police "fraud-based manipulation," with the authority to prosecute attempts to manipulate markets by misleading others, CFTC Chairman Gary Gensler has said.[150] "That fraud-based manipulation [may] broaden our arsenal of tools," and the proposal also gives the CFTC new "catch-all" anti-fraud powers that do not require it to prove intent, which lawyers said could be significant if applied in certain kinds of manipulation cases.[151]

Events of May 6, 2010

Nonetheless, the systemic risk to the market and the risk of manipulation of HFT remain a concern. In the 104-page "Findings Regarding the Market Events of May 6, 2010 Report of the Staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues," the SEC and CFTC stated that high frequency traders quickly magnified the impact of Waddell's selling.[152] Among other points, the report shows that six of the twelve HFT firms remained in the market as stocks began to crash.[153] However, those firms took "significant" buying power out of the market.[154] HFT firms began to quickly buy and resell contracts to each other, generating a "hot-potato" volume effect as the same positions were passed rapidly back and forth.[155]

The events of May 6 are a demonstration that HFT pulled out of the markets during the most volatile times. While proponents argue HFT creates liquidity, it is unwise to depend on individual firms that have no duty to be liquidity providers. High-frequency traders simply owe no fiduciary duty to anyone to create markets in stocks and thus should not be depended on for liquidity. As such, many algorithms are programmed for what is dubbed "opportunistic liquidity provisions."[156]

The fundamental question is why did HFT pull out of the market during the events of May 6? Executives at market data provider Nanex, LLC ("NANEX"), who have issued a series of statistical publications, have cast doubt on findings by the SEC and the CFTC that sales of futures contracts by Waddell started a chain of selling that bled into stocks and ETFs.[157] According to NANEX, some trading firms stated that they detected a problem with the accuracy of the data feed and decided to shut down, which further reduced liquidity.[158] An apparent delay in NYSE quotes is considered as having been the root of this matter. Apparently, when the NYSE gets deluged, its quote feed to the Consolidated Quote System ("CQS"), which is used as part of the NBBO system, gets delayed.[159] At one point on May 6, somebody launched 5,000 quotes at the NYSE for the ticker of Public Storage ("PSA") inside of just one second.[160] None of those quotes led to a trade, but that traffic by itself took the NYSE to 25% of its stable CQS capacity.[161] High frequency traders' algorithms saw the quote disparity between CQS, the NYSE open book and the rest of the market.[162] This raises the question of whether a firm was intentionally flooding the system with quotes and introducing added latency in the CQS feed.

Interestingly, on November 5, 2010, the SEC stated that it had not found evidence that traders tried to profit during the May 6 stock market crash by overwhelming exchanges with orders.[163] There is no indication thus far that "one or more parties flooded the market with quotes" to cause delays in exchange feeds that list stock prices.[164] The SEC comments were at odds with speculation by NANEX that HFT destabilized NYSE trading by submitting and then canceling thousands of rapid-fire orders.

The CME also released its own report on "What Happened on May 6?"[165] The study looked into the trading pattern of E-mini contracts and found the decline and the rise of the E-mini was "orderly," in contrast to the wild swings in "spot" prices of certain equities, such as Procter & Gamble ("PG"), Accenture ("ACN"), and 3M ("MMM").[166] The CME attributes its success to the price protection measures it has in place. The CME Globex ("Globex") electronic trading platform deploys various measures designed to preclude "run-away" markets not driven by the fundamentals of the situation.[167] These measures include order quantity restrictions, price banding, stop price logic functionality, market and stop order protection points, and message traffic throttling.[168]

V. Potential Solutions for HFT-Related Concerns

Although there is no one solution to address all of the potential HFT concerns, a holistic approach should be taken by both the SEC and CFTC to mitigate some of the risks posed to the market by HFT. Both the SEC and CFTC could require that each of the self-regulatory organizations ("SROs") and exchanges/market centers under their respective jurisdiction implement protective measures based not only on what the CME has structured but also on the recommendations made by the Futures Industry Association ("FIA") Market Access Working Group in the Market Access Risk Management Recommendations.[169]

Standardized Risk Management

To reduce the inevitable errors that occur with manual data entry, such as "fat-fingering" errors, exchanges should work towards providing a standard communication protocol that would allow firms to automate setting and updating risk parameters for individual trading entities.[170] This would also give clearing firm risk managers the ability to more efficiently disable a client from multiple exchanges simultaneously. The exchange should establish a policy as to whether the default setting for all market participants should be to maintain or cancel all working orders.[171] Further, exchanges should provide clearing firms with the ability to kill all open orders by deleting all open orders and quotes and rejecting entry of new orders and quotes.[172]

Limit Up/Limit Down

The CME presently has in place price banding that is a system functionality which prevents a trader from entering a buy order that is more than 12 points above, or a sell order that is more than 12 points below, the last transacted price (or any better bid or offer) in E-mini contracts.[173] The levels of these price bands vary on a market-by-market basis. The Globex system rejects orders entered at prices outside this protective band. Similarly, the SEC should consider requiring exchanges to institute limit up/limit down procedures that would directly prevent trades outside specified parameters. Uniform, industry-wide rules establishing limits on upward and downward price movements should replace the NYSE liquidity replenishment points ("LRP") and the proposed NASDAQ Volatility Guard ("Vol Guard").

Throttling and Quote Stuffing

Throttling can add latency if the throttling system is forced to occasionally reduce the volume of data sent, requiring some data to be re-transmitted.[174] Many exchanges have throttling systems in place that detect and prevent order message traffic exceeding acceptable levels. Further, the CME maintains automated controls on the volume of message traffic for individual connections to Globex.[175] This functionality can throttle back message volumes such that the number of messages per second falls below a pre-specified threshold. Under the messaging policy, member firms must not exceed product-specific benchmarks tailored to the valid trading strategies of each market. The CME calculates benchmarks based on a per-product volume ratio. If a clearing member firm exceeds a benchmark, it will be issued a warning notice within a rolling thirty-business-day period and subsequently a $2,000 surcharge, per product, per session, per clearing member firm when a benchmark is exceeded.[176] In addition, quote stuffing should be banned as it is a manipulative device designed to overload the quotation system. Quote and trade dissemination is a finite resource, and should be treated as such. Alternatively, exchanges could charge firms for excessive quote cancellation fees. If firms exceed a specified ratio of cancellations to executions, they should pay a fee. This quote cancellation fee would apply to all trading platforms, including dark pools and ATSs. This is an extremely disturbing development, because as more HFT systems start doing this, it is only a matter of time before quote stuffing shuts down the entire market from congestion.

Spoofing and Layering

Regulators must better define manipulative activity and provide clear guidance for traders to follow, just as

Britain's regulators have done in the area of spoofing and layering. In the August, 2009 Market Watch Newsletter, the Financial Services Authority ("FSA") stated it will fine or suspend market operators involved in manipulation practices known as "spoofing" and "layering."[177] Spoofing and layering involve putting apparent trades on share order books to create a misleading impression about the stock price or liquidity. They both constitute potential market abuse, an LSE spokesman told Reuters.[178] By providing "rules of the road," regulators can create a system better able to prevent and prosecute manipulative activity.

Co-location

The SEC has stated in the Concept Release on Market Structure that it believes that the co-lo services offered by registered exchanges are subject to the '34 Act and that exchanges that intend to offer co-lo services must file proposed rule changes and receive approval of such rule changes in advance of offering the services to customers.[179] In addition, the terms of co-lo services must not be unfairly discriminatory, and the fees must be equitably allocated and reasonable.[180] Moreover, the SEC has raised questions about the fairness of co-lo and whether the market participants that obtain co-lo services should be subject to any affirmative or negative obligations with respect to their trading behavior.[181] On June 11, 2010, the CFTC proposed rules calling for exchanges to offer equal access to co-lo facilities and to disclose latency numbers from those facilities, and that also require that there be uniform fees for co-lo and that exchanges have agreements in place with third-party service providers to carry out self-regulatory obligations.[182] Presently, if you get there first you are closest to the exchange server. There should no longer be first-come first-served, however: one possible solution is that every firm should be placed at an equal distance from the exchange server. Overall, regulators should be cautious when dealing with co-lo, for if the practice of co-lo were banned, traders would merely seek to locate their servers in the closest piece of real estate to the exchange data centers with far less potential regulatory oversight than is possible within the exchange data centers.

Maker/Taker Pricing

James Angel of Georgetown University in Washington, Lawrence Harris of the University of Southern California in Los Angeles and Chester Spatt of Carnegie Mellon University in Pittsburgh, in their paper, *Equity Trading in the 21st Century,* explained that "Make-or-take pricing has significantly distorted trading."[183] No one in the trading community questions the maker/taker model as it has become a longstanding industry practice. The possible solution for maker-taker pricing is that the exchanges either charge a flat fee for all you can trade or charge on a per-share or contract basis and while tiers are removed. Further, exchanges should not be permitted to have inverted pricing.

Proprietary Data Feeds

The proprietary quote feeds of the exchanges provide an information advantage that high frequency traders are able to act upon, according to Joe Saluzzi of Themis Trading.[184] High-frequency traders use cutting edge technology combined with purchases of raw data feeds from these market centers, to create their own inside the NBBO quote and depth of book substantially earlier than what is publicly available from the Security Information Processor ("SIP") quote.[185] This latency arbitrage has become one of the fastest growing strategies for HFT firms. Accordingly, high frequency traders are able to re-engineer the quote by employing technologies such as feed handlers to further speed the receiving of data from the exchanges. As a result, high frequency traders know with near certainty what the market will be microseconds ahead of everybody else—valuable knowledge that high frequency traders take advantage of when they trade thousands of stocks, thousands of times, every trading day.

The SEC is concerned about a two-tiered market and has raised this question in the Concept Release on Market Structure. High-frequency traders and market professionals have an unfair advantage as they have access to market data in the form of proprietary data feeds before everyone else.[186] A potential solution to this issue is that everyone get access to the same proprietary feeds. Alternatively, the CQS feeds for NYSE and American Stock Exchange ("AMEX") stocks and the SIP for NASDAQ Stocks could be speeded up so that everyone would see the same quote and market data at the same time. It is apparent that the only reason that proprietary feeds are popular is because the proprietary feeds are faster than CQS and the SIP.

Ban Flash Orders

Flash orders are an attempt to end-run SEC Regulation NMS Rule 611, which states that exchanges must route orders to another exchange when that exchange is offering a better price.[187] If an exchange allows flash orders, it displays the order for 500 milliseconds before routing it elsewhere, which means that for a twentieth of a second, certain traders have a monopoly on trading information.[188] The banning of flash orders removes this information advantage.

Algorithm Testing

Both the SEC and the CFTC should ensure that the algorithm used by HFT firms does not disadvantage other customers, market participants, or result in violative conduct. There should be a regulatory requirement for HFT firms to conduct periodic testing to verify that the algorithm works as intended, including document testing of any changes that are being made to the algorithm and the reason for the update.

Conclusion

Both the CFTC and the SEC are looking for ways to mitigate overall risks in the market so that another May 6 flash crash doesn't occur, and they are intensely focusing in on HFT. Both agencies are looking at whether to go further and ban more acts that can roil markets, including practices used by HFT. Both have stopped short of immediately proposing new rules specifically aimed at algorithmic trading and HFT. It appears that both agencies are slowly leading up to directly prohibiting and making some of the potential HFT practices described above per se violative of regulatory rules. Unless and until both agencies can define what HFT is and expressly statutorily prohibit certain actions of HFT, the risks that high frequency traders place on the market will remain.

Some in the industry, including NANEX, have proposed to slow down the market and create an expiration period for quotes. This is not a good idea as it will only cause more potential latency issues as the amount of time that should be used for this expiration period is purely arbitrary. There is no way to determine if this expiration period of, for example, 50 milliseconds is the correct time or whether it alternatively should be 75 milliseconds or 25 milliseconds. Further, this time period would be impossible for the regulators to enforce; because there are so many market centers, exchanges, ATSs and BDs, undoubtedly latencies will continue to exist. In addition, there will be clock drift and everyone could potentially have slightly different time clocks on their trading systems. Accordingly, this would bring us back to the trade-through days of ITS and undo all of the tremendous benefits that the market has experienced due to Regulation NMS. The advances in technology with regard to speed which impact the amount of orders that HFT submit to exchanges and market centers will continue to challenge the backbone of the overall market infrastructure until both agencies effectively and efficiently use regulation as a means of successfully mitigating these risks. The fundamental consideration for the agencies is that all of the markets remain fair, orderly and competitive.

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Manny Alicandro is a candidate for the LLM degree in Financial Services Law at New York Law School.

Report of the Chair

In common with their clients and colleagues in the Bar, the members of the Business Law Section are increasingly reliant on web interaction. Accordingly, at the January 2011 meeting of the Section Executive Committee, I appointed the Website Subcommittee to consider how the Section website could be made more useful to the members. I thank the members of the Subcommittee for their well-reasoned and practical recommendations, as presented in their report to the Section's Executive Committee (reproduced at the end of the Committee Reports). The Report was adopted and approved by motion at a recent meeting of the Executive Committee. The website enhancements are in various stages of being implemented by the Bar web master. We look for feedback from our Section members on these enhancements, as each comes on-line.

—Paul H. Silverman
Chair of the Business Law Section

Banking Law Committee

The Banking Law Committee has continued to pursue an active agenda in 2011, broadened by the newly consummated merger with the former Consumer Finance Committee. At the Committee's January meeting, held in conjunction with NYSBA's Annual Meeting, the program included Mr. Randy Henrick, Associate General Counsel of DealerTrak, Inc., who reported on the final rules issued jointly by the Federal Reserve Board and the Federal Trade Commission to implement, effective January 1, 2011, the risk-based pricing provisions of the Fair and Accurate Credit Transactions Act of 2003 (FACT Act), which amended the Fair Credit Reporting Act (FCRA). The purpose of the rule is to require notice to consumers when they are offered or provided credit on terms that are materially less favorable than those available to a substantial proportion of consumers from that creditor, based in whole or in part on a credit report obtained for that consumer. The agencies issued the rules to clarify that the risk-based pricing notice requirements apply only in connection with credit that is primarily for personal, household, or family purposes—not credit extended for business purposes. The final rules provide two alternative methods for determining which consumers must receive risk-based pricing notices for those creditors that prefer not to compare directly the material terms offered to their consumers:

1) the credit score proxy method. A credit score is a numerical representation of a consumer's credit risk based on information in the consumer's credit file. The final rules permit a creditor that uses credit scores to set the material terms of credit to determine a cutoff score, representing the point at which approximately 40 percent of its consumers have higher credit scores and 60 percent of its consumers have lower credit scores, and provide a risk-based pricing notice to each consumer who has a credit score lower than the cutoff score. When credit has been granted, extended, or provided on the most favorable material terms to more than 40 percent of consumers, the creditor may set its cutoff score at a point at which the approximate percentage of consumers who historically have been granted, extended, or provided credit on material terms other than the most favorable terms would receive risk-based pricing notices. The cutoff score must be updated once every two years.

2) the tiered pricing method. Under this method, a creditor that sets the material terms of credit by assigning each consumer to one of a discrete number of pricing tiers, based in whole or in part on a consumer report, may use this method and provide a risk-based pricing notice to each consumer who is not assigned to the top pricing tier or tiers.

The final rules also include certain exceptions, including one for creditors that provide a consumer with a disclosure of the consumer's credit score in conjunction with additional information that provides context for the credit score disclosure.

Mr. Henrick also reviewed the changes to FTC "Red Flags Rules" that require that each "financial institution" or "creditor" that offers or maintains one or more "covered accounts" to develop and implement a written Identity Theft Prevention Program that is designed to detect, prevent, and mitigate identity theft in connection with the opening of a covered account or any existing covered account. The changes enabled the FTC to begin full-fledged enforcement of the rules on January 1, 2011.

With echoes of its previous ill-considered treatment of lawyers as "financial institutions" required to send consumer privacy notices to their clients—a position defeated in court in a lawsuit brought by the NYSBA—the FTC has been seeking to apply the Red Flags Rule to lawyers as well. The Congress has overridden this effort in the Red Flag Program Clarification Act ("RFPCA"), which narrows the term "creditor" to one who regularly and in the ordinary course of business:

- obtains or uses consumer reports in connection with credit transactions;
- furnishes information to a consumer reporting agency (CRA) in connection with a credit transaction; or
- advances funds to or on behalf of a person based on that person's obligation to repay the funds or repayable from specific property pledged by or on behalf of the person.

The third category does not include a creditor that advances funds on behalf of a person that are incidental to a service provided by the creditor to the person. The exclusion for an entity that "advances funds on behalf of a person that are incidental to a service provided by the creditor to the person" is meant to exempt professional service providers such as lawyers, doctors, and dentists. At the same time, the RFPCA also allows the FTC and the banking agencies to include, by regulation, any other entity that is a "creditor" under the Equal Credit Opportunity Act that the FTC determines to offer or maintain accounts that are subject to a reasonably foreseeable risk of identity theft. This creates a potential tension between provisions in the RFPCA, as the FTC, by regulation, could arguably include entities that would otherwise be excluded by the RFPCA. Because this would have to be done through the rulemaking process, there would presumably be at least one public comment period during which the public could express support for, or object to, the coverage of any entity as a creditor.

The Chair then led a discussion of the legal impediments to investing in a bank or thrift institution by a non-banking investor (e.g., a private equity or sovereign wealth fund) and the Federal Reserve Board's and FDIC's efforts to facilitate such investments, based upon his article "So You Think You Want to Buy a Bank?" (which appeared in the Winter 2010 issue of the *NY Business Law Journal*). Although the number of problem banks on the FDIC's "watch list" has reached the highest level in more than 20 years, the results of the FRB's and FDIC's efforts to encourage non-bank investments in banks have been less than they might have been because of the thicket of regulation that surrounds any entity that would presume to own or invest in a bank and the uncertain legislative climate. While private equity firms seek a controlling position in undervalued companies, then "fix them, grow them, and sell them," usually in a period of three to five years, bank regulatory laws place severe restrictions on entities that control banks that may make this difficult or impossible to achieve.

During the Spring, at the request of NYSBA President Stephen Younger, the Committee actively debated whether the NYSBA should take a position regarding Governor Cuomo's proposal, as part of his budget bill, to combine the State Banking and Insurance Departments and the Consumer Protection Board. The Committee members expressed some concerns about the breadth and scope of the new Department's authority, particularly with respect to the expansive definitions of financial fraud and financial products and services. However, subsequent amendments alleviated those concerns, by eliminating from the definition of financial fraud, among other things, Martin Act (securities law) violations and criminal activity. The definition of financial products has also been narrowed to appropriately encompass only the banking law and insurance law, rather than an array of undefined "other laws." Further amendment assured that the safety and soundness of financial institutions would be a clearly articulated policy goal of the Department, along with consumer protection, and that assessments on insurance companies and financial institutions would be structured to ensure that no insurance company expenses are assessed against banks, and vice versa.

—David L. Glass, Chair

Bankruptcy Law Committee

The Bankruptcy Law Committee met in January at NYSBA's Annual Meeting in New York City, where we discussed the types of issues that the Committee would like to see addressed during the coming year. At the Committee's meeting in conjunction with the Section's spring meeting, there was a presentation on "Asset Identification and Asset Protection: Counseling Clients in Distress." Kenneth Rubinstein, a well-known asset protection lawyer, reviewed pre-bankruptcy and pre-litigation techniques, and Philip Segal, an asset investigator, discussed some of the tools available for finding assets.

The Committee has also collaborated with the NYSBA CLE Department to present a Basics of Bankruptcy Practice course scheduled to be held throughout New York State in June. We plan to sponsor a CLE program at the Section's fall meeting that is commercial in nature.

We always welcome new members to join the Committee! For more information about the Bankruptcy Law Committee or to join, please visit www.nysba.org/business.

—Norma Ortiz, Chair

Franchise, Distribution and Licensing Law Committee

The Franchise, Distribution and Licensing Law Committee has been very active. It 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. The last Committee meeting was held in January and featured a presentation by Christine Harris and Edith Wiseman of Frandata. Ms. Harris spoke to the Committee members about the 2011 changes to the SBA Franchise Registry Guidelines and Procedures and Ms. Wiseman discussed Frandata's October 2010 Economic Forecast for Franchising in 2011 and beyond. Approximately 20 Committee members attended the meeting. The Committee is planning an "Introduction to Franchising" CLE Program for the Fall.

—David W. Oppenheim, Chair

Securities Regulation Committee

The Securities Regulation Committee has continued its monthly meeting programs addressing a wide range of matters of importance to securities law practitioners. Our dinner meetings tend to foster lively discussions, and afford Committee members an opportunity to discuss "hot topics" with persons closely associated with them. Since our last Committee report in Summer 2010, among the topics discussed at meetings were:

1. Corporate Governance and Risk
2. Fairness Opinions—Recent Cases and Other Developments
3. Financial Reform Legislation—an Insider's View
4. Current Issues in Executing Capital Markets Transactions
5. FINRA Regulatory Notice 10-22: Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings, plus other developments
6. Reverse Mergers
7. Dodd Frank Act: (A) Investment Adviser registration and other provisions affecting Hedge Funds and Private Equity plus (B) the Corporate Governance & Executive Compensation provisions
8. Dodd-Frank Act: Derivatives provisions (that even non-derivatives lawyers need to know)
9. After the Subprime Crisis: A New Era of Financial Reporting
10. "Proxy Access"
11. Recent 2nd Circuit decision involving SOXA 304 (clawback) and indemnification rights of the CEO and CFO
12. "Proxy Plumbing" & the SEC Concept Release
13. Hedge Fund Compliance: How to Avoid A Mess/ FCPA Developments: Bribery and Corruption
14. Trends in Financial Statement Fraud/Current Issues at the PCAOB
15. Professional Responsibility and the General Counsel
16. SEC proposal on Investment Adviser Registration
17. SEC proposal on Whistleblower provision in the Dodd-Frank Act
18. Activist Investors and Activist Investing
19. Information Security in the Practice of Law
20. 2010 Securities Enforcement Update and 2011 Outlook
21. M & A Disclosure Matters and Other SEC Considerations
22. Recent "Poison Pill" Developments
23. New Lobbyist Regulations' Impact on Investment Managers, Private Investment Funds, Placement Agents and Others
24. Dodd-Frank Act update and other developments for public companies

In addition, the Private Investment Funds Subcommittee was formed. Its mission is to closely track developments and emerging trends in the private investment funds industry. The subcommittee will monitor the adoption of new rules and regulations and pending proposals for reform. It will also monitor the emergence of new industry standards and best practices in respect of fund formation and operations. The subcommittee expects to meet on a quarterly basis. Participants will include law-firm and in-house practitioners representing both hedge fund and private equity/VC fund managers and investors. The subcommittee's successful inaugural meeting was held on March 10, 2011, and had a presentation on "Recent Insider Trading Cases and Enforcement Activities."

The Committee also submitted comment letters to regulatory authorities on a variety of proposed rules (some of which implement the Dodd-Frank Act):

- SEC: Disclosure Related to "Conflict Minerals"
- SEC: Disclosure of Mine Safety Information
- SEC: Disclosure by Resource Extraction Issuers

- SEC: (i) Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers and (ii) Rules Implementing Amendments to the Investment Advisers Act of 1940
- FINRA: amendments to FINRA Rule 5122 to Address Member Firm Participation in Private Placements
- CFTC: Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations

—Howard Dicker, Chair

MEMORANDUM

TO: Members of the New York State Bar Association Business Law Section Executive Committee

FROM: Members of the Business Section Web Site Enhancement Subcommittee (David W. Oppenheim (Chair–Website Subcommittee and Franchise Law Committee), Samuel F. Abernethy (Executive Committee Liaison), Laurie Bigman (Banking Law Committee), Howard Dicker (Chair—Securities Regulation Committee), Matthew Kaplan (Chair—Insurance Law Committee))

SUBJECT: Preliminary Recommendations Concerning Enhancement of the NYSBA Business Law Section Website and Use of Social Media

DATE: March 10, 2011

Introduction

The Section Web Site Enhancement Subcommittee (the "Subcommittee") was formed on January 26, 2011 at the request of Paul H. Silverman, Chair of the NYSBA Business Law Section (the "Section") and with the approval of the members of the Section's Executive Committee. The members of the Subcommittee undertook a comprehensive review of the Section's website and then met on two occasions to discuss areas where improvement in the Section's website and use of social media could be achieved.

Committee Findings and Recommended Enhancements

The Subcommittee recommends the following changes and action items concerning the Section's website and use of social media:

1. **Links to Resources which can assist attorneys in their practice areas.** Each Committee Chair shall be responsible for updating the list of links that appear on each Committee's home page. Going forward, a Section Staff member should be responsible for ensuring that the links are updated periodically.

   (Basis for Recommended Change—Based on its review, the Subcommittee concluded that the "links" that are currently provided on each Committee page are outdated and in need of updating.)

2. **Consistency among Committee Home Pages.** Each Committee Home Page shall be updated and at a minimum should contain the following subpages: "Recent Committee Activity"; "Committee Roster"; "Links of Interest" and "Join this Committee." Going forward, a Section Staff member should be responsible for ensuring that the pages are updated periodically.

   (Basis for Recommended Change—Based on its review, the Subcommittee concluded that there is no consistency among the committee pages. Some pages contain several links to other sites or a link to a Committee Membership page while others do not. Many Committee pages are outdated. The Subcommittee further concluded that the website will be increasingly important to the Association and Sections and as a result it will be necessary for NYSBA to designate staff in Albany to be responsible for ensuring that content is updated regularly.)

3. **Links from the Section Homepage directly to the helpful links on each Committee's homepage.** The Section homepage should be revised to provide for a direct link on the Section homepage directly to the links that appear on each Committee's homepage.

   (Basis for Recommended Change—This change will enable visitors to easily access practice-specific and helpful links without first having to navigate to each Committee page.)

4. **Re-design of the Section Homepage.** The Section shall work with the website programmers retained by the Section to redesign the homepage to make better use of wasted space and to change the font for topic headings to make the page easier to read and navigate. The Section shall also recommend that the New York State Bar homepage be redesigned to make better use of available space.

   (Basis for Recommended Change—The Subcommittee observed that there is a lot of wasted space on the Section homepage, including 1-inch borders on each side of the page. The Subcommittee also observed that the font is basically the same on the homepage and as a result, the topic headings do not stand out (See e.g., “Upcoming Events” and “Announcements” links. With regard to the New York State Bar homepage, the Subcommittee observed that the entire right hand side of the home page consists of a picture. The Subcommittee believes that the Bar can make better use of this space.)

5. **User Preferences.** The Section shall work with the website programmers to determine whether the “User Preferences” option can be modified to make it easier for members to update their preferences.

   (Basis for Recommended Change—As traffic increases and more members rely on the site, members need to be able to tailor the site for each of their individual needs. Some members may want to receive every e-mail from the Section while others may only want to receive e-mails relating to Annual Meetings or CLE programs. The Subcommittee believes that the Section site can be revised to make it easier to update user preferences.)

6. **Social Media.** The Section shall work with the website programmers and the New York State Bar to explore the possibility of creating a Section Facebook page and possibly a Twitter account. If a separate Facebook page or Twitter account is established, the Section shall work with the New York State Bar to continuously monitor the sites to ensure that third party comments and other content are consistent with New York State Bar and Section standards.

   (Basis for Recommended Change—The Subcommittee observed that the New York State Bar maintains a Facebook Page with 747 followers. The page includes news updates which appear on the Facebook page automatically each time the New York State Bar homepage is updated to include current news and events. The Subcommittee believes that in the future social media will be an effective way to communicate with Section members.)

7. **ADA Compliance.** The Section shall confirm that the current and the suggested revisions comply with the standards of the Americans with Disabilities Act of 1990 and its standards for accessible website design.

   (Basis for Recommended Change—The Subcommittee noted that this is a heavily regulated area and in light of the proposed changes to the site, it would be prudent to confirm that the site is ADA-compliant.)

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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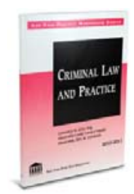

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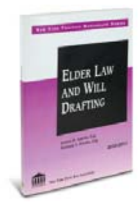

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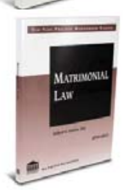

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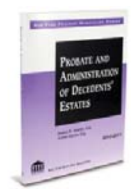

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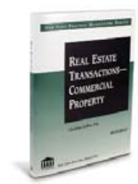

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